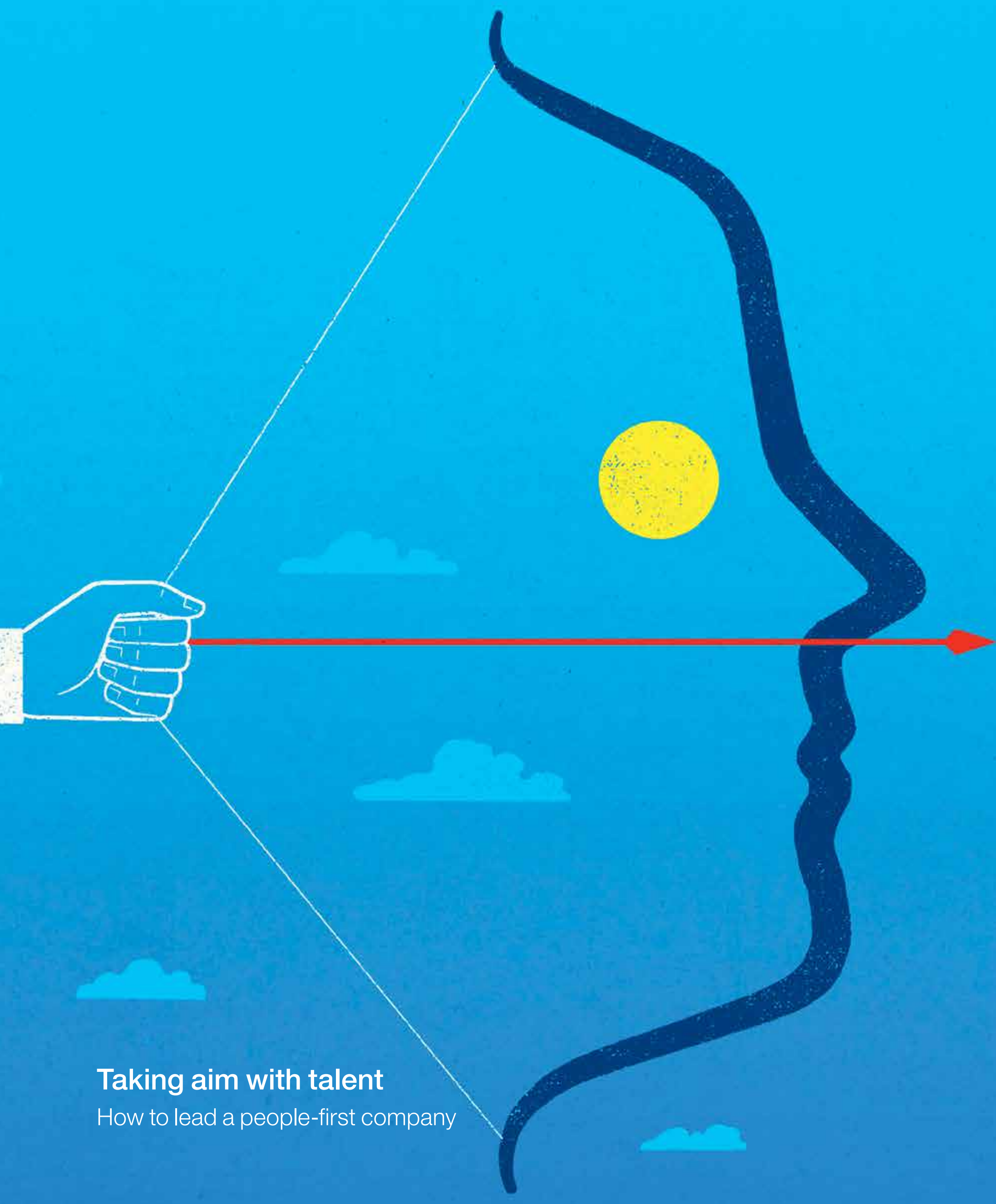
2018 Number 2

McKinsey Quarterly



Taking aim with talent

How to lead a people-first company

McKinsey&Company

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THIS QUARTER

This issue of *McKinsey Quarterly* will be the last published during my tenure as McKinsey's global managing partner. Over the nine years I have been in this role, I have been privileged to meet with more than 2,000 CEOs and senior government and social-sector leaders around the world. I always ask the leaders I meet two questions: First, what advice would you want to give to your younger self? Second, what are the top two or three issues on your mind now? The articles in this issue of the *Quarterly* tackle two of the most common topics I hear in response to these questions: talent and leadership.

Nearly every leader says talent is his or her company's top priority, but what does it mean to be a talent-first CEO? A few years ago, I began collaborating with two thought leaders who have also wrestled with that question: Ram Charan, who counsels many CEOs and boards and who has written on a wide range of business topics; and Dennis Carey, the vice chairman of Korn Ferry. This issue's cover story, "An agenda for the talent-first CEO," distills some of the core insights from this work. In the article and in our new book, *Talent Wins*, we argue that putting people first needs to be much more than a slogan. Leaders who want to make talent a competitive advantage need to manage their human-capital allocation with as much rigor and focus as their financial-capital allocation—which requires an elevated role for the chief human-resources officer, who must work closely with the CEO and CFO in what we call a "G3." This is one of a number of topics—including identifying the "critical 2 percent" that drive most of the value of the company—that we explore in this article.

Our second theme is leadership—more specifically, the demands placed on leaders in an increasingly complex world. Today's top executives arguably face greater cognitive and emotional stress than they might have in previous generations. In "Leading with inner agility," my colleague Johanne Lavoie and her coauthors have created a handbook for leaders seeking to become more mindful and more in touch with their own complexity. Johanne and her coauthors offer some practical suggestions and examples, such as the CEO who, newly unencumbered by the need to provide a quick answer to every question, learns to become a deeper listener, thereby stimulating the empowerment and creativity of her colleagues. I hope you will find these practices intriguing and useful.

Digitization and the growing importance of data and analytics are of course on every leader's agenda—and also offer fresh solutions to perennial talent and leadership problems. New digital tools can help link top talent with the company's most valuable strategic opportunities and can support improved real-time performance-management systems to replace outmoded and bureaucratic year-end performance-review processes. You can read about these approaches in two other articles in this issue, "Linking talent to value" and "The fairness factor in performance management." And don't miss "Will artificial intelligence make you a better leader?," a case study of a leader who applied AI to help resolve an ambiguous leadership challenge—and in the process became not only more effective but also more sanguine during a difficult time.

Finally, I am excited to announce a new digital service reserved for McKinsey clients and for our firm members, one aimed at helping readers consume *Quarterly* content when on the move. In some sense, the *Quarterly* has always been a "mobile" publication; its distinctively slim profile slips easily into a carry-on bag for a flight or long commute. That said, we recognize that there are other mobile platforms—specifically, phones and tablets—where our readers frequently consume content. The new *McKinsey Quarterly Pocket Edition* offers a set of concise executive summaries and other highlights tailored for consumption on smartphones. As with the print *Quarterly*, clients will receive the *Pocket Edition* four times a year.

On a personal note—it has been my honor to serve as McKinsey's global managing partner over the past nine years, and I want to thank all of the *Quarterly* readers for your engagement, insights, and support.

Dominic Barton
Global managing partner,
London office
McKinsey & Company

Features

TAKING AIM WITH TALENT

SPOTLIGHT ON LEADERSHIP

Features

Leading Edge

Closing View

Last Laugh

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Leading Edge

Research, trends, and emerging thinking

AI'S GROWING IMPACT

Smart machines are giving storytellers and risk managers alike a helping hand.

USING ARTIFICIAL INTELLIGENCE TO ENGAGE AUDIENCES

Machine-learning models can help screenwriters and directors fine-tune scripts and imagery. Company communicators should take note.

by Eric Chu, Jonathan Dunn, and Deb Roy

Master storytellers are skilled at eliciting our emotions, but even the best sometimes miss the mark. Could machines, using artificial-intelligence (AI) capabilities, collaborate with writers to improve their stories?

McKinsey and the Massachusetts Institute of Technology Media Lab recently studied that question, focusing on movies and videos. We speculated that a story's emotional arc—shifts in tension and emotion that shape a narrative as it progresses and develops—determines viewer engagement. To test our theory, we developed machine-learning models to "watch" small slices of video and estimate their emotional content. When the content of all the slices are considered together, the story's emotional arc emerges. The models can evaluate audio and visual elements in isolation or together.

Consider the opening sequence of the movie *Up*, which provides the backstory for

Exhibit 1

A machine scored the emotional arc in the opening sequence of the animated film *Up*.

Emotional arc of visuals[1]
(0 = most negative, 1 = most positive)

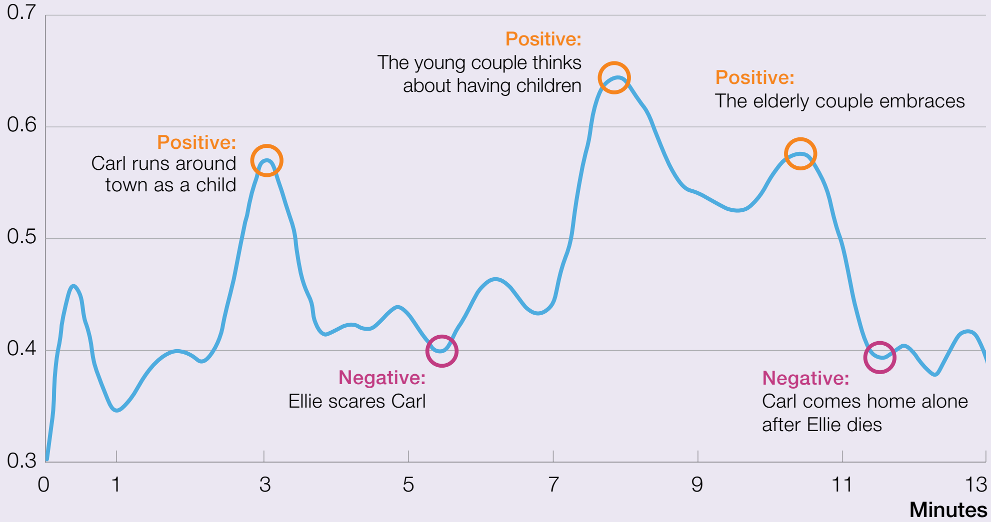


Exhibit 2

Some story families provoke more audience engagement than others.

Emotional arc of visuals[1] by families—ie, clusters of stories that share the same emotional trajectory (0 = most negative, 1 = most positive)

[1] That is, visual valence—extent to which an image elicits positive or negative emotions; all movies tend to score low at beginning and end, during credits.
[2] Researchers selected the number of families to examine; heuristics suggest that many stories fall into 5–10 shapes.
Source: Massachusetts Institute of Technology, Laboratory for Social Machines

Carl, the main character. The visual valence—or the extent to which an image elicits positive or negative emotions—alternates throughout the opening sequence (Exhibit 1). The valence plummets, for instance, when Carl returns home after his wife, Ellie, dies.

After analyzing data for thousands of videos, we classified stories into families based on their emotional arc. Some families had stories with extremely positive endings, and these tended to generate the most comments on social media (Exhibit 2). This finding supports prior research showing that positive feelings generate the greatest audience engagement.

Our results suggest that AI could play a supporting role in video creation. As always, human storytellers would create a screenplay with clever plot twists and realistic dialogue. AI would enhance their work by providing insights that increase a story's emotional pull—for instance, identifying a musical score or visual image that helps engender feelings of hope. This breakthrough technology could supercharge storytellers, and not just in the movie business. For example, AI insights could potentially improve the emotional pull of commercials or corporate communications. Q

Eric Chu is a doctoral candidate at the Massachusetts Institute of Technology (MIT) and conducts research at the Laboratory for Social Machines, part of MIT's Media Lab, where **Deb Roy** is the director. **Jonathan Dunn** is a partner in McKinsey's New York and Southern California offices.

The authors wish to thank Geoffrey Sands and MIT Media Lab's Russell Stevens for their contributions to this article.

For the full report on which this article is based, see "AI in storytelling: Machines as cocreators," on McKinsey.com.

MONITORING MONEY-LAUNDERING RISK WITH MACHINE LEARNING

More robust algorithms applied to better data can reduce the false positives that drive up banks' costs of policing risk.

by Piotr Kaminski and Jeff Schonert

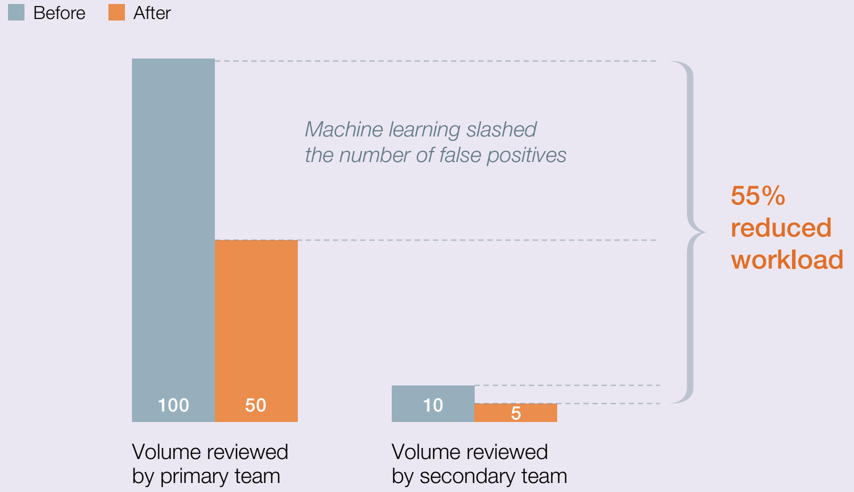
Money laundering is a low-frequency event, but banks can pay a high price for missing an incident. To detect money laundering, banks deploy monitoring systems to alert them of atypical transactions. Based on certain criteria, a financial-investigations unit then attempts to identify likely instances of money laundering from among the alerts, filing suspicious-activity reports with appropriate authorities as needed.

But anti–money laundering (AML) operations are often hampered by high levels of false positives—much higher than you would expect. Here's why: A very effective transaction-monitoring system might be 95 percent specific for suspicious activity and 95 percent accurate in detecting it. This means that the control falsely detects suspicious activity in 5 percent of normal cases while flagging 5 percent of all activity as not

Exhibit

One bank combined AI with improved data to reduce false positives dramatically in monitoring potential money laundering.

Disguised example of US bank, % of alerts



conforming to the established criteria. In those cases, further work will be needed to determine whether they are legitimate or suspicious. If, after all, 0.1 percent of transactions truly meet the criteria for suspicious activity (1 in 1,000 among the 50 in 1,000 falsely flagged), then this particular control will have produced a false-positive rate of more than 98 percent. Fewer than 2 percent of alerts will correspond to activity that upon further examination qualifies as suspicious.

At one large US bank, the false-positive rate in AML alerts was very high. The elaborate remedial process with meager results was overtaxing resources. To improve the up-front specificity of its tests so that AML expertise could be better utilized, the bank looked at the data and algorithms it was using. It discovered that databases identifying customers and transactions lacked key information. By adding more data elements and linking systems through machine-learning techniques, the bank achieved a more complete understanding of the transactions being monitored.

It turned out that more than half of the cases alerted for investigation were perfectly innocuous intracompany transactions. With a more complete database, the bank was able to keep its monitoring system from issuing alerts for these transactions, which substantially freed resources to fight actual money laundering and fraud (exhibit). Combined with better data, machine learning and other forms of artificial intelligence can also be used to combat false positives in a variety of banking activities—such as those that mine data for an individual's creditworthiness or probe digital interactions for signs of cybersecurity threats. Q

Piotr Kaminski is a senior partner in McKinsey's New York office, where **Jeff Schonert** is an associate partner.

For the full article, see "The neglected art of risk detection," on McKinsey.com.

RISING INCOMES, RISING RENTS, AND GREATER HOMELESSNESS

The experience of one high-tech hub suggests homelessness can be an unintended consequence of rapid economic growth.

by Maggie Stringfellow, Dilip Wagle, and Chris Wearn

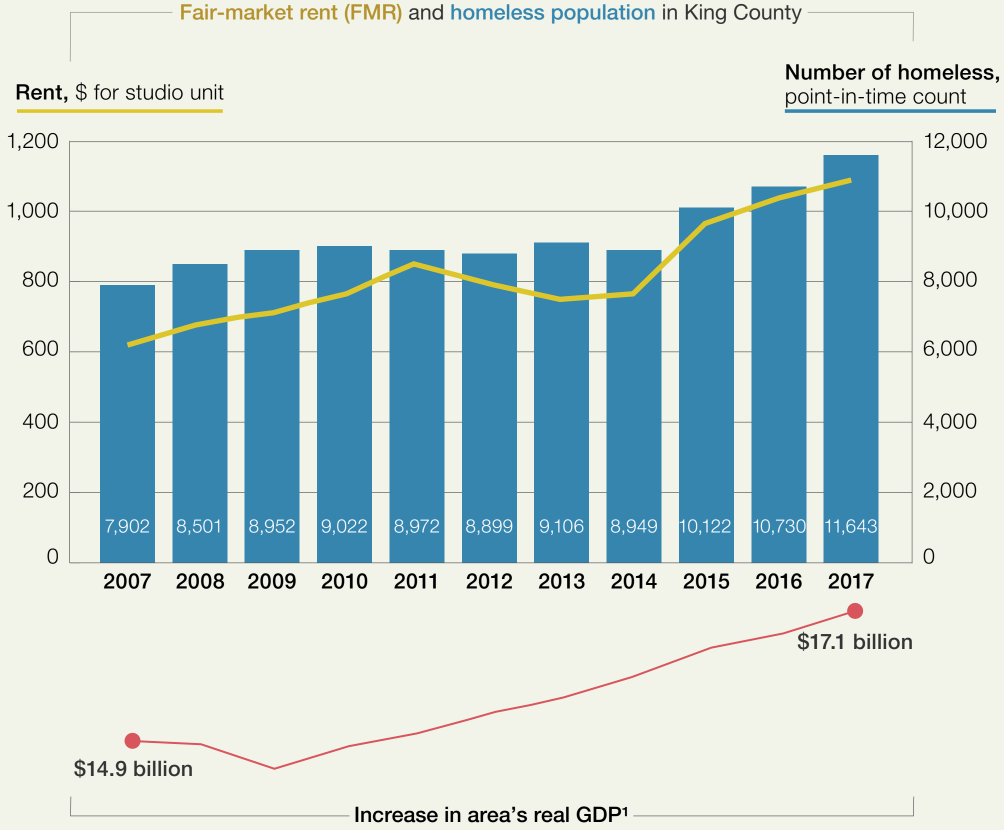
The number of homeless has fallen in most US communities. But it is climbing in affluent coastal cities such as Seattle, in King County, Washington. The exhibit suggests why: the cost of housing. In King County, homelessness has risen in line with the fair-market rent (FMR), which has in turn increased in line with the county's strong economic growth, propelled by the swelling ranks of high-income digital workers. On a single winter night in 2017, volunteers counted 11,643 homeless people, an annual average rise of 9.2 percent since 2014. Over the same period, the FMR has risen an average of 12.3 percent a year.

An essential component of the solution in Seattle and other prosperous urban areas is more affordable housing. In King County, as rents climbed, the stock of affordable units[1] fell by 13 percent a year between 2014 and 2016, such that in 2017, some 22,000 households sought help from the county's homeless services, but only about 8,000 affordable units were available. The homeless population had to compete with higher-income individuals for these units.

In King County, we estimate it would cost between $360 million and $410 million a year to tackle current levels of homelessness—that's twice today's spending. Action would be needed on three fronts: preventing more people from becoming homeless in the first place, assisting the homeless to find accommodation, and most important, providing more affordable housing. Investments in affordable housing account for about 85 percent of the extra funding required. Housing subsidies—payable to landlords to make unaffordable accommodation affordable—may be the most effective investment, as they quickly boost the supply of cheap housing.

Exhibit

Rent increases in Seattle's King County show a strong correlation with homelessness.



[1] Real GDP for January 1 of each year, measured in 2009 dollars, not seasonally adjusted.

Source: Fair-market rents and point-in-time (PIT) count from US Department of Housing and Urban Development; King County 2017 PIT count administered by All Home; US Federal Reserve Economic Data

Some corporations keen to alleviate homelessness in their local communities already fund emergency shelters. These are crucial. But they are not a long-term solution. Affordable housing is. Partnerships with local governments to support more of it could therefore be one of the best ways for companies to do more. Q

[1] Defined as affordable to households making 50 percent or less of the local median wage. Since 2011, units affordable to those households have almost halved.

Maggie Stringfellow is an associate partner in McKinsey's Seattle office, where **Dilip Wagle** is a senior partner and **Chris Wearn** is a consultant.

The authors wish to thank Katy Dybwad and Lukas Gemar for their contributions to this article.

THE CONGESTION PENALTY FROM URBAN SUCCESS

Commercial vehicles and online deliveries make city traffic worse and carry significant economic costs that demand creative solutions.

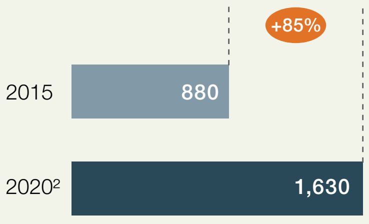
by Shannon Bouton, Eric Hannon, and Stefan Knupfer

Attracting energetic residents and thriving businesses are signs of urban success. But they also make traffic worse, as does the growing congestion caused by e-commerce deliveries. Commercial vehicles (CVs), such as trucks, vans, and buses,[1] can be particular trouble. Trucks accounted for 7 percent of urban travel in the United States in 2015, for example, but 18 percent of congestion. Cities can't do without CVs, of course; trucks deliver much of the material and services that residents need to live, from food to power repair. The rise of e-commerce has added to the flow. E-commerce sales in the largest 20 markets could hit $1.6 trillion in 2020, an 85 percent increase over 2015. Congestion costs can be surprisingly

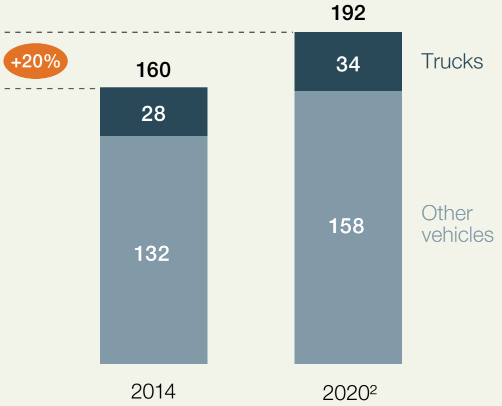
Exhibit

Rising e-commerce sales may flood city streets with delivery trucks.

Global e-commerce sales in the 20 largest e-commerce markets,[1]
$ billion



Cause of urban-congestion costs experienced by Americans,
$ billion



[1] Adjusted for inflation.

[2] Estimated; urban-congestion estimate assumes 2014 share of congestion costs between trucks and other vehicles continues unchanged.

Source: "Number of passenger cars and commercial vehicles in use worldwide from 2006 to 2014," Statista, 2017; *2015 Urban Mobility Scorecard*, INRIX and Texas A&M Transportation Institute; McKinsey analysis high. These “externalities”—in economic parlance—represent as much as 2 to 4 percent of city GDP.

Logistics staging areas outside city centers (urban consolidation centers), load pooling, and parcel lockers have proved successful in reducing miles driven by CVs and the number of deliveries, as well as costs. Allowing night deliveries reduces congestion during peak hours and lowers vehicle-related emissions. These practices, plus the use of electric vehicles and autonomous ground vehicles, show the greatest potential, in both environmental and economic terms. In the longer term, droids, drones, and individualized delivery could also make a difference. Q

[1] For more, see “Urban commercial transport and the future of mobility,” September 2017, McKinsey.com.

Shannon Bouton is the global executive director of the sustainable-communities program at McKinsey.org and is based in McKinsey’s Detroit office; **Eric Hannon** is a partner in the Frankfurt office; and **Stefan Knupfer** is a senior partner in the Stamford office.

THREE SURPRISING RESOURCE IMPLICATIONS FROM THE RISE OF ELECTRIC VEHICLES

The economic consequences for energy, raw materials, and land may not be what you'd expect.

by Russell Hensley, Stefan Knupfer, and Dickon Pinner

Demand for electric vehicles (EVs) is primed for the passing lane. While EVs accounted for only about 1 percent of global annual vehicle sales in 2016 and just 0.2 percent of vehicles on the road, McKinsey estimates that by 2030 EVs (including battery electric vehicles and plug-in hybrids) could rise to almost 20 percent of annual global sales (and almost 35 percent of sales in Europe). These rates could rise even faster under aggressive scenarios. Already, demography is proving to be destiny. Recent surveys suggest that 30 percent of car-buying individuals and nearly 50 percent of millennials will consider purchasing an EV for their next car instead of one powered by a traditional internal-combustion engine (ICE).[1]

Increased EV adoption will affect more and different natural resources, as well as multiple industries, different geographies, and levels of carbon emissions. Indeed, ecological concerns figure strongly in most consumers' decisions to purchase an EV. Wanting to help the environment was the number-one given reason (by a substantial margin) that American buyers chose an EV in a 2017 CarMax survey.[2] A study by AAA that same year also found environmental concerns to be EV purchasers' leading consideration—at a staggering 87 percent rate.[3] Yet our research reveals that several common assumptions about EVs and the Earth's resources are misplaced. And in some cases, the common wisdom is almost entirely wrong.

Fossil fuels: EVs do not spell peak oil

Start with crude oil. More EVs will dramatically depress oil demand—right? Actually, no; having more electric and hybrid vehicles on the road is expected to reduce oil demand only modestly over the next 10 to 15 years. To the extent that there is downward pressure on oil demand, it will come in large measure from improvements in ICE efficiency and from making vehicles more lightweight. Those efficiencies have already increased at about 2 percent per annum since 2005 (raising miles per gallon for an average ICE vehicle in the United States from 26 in 2005 to 32 today). We anticipate they will continue to rise at more than 2.5 percent a year through 2025.

Yet even as internal-combustion-powered vehicles become more efficient and less predominant, global crude-oil demand will continue to grow, all while EVs experience a significant increase as a proportion of vehicles on the road. Increased oil demand will come from a variety of sources, including industries such as chemicals and aviation; growing regions, notably China and other emerging markets; and the sale of more automobiles globally, including more ICE-powered automobiles, and hence more vehicle miles traveled worldwide.

EV adoption will, however, significantly affect demand for a different fossil fuel: natural gas. More EVs mean that more electricity will have to be produced. While coal will be part of the equation, approximately 80 percent of the forecast growth in US electricity demand is expected to be met with natural gas. If half of the automobiles on American roads were EVs, daily US natural-gas demand would be expected to increase by more than 20 percent.

Land: An unexpected squeeze?

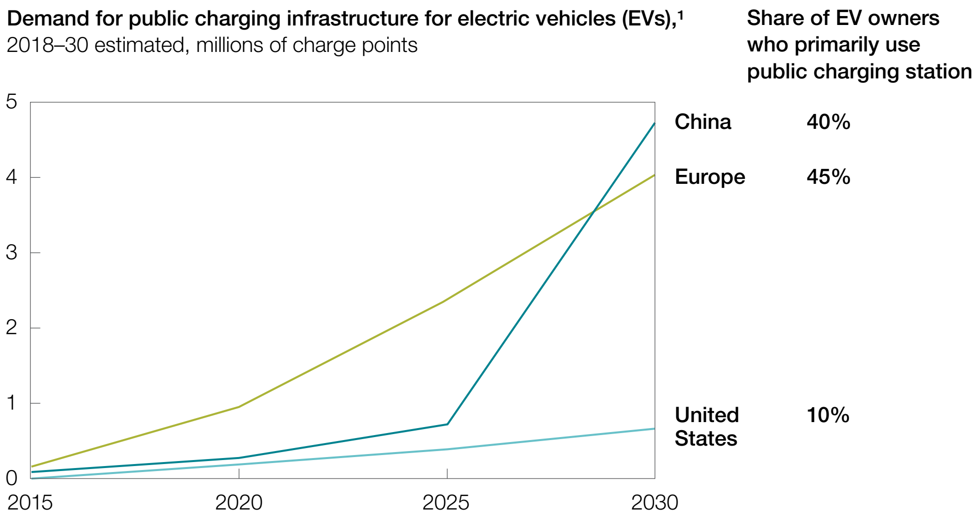
There are currently more than 400,000 public charging points that support the more than three million EVs now in use globally. This number will have to rise significantly to meet the global EV-adoption increases forecast by 2030 (Exhibit 1). Simply replacing gas stations with charging points or adding more charging points that are the size of gas stations won't be sufficient to service the expected number of EVs. It will take multiple rapid 120-kilowatt charging stations with eight outlets to dispense a similar amount of range per hour as the standard-size gas station of today.

The possibility of a land squeeze will be much greater in Europe and China than in the United States. Only 40 percent of European and 30 percent of Chinese EV owners have access to private parking and wall charging, versus 75 percent of US EV owners. Nor is the challenge merely a question of where to plug in or power up; generation and distribution are also factors. Today's power facilities can accommodate tomorrow's significant rise in the number of EVs, as long as the vehicles are charged off peak. Faster charging during peak demand, however, will indeed have an impact. In fact, peak demand from a single EV using a top-of-the-range fast charger is 80 times higher than the expected peak demand of a single typical household.

These potential constraints will likely have to be addressed through a variety of approaches, from innovation to top-down mandates. China has set a target of 4.8 million charging stations by 2020; McKinsey expects that the country's governmental record of centralized policies and compulsory implementation will ensure the country meets its mark. Funding outside of China, however, will be more challenging. California utilities, for example, look to increase publicly funded investments, with regulated returns. Private funding, on the other hand, could come from companies such as retailers. Several retail leaders are already beginning to consider how to turn the charging experience to their advantage by giving customers the opportunity to purchase while powering up. Just as shopping malls have long conjured images of leading retailers anchoring the buying experience, large retail-driven charging stations may come to mark the commercial landscape.

Exhibit 1

As electric-vehicle adoption increases, the demand for public charging stations will skyrocket.



[1] Assumes people who have access to charging their vehicles either at home or at work use public stations once a month, those with no private access use public stations 10 times a month, and those with access at both home and work do not use public stations at all (ie, 5% of EV owners in each country).

Ores and metals: Between a cliff and a hard place

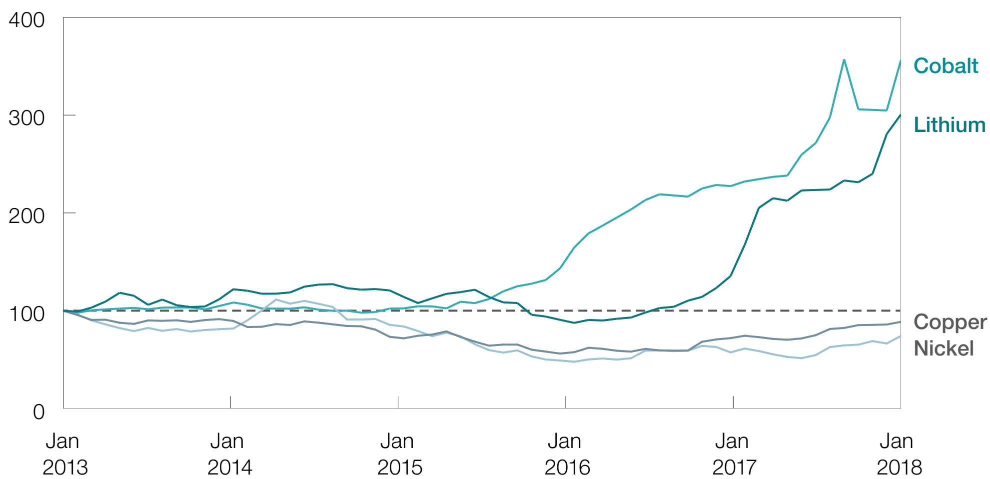
It's not surprising that more EVs on the road will result in greater price pressure for their constituent parts. The cost of an EV can be broken down largely into the cost of its battery (40 to 50 percent), electric power train (about 20 percent), and other elements of the vehicle itself (30 to 40 percent). Of these, battery costs will be the most important in the medium term. And pricing dynamics will reflect more than just demand. Currently, battery costs are about \$200 to \$225 per kilowatt hour. We estimate that a battery cost of \$100 per kilowatt hour will be required to achieve cost parity with ICE vehicles for most C-segment and D-segment vehicles[4] and \$75 per kilowatt hour for larger ones, unless government subsidies are continued—an unlikely proposition, as subsidies worldwide are already being phased out. If EV sales are to meet forecast levels, battery-manufacturing capacity will need to increase too—by our analyses, threefold by 2020. Technological improvements must also continue apace.

Higher EV sales will help reduce battery costs, with major battery manufacturers racing to expand capacity. At the same time, EV growth will put pressure on the costs of crucial battery inputs, including cobalt and lithium, for which demand will rise sharply. That dynamic has already begun to unfold; the costs of cobalt and lithium have more than doubled since 2015, an effect that has resulted in a net increase in EV production costs over that time (Exhibit 2).

Exhibit 2

Electric-vehicle growth has already begun to strain demand for cobalt and lithium.

Raw-materials prices; index: Jan 2013 = 100



Source: SNL Metals & Mining; McKinsey analysis

Will the availability of these materials constrain greater EV penetration? Optimistically, no. Even with the predicted rise in input costs, batteries can still come close enough to the $75 to $100 per kilowatt threshold needed to approach broad ICE price parity. While concerns such as a "cobalt cliff" exist and demand implications could present a temporary speedbump, the constraints and uncertainties should be addressable. Shifting to other battery chemistries can mitigate risks of shortage. Mining more of the raw materials will also be needed, which, we estimate, will require investments of $100 billion to $150 billion. As well, mining's hard realities will still apply, including lead times of up to several years and ecological and social concerns in regions within Africa and South America where much of these raw materials are found. Even as a green solution, in other words, EVs will have costs as well as benefits for society, our environment, and the resources we consume. Q

[1] *Aspiring drivers weigh automotive revolution*, Driving-Tests.org, March–April 2017, driving-tests.org.

[2] *2017 hybrid & electric cars survey results*, CarMax Business Services, July 18, 2017, carmax.com.

[3] "Consumer appetite for electric vehicles rivals pickups," *NewsRoom*, April 18, 2017, aaa.com.

[4] These refer to two European car segments. C-segment vehicles are the largest of the small cars, typically called compact cars in the US market (for example, Honda Civic, Ford Focus, and Toyota Corolla). D-segment vehicles refer to the smallest of the large cars, typically called midsize cars in the US market (for example, Chevrolet Malibu, Ford Fusion, Volkswagen Passat, and Audi A4).

Russell Hensley is a partner in McKinsey's Detroit office, **Stefan Knupfer** is a senior partner in the Stamford office, and **Dickon Pinner** is a senior partner in the San Francisco office.

The authors wish to thank Hauke Engel, Patrick Hertzke, Shivika Sahdev, and Patrick Schaufuss for their contributions to this article.

TAKING THE MEASURE OF INNOVATION

Don't overlook the insight that two simple metrics can yield about the effectiveness of your R&D spending.

by Guttorm Aase, Erik Roth, and Sri Swaminathan

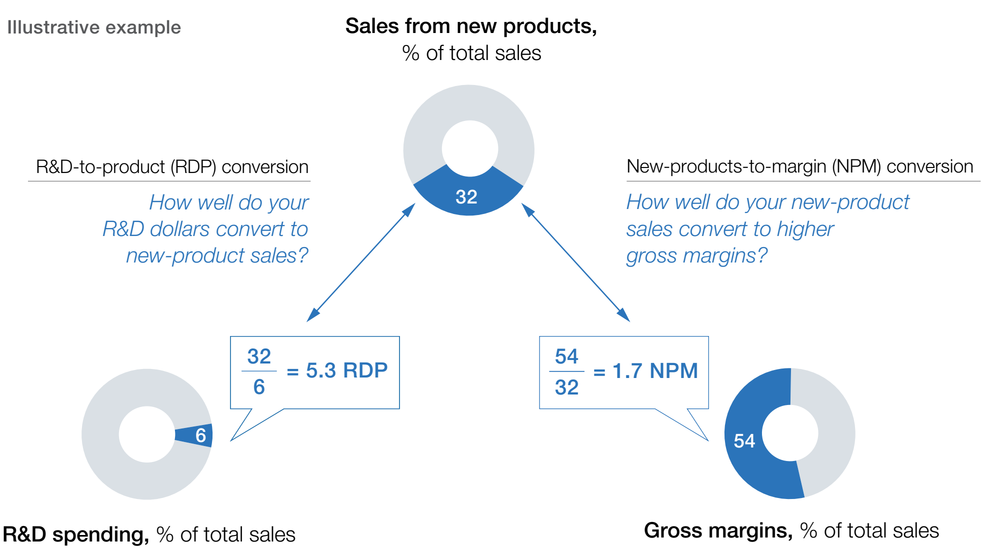
You've probably heard the old joke about the two economists who saw $20 on the sidewalk. "Look," exclaimed the first economist, "a $20 bill!" "It can't be," the other economist answered. "If it were a $20 bill, someone would have already picked it up."

We were reminded of this story when we began to notice a pair of innovation metrics that seemed so intuitive that we assumed they must have been conspicuously applied and rejected before. So far, however, we've found no indication of widespread use—and a reasonable amount of evidence suggesting that, at least for most industries, the measurements work.

We call these indicators R&D conversion metrics: R&D-to-product (RDP) conversion and new-products-to-margin (NPM) conversion. Their core components—gross margin, R&D, and sales from new products—are not new, but combining them can reveal fresh insight on the relative innovation performance of business units, within an organization and

Exhibit 1

Two metrics combine R&D spending, sales from new products, and gross margin to shed light on relative innovation performance.



relative to external peers (Exhibit 1). The first metric, RDP, is computed by taking the ratio of R&D spend (as a percentage of sales) to sales from new products. This allows organizations to track the efficacy with which R&D dollars translate into new-product sales. The second metric, NPM, takes the ratio of gross margin percentage to sales from new products, which provides an indication of the contribution that new-product sales make to margin uplift.

Notably, these metrics can be gauged outside in, making them ideal for benchmarking. They also apply on the portfolio level, where the net effect of individual project investments reflects the results as a whole. That broader perspective accords with how senior executives and investors typically consider innovation performance. It's not the most granular way to consider project value creation, and it doesn't aspire to be. In seeking the ideal metric, one should not let the perfect be the enemy of the good. When a business can convert a high rate of R&D dollars to new products, and when its new products flow through to higher gross margins, good things will happen.

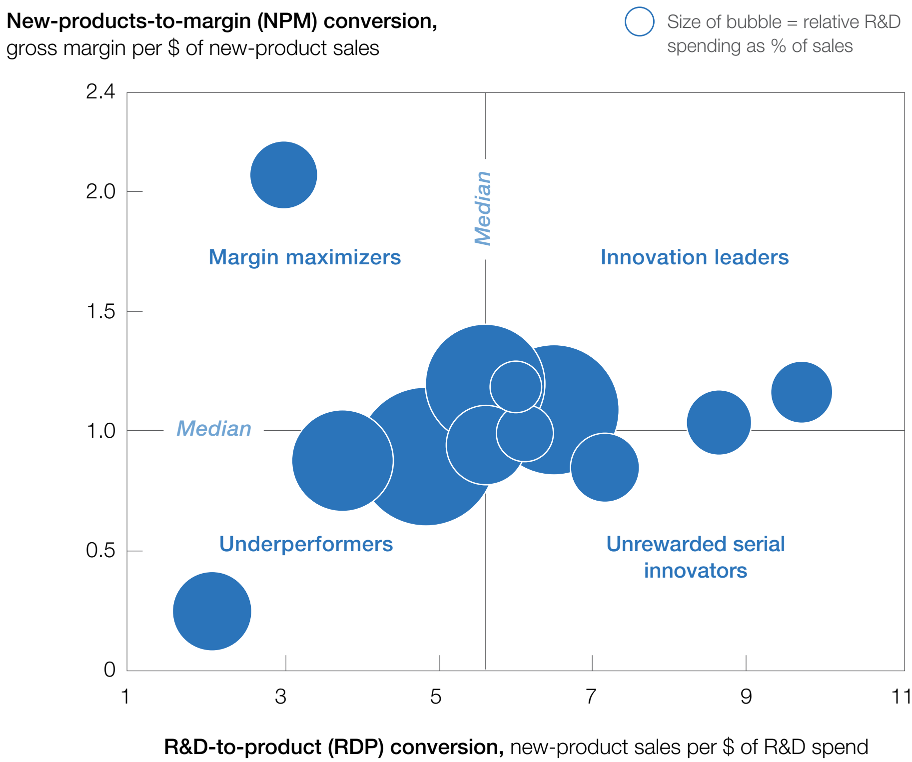
As we'd expect, the R&D conversion metrics show that higher spend does not inevitably translate to stronger performance. That should come as no surprise to seasoned executives and analysts. Rather, when we benchmarked companies within select industries, results varied markedly. The R&D conversion metrics also demonstrate—sometimes strikingly—where some organizations are falling short and where opportunities for improvement may be found (Exhibit 2). Not every company that scores strongly on RDP is able to follow through to higher margins, and a company scoring above-median performance on NPM may underperform in RDP.

While the R&D conversion metrics are useful, context is essential. Benchmarking must be conducted against comparable firms—pure plays versus pure plays, diversified companies against companies with multiple business lines, and product-to-product comparisons with cycle times that are as close in duration as possible. These metrics also work best in industries where product turnover is higher and the incremental effect of innovation is both more immediate and more critical to the business model. For example, in specialty chemicals and consumer goods, two industries with rapid innovation cycles, the three-year average in gross margins correlates strongly with the five-year average of new-product sales. In industries with markedly longer cycles, such as pharmaceuticals and agribusiness, the r-squareds are lower.

But in a real sense, those exceptions help prove the rule: the more that innovation matters with immediacy, the more insight is to be gained by tracking your innovation efforts. In our experience, many companies spend too much time looking inward at measures of activity

Exhibit 2

Taken together, the R&D conversion metrics can help identify favorable and unfavorable innovation-performance outliers.



Source: Capital IQ; company investor presentations

(for example, number of patents, or progress of ideas through a pipeline), and not enough scrutinizing the returns on innovation. Creating value is the name of the game, and these R&D conversion metrics help you keep score. Ⓠ

Guttorm Aase is an associate partner in McKinsey's New York office, where **Sri Swaminathan** is a consultant; **Erik Roth** is a senior partner in the Stamford office.

CHINA'S BREAKNECK PACE OF DIGITIZATION

The consumer economy is now among the world's most digitized, and business transformation is accelerating with an explosion of start-ups and new business models.

by Jeongmin Seong, Kevin Wei Wang, and Jonathan Woetzel

Everything speeds up in the digital economy, and nowhere is that more evident than in China. In little more than a decade, China has come from almost nowhere to become the largest e-commerce market in the world, accounting for more than 40 percent of global e-commerce transactions (exhibit). China's mobile payments are 11 times the value of those in the United States thanks to consumers' early embrace of the technology. This flourishing digital culture is paying innovation dividends, as China is home to one in three of the world's start-up "unicorns," those with more than $1 billion in market cap. And China now places in the top ranks of global venture-capital investment in virtual reality, autonomous vehicles, 3-D printing, robotics, drones, and artificial intelligence.

That innovation base is leading to a host of new business models based on emerging technologies that might soon revitalize other, previously lagging sectors of China's economy. According to a recent report from the McKinsey Global Institute, these new approaches include directly linking business buyers and suppliers in disintermediation plays, disaggregating incumbent value chains as digital attackers move in, and creating a raft of new digitally "dematerialized" products and services.[1] Creative destruction on a grand scale, which would boost productivity and the international competitiveness of China's economy, might be next. Between 10 and 45 percent of revenue in China's industries could shift from old business models to new ones enabled by digital by 2030. The transformation is picking up steam: in 2013, industries in the United States were 4.9 times more digitized than ones in China; in 2016, that figure had fallen to 3.7 times.[2] Q

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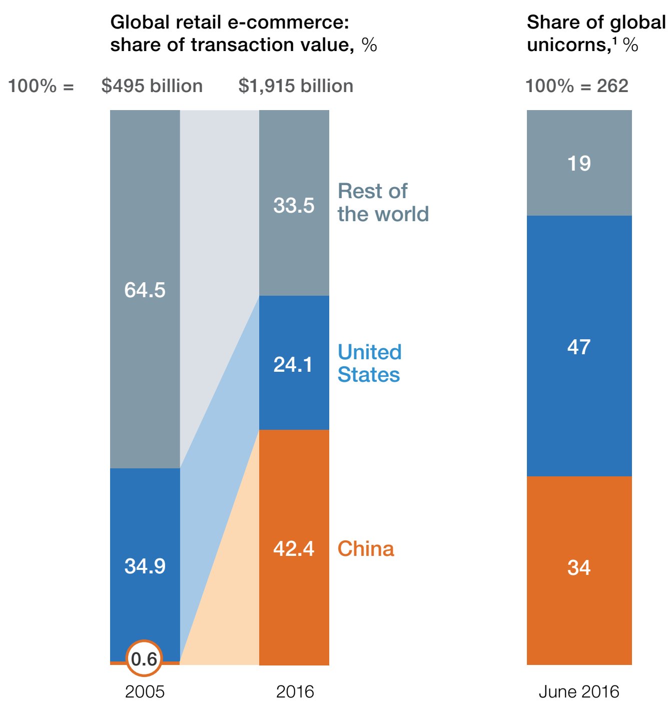
[1] For more information, see "Digital China: Powering the economy to global competitiveness," McKinsey Global Institute, December 2017, McKinsey.com.

[2] Based on the McKinsey Global Institute Industry Digitization Index, which measures the degree of digitization in 22 industries by analyzing more than 20 indicators on digital asset, usage, and labor.

Jeongmin Seong is a senior fellow at the McKinsey Global Institute (MGI) and is based in McKinsey's Shanghai office, where MGI director **Jonathan Woetzel** is a senior partner; **Kevin Wei Wang** is a senior partner in the Hong Kong office.

Exhibit

China's digital economy has jumped from almost nowhere to lead in e-commerce and seed many successful start-ups.



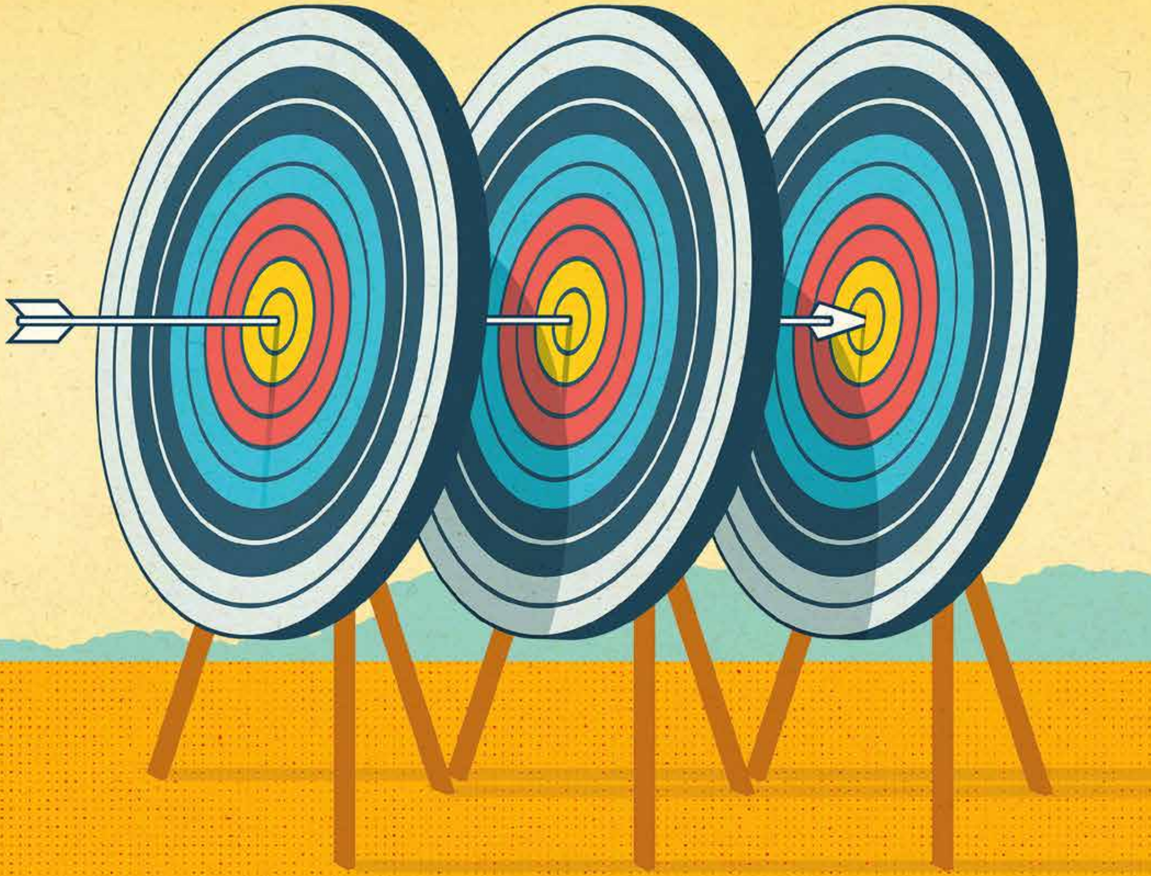
[1] Defined as a privately held start-up valued at more than $1 billion.

Source: Dealogic; eMarketer; iResearch Consulting Group; PitchBook Data; TechCrunch Crunchbase Unicorn Leaderboard; McKinsey Global Institute analysis

TAKING AIM WITH TALENT

Illustrations by Dan Page

Talent is a make-or-break asset in today's fast-changing business environment. Companies need a more disciplined approach to matching their best people to critical roles and to helping them thrive. The articles that follow show how leaders are tackling these and other challenges to stay ahead.



An agenda for the talent-first CEO

In tumultuous times, a company's talent is its most valuable and reliable asset. What does it take to lead an organization that truly unleashes its human capital?

by Dominic Barton, Dennis Carey, and Ram Charan

In our combined 90 years of advising CEOs and their boards, the three of us have never come across a moment like this, when virtually every CEO we work with is asking the same daunting set of questions: Are my company's talent practices still relevant? How can we recruit, deploy, and develop people to deliver greater value to customers—and do so better than the competition? How can I be sure that I have the right approach to talent—and the right HR—to drive the changes we need to make?

We sought to answer these questions in our new book, *Talent Wins* (Harvard Business Review Press, 2018), which explores what it takes to build and lead a talent-driven organization. The list of critical priorities, which includes everything from continual, agile reorganization to the reinvention of HR and the creation of an external M&A strategy, is long—and it creates a complex set of challenges for the CEO. The experiences of CEOs at talent-driven companies such as Amgen, Aon, Apple, BlackRock, Blackstone, Facebook, Google, Haier, Shiseido, Tata Communications, and Telenor suggest that meeting those challenges requires a distinct set of mind-sets. As we show in the book, leaders at talent-driven companies are as focused on talent as they are on strategy and finance. They make talent considerations an integral part of every major strategic decision. They ensure that their own focus on talent is woven into the fabric of the entire company. And they are comfortable leading flattened organizations—often centered around the work of small, empowered teams—built to unleash the talent that will drive outsize value.

How do you become such a leader, and lead such a company? This article focuses on four key priorities for the CEO. The first two are moves the CEO must make to secure alignment at the top of the organization. Misalignment at the top is trouble for any company, but it is disastrous for talent-driven ones, where HR and finance must work in tandem and the CEO must oversee a complex, fluid structure. With that foundation in place, CEOs can turn their attention to the two most critical aspects of leading a people-first company: finding, recruiting, developing, and deploying key talent; and ensuring that talent is truly integral to every major strategic decision across the organization.

LEAD WITH A G-3

The talent-driven organization needs a central brain trust, and all that we've seen argues for it being a "G-3" consisting of the CEO, CFO, and chief human-resources officer (CHRO). Why these three executives in particular? Because deploying financial capital and human capital together is the key to success. "People allocation is as powerful as financial allocation," explains Aon CEO Greg Case, who works closely with CHRO Tony Goland and CFO Christa Davies to make sure the company has the right talent to meet the challenges of the future.

By putting talent and finance on equal footing, the G-3 will change the way and sequence in which critical matters are discussed. This trio of top executives doesn't turn to personnel and organizational issues only after having reviewed financial results and strategic initiatives across each business unit, as typically happens today. "We work together to make talent decisions and integrate solutions," says Case. "Pure capital allocation is essential, but that's not enough. Do we have the right talent in place? How should we think about talent development? If you have an opportunity to acquire a company, do you have the right people in place to do the deal and operate it afterward? It's not a matter of getting input from my team so I can make a decision. The three of us work together as peers and answer those strategic questions as a team."

The G-3 isn't just focused on talent as some discrete item on the agenda. Instead, the G-3 ties talent to *every* item on the agenda. Consider the turnaround over the past few years at McGraw-Hill. In 2010, Wall Street was punishing then-CEO Terry McGraw's company. The reputation of its S&P ratings service had been damaged in the financial crisis, and investors didn't see any synergy with the conglomerate's other assets, an educational-publishing arm and a collection of media properties. McGraw relied on his new CHRO and CFO, John Berisford and Jack Callahan, to evaluate the company from their perspective as outsiders and tell him how to unlock value.

Working together and meeting constantly, both formally and informally, Berisford and Callahan were able to evaluate the company holistically. They discovered pockets where paternalistic practices had fostered bureaucracy at the expense of innovation. They also discovered that Wall Street was right—there were no real synergies between the divisions. With McGraw, they decided that the only way to unleash the talent within was to engineer a breakup—S&P as one company, education and media as another—and sell assets that didn't fit. It was a plan that McGraw, who had been at the company since 1980, might not have been able to design without his CHRO and CFO. Once the board agreed, Berisford and Callahan led the exercise of splitting the company. Again and again, their respective experiences came together to deliver unified solutions to tough problems: compensation levels at both companies, the bottom-line impact of key personnel in critical roles, and a leadership structure for the stand-alone education business. Callahan got the facts, Berisford figured the human equation, and together with McGraw they arrived at holistic solutions. "If finance and HR aren't talking," says Callahan, "they aren't creating new value." While the education company is privately held, the market cap of S&P Global (as it was renamed) is four times higher than the value of McGraw-Hill in 2010.

As the example suggests, CEOs in a G-3 will demand much of their CHRO, perhaps more than they ever have. Ed Breen, who turned around Tyco before signing on as CEO of DuPont, says, "You're going to be more brutally honest. The CHRO and the CFO might have to tell the CEO that someone he's very close to in the organization isn't an A-plus player. That's how you'll come to better decisions." Breen's former CHRO at Tyco, Laurie Siegel, believes the CHRO of a talent-driven organization must be a great business person, not just a great people person. "The conversation with a CHRO," she says, "is not, 'We can't do it.' Instead it's, 'Here's how we can get there.' What you want is a CHRO who is a problem solver, not a deal killer." That's why line experience should become a central part of the career path of any HR executive who shows real leadership potential. And just as the CHRO must understand the key financial drivers, the CFO must understand the human drivers of value creation.

One word of caution: the success of the G-3 depends on the CEO's commitment, attention, and care. It doesn't just happen because the CEO hires a great CHRO and a great CFO. McGraw elevated the CHRO, set a tone of openness and intellectual honesty, fostered a close rapport in informal chats and formal weekly meetings, and gave the G-3 a mandate that was as broad as his own. The CEO is the lynchpin of the G-3. With his or her strong leadership and support, a G-3 is the best way to ensure that the value of talent is represented in every major decision.

ALIGN THE BOARD OF DIRECTORS

One of the ironies of today's agile, flatter structures is that they can't succeed without commitment and alignment at the top. Transforming a company to be a talent-driven organization requires a top-down revolution. CEOs who try to drive this kind of change must have the alignment of both senior management (starting with the G-3) and the board of directors.

The role of the board is often underplayed in discussions around talent. That's because so many boards focus on strategy and compliance first, and limit talent discussions to the question of CEO succession and executive compensation. But CEOs running a talent-first organization must help the board see that talent is *the* value creator and therefore belongs at the top of its agenda. The talent-driven CEO wants the board to focus on *two* forms of "TSR": not just total shareholder return, but also talent, strategy, and risk.

It's a profound change, but most directors will welcome the shift. According to a recent McKinsey survey of corporate directors, most believe they are effective on strategy, yet very few feel they are doing a good job developing people and ensuring that the company has a strong, healthy culture.

How to drive this shift of mind-set? A critical move is to transform the mandate and scope of the compensation committee. Just as many audit committees have evolved into bodies focused on strategic financial allocation, the compensation committee must evolve into a group focused on the recruitment, deployment, and development of talent. That's why it should be given a new name, such as the talent and rewards committee, or perhaps the people committee.

The name change has symbolic value, given that most compensation committees are noteworthy only when they overpay their CEO. A talent and rewards committee, on the other hand, promises to focus on a wider group of executives and to look more holistically at how to maximize the quality and effectiveness of talent throughout the company.

The talent and rewards committee can lead activities that are of great value to the talent-driven CEO: everything from recruiting to regular evaluations of the critical talent-development system. Talent will no longer be an afterthought. Instead, every meeting of the board of directors must include a discussion of not just CEO succession but also the health of a wider swath of top talent (which one might call the "critical 2 percent") and diversity.

The board of Telenor, the Norwegian telecom, offers a good example of how a board that is focused on talent can support a people-first CEO. Just 22 percent of the company's leaders are women, but CEO Sigve Brekke hopes to increase that number to 30 percent by 2020. Directors are updated on diversity at every meeting, and they engage at a deep level: chairperson Gunn Waersted, like three of the other nine directors, is a woman. Waersted also leads the people and governance committee, which used to be called the compensation committee. This kind of involvement is how directors can help an "HR issue" such as gender diversity become a competitive advantage. "What we see," says former chief people officer Jon Erik Haug, who left the company in December 2017, "is that by focusing on gender we stand out in some markets, like Asia, because our competitors are not focusing on it."

CONSTANTLY DEVELOP YOUR TOP TALENT

In his former role as operating partner at Blackstone, Sandy Ogg often worked with the leadership of the private-equity giant's portfolio companies. One company's value agenda was to increase earnings from $600 million in earnings before interest, taxes, depreciation, and amortization (EBITDA) to $1 billion, while shifting the multiple from eight to ten. Using an approach that he had developed while working with other companies in the portfolio, Ogg identified the pivotal roles in the 12,000-person organization. He boiled it down to 37 critical positions, one of which could single-handedly generate $60 million in EBITDA. The men and women in those 37 critical roles held the fate of that investment in their hands. Ogg, along with the company CEO and the rest of the Blackstone team, then took the time to ensure that those positions were filled with leaders who were up to the task ahead. (For more on how Blackstone and other companies are aligning their most capable people with key roles, see "Linking talent to value," on page 36.)

Thirty-seven people in a 12,000-employee company! In almost every organization, success depends on a small core of people who deliver outsize value. The success of the talent-first CEO largely depends on how he or she leverages this critical 2 percent of people. (That 2 percent figure is merely a guideline; in big corporations, the "2 percent" may be a group of fewer than 200 people.)

Knowing where to look is important. According to one McKinsey study, about 70 percent of senior executives are wrong about who is most influential in their organization. The G-3 must pinpoint the company's crucial decision nodes, the places in the organization where important choices are made by people who can drive tremendous value. Who is really exercising power at those key points? (Often, it's not the official decision maker.) How do decisions at those nodes create or destroy value? The 2 percent is most definitely *not* limited to a group of employees with the fanciest titles in the company. Instead, this high-leverage group can include key designers, scientists, salespeople, up-and-coming leaders, influencers, integrators, and support staff tucked away in unglamorous corners of the company. Jony Ive, Apple's chief design officer, is obviously one of the 2 percent at the company, as is Steven Nissen, star cardiologist and chairman of cardiovascular medicine at the Cleveland Clinic. But so, for that matter, is the navigation team at United Parcel Service, whose software, which encourages drivers to take as few left-hand turns as possible, saves the company millions of dollars each year on gas.

Identifying the 2 percent is just one part of the continual process of talent development. At a talent-first company, pay scales and new opportunities are often rewarded "unfairly." As Laszlo Bock, Google's former CHRO, writes in his book, *Work Rules!*, "At Google, we . . . have situations where two people doing the same work can have a hundred times difference in their impact, and in their rewards. For example, there have been situations where one person received a stock award of $10,000, and another working in the same area received $1,000,000." While this isn't typical, bonuses for the best performers can be five times higher than for the rank and file. High-performing workers at junior levels in the company can earn more than average performers working at higher levels.

This devaluation of hierarchy in favor of meritocracy opens up opportunities for the most talented people at any level of the company. Tadashi Yanai, CEO of Fast Retailing, whose brands include Uniqlo and Compte des Cottonniers, believes that digital changes everything for anyone selling anything. To prepare Fast Retailing for that future, he isn't relying on his most experienced people. As he puts it, "To tell the truth, my high-level executives are very good in the day-to-day nitty gritty, but we need a fresh perspective." Instead, he's turned to 38 young workers from all corners of the globe and all levels of the company.

CEOs of talent-driven companies use every tool at their disposal to develop their critical 2 percent. When a company doesn't have the skill sets or the innovation firepower it needs for the future, it's up to the CEO to go out and recruit "people who can generate better ideas than other people," as Shiseido CEO Masahiko Uotani says. The CEO must ensure that the company has cutting-edge analytics software that can help track the progress of these key executives, and even evaluate the likelihood of success in the next steps on their career paths. The CEO must be sure that the company is constantly creating the next generation of leaders. At BlackRock, for example, one criterion used in evaluations of top executives is their ability to create new leaders. As chief talent officer Matt Breitfelder explains, "By design, we create some social pressure in the organization by asking our managers, 'Yeah, you think of yourself as a leader, but what's your track record? Name the people that you've developed.' We call it positive paranoia."

UNLEASH TALENT AND STRATEGY WITH AGILITY

When CEOs of talent-driven companies launch new initiatives, they make sure to have the right talent on hand before going too deeply into strategic and financial planning. Agile organizations built around empowered teams are the best way to constantly and nimbly match the right talent to the right strategic initiatives.

A few years ago, Facebook CEO Mark Zuckerberg decided that his company had to make a dramatic shift from a desktop business model to a mobile one. Zuckerberg's vision was clear: He told product teams, "Come in with mobile. If you come in and try to show me a desktop product, I'm going to kick you out." That clear vision, of course, guaranteed nothing: the CEO graveyard is full of visionaries who fell back to earth when their teams couldn't deliver. But Facebook did deliver. Every product team got a mobile developer. Desktop products in development were simply dropped. The teams delivered a slew of mobile offerings. Not all were hits, but enough made the cut—by the end of 2016, mobile accounted for 84 percent of the company's ad revenue.

Priority initiatives like the mobile shift are supported, says Facebook CHRO Lori Goler, by a culture of autonomy and initiative. People find their way to projects that interest them. Some teams stay together for years, others disband after just a few weeks. The organization constantly reorganizes itself. Facebook still faces multiple challenges, of course, such as managing user data. Solving these dilemmas could tax Zuckerberg's historic ability to provide a clear vision and aggressively deploy talent to effect the change he seeks.

It's not just technology companies that have embraced the principles of agile organization. Another, perhaps familiar, example of how agility can connect talent and strategy is Haier, the Chinese appliance manufacturer. Two thousand microenterprises are the basic innovation units of the company's organizational grid, each composed of 10 to 20 people drawn from a range of functions. Like Facebook's teams, some units stay together for years, while others disband within weeks. Each unit is ferociously focused on a set of customers who use its particular product. The units are empowered to find the solutions their customers need, as opposed to being tasked to sell them a particular product. The solutions created by these microenterprises drive Haier's product strategy. Giving talent so much power might seem daunting, but it's hard to argue with the results: Haier is now the world's largest appliance maker.

Haier CEO Zhang Ruimin says that today's CEOs must learn how "to lose control, step by step." That's a challenge for anyone comfortable with top-down leadership. But note the second half of Zhang's quote: "step by step." Leading a talent-first organization is something that must be managed incrementally. The steps it requires—alignment at the top; continual development of talent; a commitment to link talent and strategy; an agile, flexible corporate structure; and others that we discuss in our book—are each important. But built one upon the other, they trigger a multiplier effect that can exponentially increase the value that talent delivers to the organization. And that, of course, is the great promise of leading a talent-first organization: seeing new ideas lead to even better new ideas, watching the creative thinking that's been enabled amplify itself across divisions and varying levels of seniority and expertise, and reaping the benefits of explosive value that arises from expected, and unexpected, parts of the company. Q

Dominic Barton is the global managing partner of McKinsey & Company and is based in McKinsey's London office. **Dennis Carey** is the vice chairman of Korn Ferry. **Ram Charan** is an author and an adviser to CEOs.

This article is adapted from the authors' book, *Talent Wins: The New Playbook for Putting People First* (Harvard Business Review Press, 2018).

Linking talent to value

Getting the best people into the most important roles does not happen by chance; it requires a disciplined look at where the organization really creates value and how top talent contributes.

by Mike Barriere, Miriam Owens, and Sarah Pobereskin

To understand how difficult it is for senior leaders to link their companies' business and talent priorities, consider the blind spot of a CEO we know. When asked to identify the critical roles in his company, the CEO neglected to mention the account manager for a key customer, in part because the position was not prominent in any organization chart. By just about any other criterion, though, this was one of the most important roles in the company, critical to current performance and future growth. The role demanded a high degree of responsibility, a complex set of interpersonal and technical skills, and an ability to respond deftly to the client's rapidly changing needs.

Yet the CEO was not carefully tracking the position. The company was unaware of the incumbent's growing dissatisfaction with her job. And there was no succession plan in place for the role. When the incumbent account manager, a very high performer, suddenly took a job at another company, the move stunned her superiors. As performance suffered, they scrambled to cover temporarily, and then to fill, a mission-critical role.

Disconnects such as this between talent and value are risky business—and regrettably common. Gaining a true understanding of who your top talent is and what your most critical roles are is a challenging task. Executives often use hierarchy, relationships, or intuition to make these determinations. They assume (incorrectly, as we will explain) that the most critical roles are always within the "top team" rather than three, or even four, layers below the top.

In fact, critical positions and critical people can be found throughout an organization (Exhibit 1).

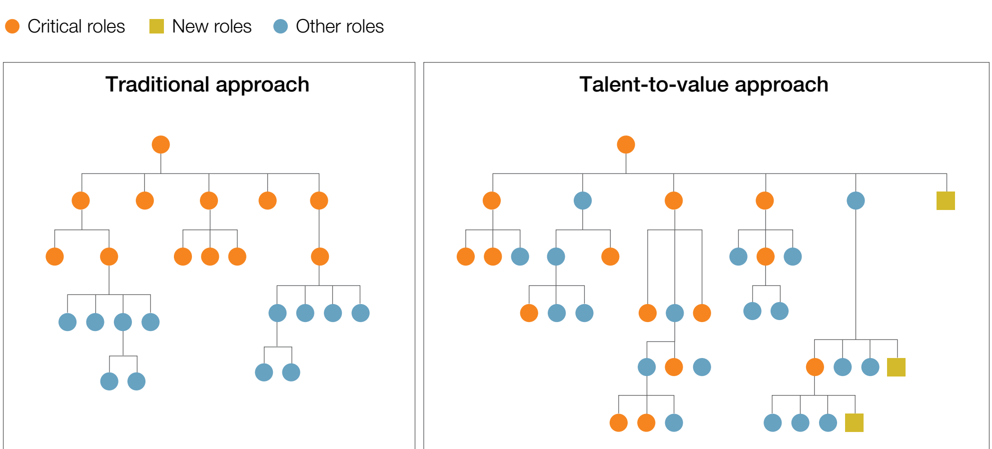
Fortunately, there is a better way. Companies can more closely connect their talent and their opportunities to create value by using quantifiable measures to investigate their organizations' nooks and crannies to find the most critical roles, whether they lie in design, manufacturing, HR, procurement, or any other discipline. They can define those jobs with clarity to ensure that top performers with the appropriate skills fill the roles. And they can put succession plans in place for each one.

The leaders at such companies understand that reallocating talent to the highest-value initiatives is as important as reallocating capital. This is not an annual exercise: it is a never-ending, highest-priority discipline. In a survey of more than 600 respondents, we found the talent-related practice most predictive of winning against competitors was frequent reallocation of high performers to the most critical strategic priorities. In fact, "fast" talent reallocators were 2.2 times more likely to outperform their competitors on total returns to shareholders (TRS) than were slow talent reallocators.[1]

[1] From November 14 to November 28, 2017, we surveyed 1,820 participants on their companies' talent-management practices. Of those respondents, 628 were from public companies and were asked to describe their companies' current TRS relative to their competitors.

Exhibit 1

Roles that drive or enable value can be found across an organization.



Traditional approach	Talent-to-value approach
Hierarchy heavily influences which roles are viewed as most important	Role importance is linked to an explicit perspective on value that can be created or enabled by role
Within a hierarchical level, roles are assigned similar levels of importance	Not all roles in the same hierarchical level are assigned the same importance

Those results are consistent with the experience of Sandy Ogg, founder of CEOworks, former chief HR officer (CHRO) at Unilever, and former operating partner at the Blackstone Group. While in the latter role, Ogg began paying attention to which Blackstone investments made moves to match the right talent to the important roles from the start. He observed that 80 percent of those talent-centric portfolio companies hit all their first-year targets and went on to achieve 2.5 times the return on initial investment. Ogg also noted that the 22 most successful portfolio companies out of the 180 he evaluated managed their talent decisions with an eye toward linking critical leadership roles to the value they needed to generate. He recalled using similar value-centric talent-management approaches in his previous roles at Motorola, Unilever, and Blackstone, and he now had even clearer evidence of their impact. In partnership with McKinsey, he set out to codify this approach for linking talent to value.

Real-world examples best describe our learnings. In this article, we describe the journey of a CEO of a consumer-products company, "Company X," who recently found herself reflecting on how to achieve dramatic revenue growth. The effort would demand reimagining how Company X generated value and then redefining critical roles and the people who filled them.

DEFINE THE VALUE AGENDA

The first step in linking talent to value is to get under the hood of a company's ambitions and targets. It is not enough just to know the overall numbers—the aspiration should be clearly attributable to specific territories, product areas, and business units. Company X already understood its overriding goal: to grow revenue by 150 percent within the next five years in its highly disrupted industry. When taking a more detailed look, however, the CEO and her team found that some small business units were likely to grow out of proportion to their size, making the value at stake in these businesses greater than in the larger ones. Design and manufacturing innovation would clearly have a positive impact on all business units, but if the two largest ones were to grow, they would also have to take advantage of international opportunities and digitally deliver their products and services.

Disaggregating value in this granular fashion set the table for a strategic discussion about which roles mattered most and about the skills and attributes needed by the talent who would fill those roles and drive future growth. Even at this early stage of the process, it was clear that the company's future leaders would need to be comfortable in an international environment, leading teams with a high degree of cultural diversity; have experience in cutting-edge design and manufacturing processes; and possess digital fluency. The leaders would also have to be flexible and comfortable adapting to unforeseen disruptions.

Unfortunately, these character traits were not common across Company X's cadre of leaders at the time. The CEO now understood the serious issue she had to confront—the profiles of Company X's current top talent did not necessarily match the ideal profiles of its future top talent.

IDENTIFY AND CLARIFY CRITICAL ROLES

Identifying and quantifying the value of the most important roles in an organization is a central step in matching talent to value. These critical roles generally fall into two categories: value creators and enablers. Value creators directly generate revenue, lower operating costs, and increase capital efficiency. Value enablers, such as leaders of support functions like cybersecurity or risk management, perform indispensable work that enables the creators. These roles are often in counterintuitive places within the organization. Typically, companies that consciously set out to pinpoint them find about 60 percent are two layers below the CEO, and 30 percent are three layers or more below the CEO.

The ability to achieve true role clarity is closely tied to overall organizational performance and health, according to McKinsey research.[2] In the pursuit of such clarity, it is critical to think first about roles rather than people. The initial goal is assessment of where the greatest potential value is and what skills will be necessary to realize that value—not identification of the top performers. This approach allows leaders to think more strategically about matching talent and value rather than merely focusing on an individual's capabilities.

Each of Company X's business-unit leaders had defined their value agenda; now they needed to map, in collaboration with their HR teams, the most critical roles. In each unit, leaders addressed the following series of questions:

- Where did the value for this unit come from?
- Which roles have been most critical?
- Would the new strategy entail new roles?
- What big disruptions might change role responsibilities?

[2] See Aaron De Smet, Bill Schaninger, and Matthew Smith, "The hidden value of organizational health—and how to capture it," *McKinsey Quarterly*, April 2014, McKinsey.com.

Then they went into even more detail. They mapped potential financial value to each role using the metric of projected five-year operating margin. Value creators were assigned the full economic value of their business's operating margin. Value enablers were assigned a percentage of value based on human judgment of their relative contribution to the relevant operating margin combined with an analytic perspective on which value levers those functions influenced.

Through this fact-based process, leaders identified more than 100 critical roles across all business units and corporate functions. In line with our experience, 20 percent were three layers or more below the CEO, often in counterintuitive places. More than 10 percent of the critical roles focused on digital priorities, advanced analytics, and other capabilities in very short supply in the current organization. About 5 percent focused on cross-functional integration. And at least 20 percent were entirely new or greatly evolved in scope.

The CEO, CHRO, and CFO sifted through the list to identify the 50 highest-value roles (for more on collaboration opportunities for these three executives, see "An agenda for the talent-first CEO," on page 28). The choice of 50 was not because it is a nice, round number. It is hard for a CEO to have clear visibility into more than about 50 roles. Also, in our experience, the top 25 to 50 roles can typically orchestrate the bulk of a company's potential value. The hiring, retention, performance management, and succession planning in these critical roles should all be of personal interest to the CEO.

The company's top managers then worked with business-unit leaders to create unique "role cards" for these top positions. Each card specified the role's mission; a list of jobs to be done, with a checklist of what was needed to capture the role's outsized share of value; and key performance indicators (KPIs). The KPIs were quite detailed. For instance, the KPIs assigned to the role of the general manager for one site were percent of on-time delivery, product- and account-specific earnings, percent share of spot volume, and share of volume from new customers. Creating such specific KPIs allowed leaders to articulate objectively the role's requirements, such as extensive sales and negotiation experience, demonstrated financial acumen, proven results as a strong team leader, experience in a corporate staff function, and a history of profit-and-loss ownership in a manufacturing setting. This objective articulation of requirements enabled both a fact-based assessment of incumbents in the role and a clear set of criteria against which to select new general managers.

Role identification and clarification is a process that works with any kind of organizational structure, including those based on agile principles. In fact, the potential rewards of value-based role clarity might even be greater in agile organizations, because flatter organizations build themselves around the principle that empowered talent in the right roles is the key to unlocking value. Pinpointing where a critical role sits in an organization chart is not important. What matters is knowing the potential outcomes of any given role, anywhere in the organization.

MATCH TALENT TO ROLES

Business leaders at Company X next turned to the job of finding the right people for the more clearly defined critical roles. Their search process was more efficient and effective than those associated with traditional "high potential" talent reviews thanks to two types of benefits that generally emerge from taking a more rigorous approach.

First, the articulation of value and roles for Company X allowed for objective comparisons between candidates across a variety of specific dimensions rather than relying on subjective hunches or a perfunctory succession plan. When a company uses such an approach, the talent-selection process becomes an evaluation of specific evidence. The CFO of a business unit that aims to increase value through a strategy of acquisitions, for example, should have a different background and experience base from the CFO of an organization that aims to increase value through aggressive cost reduction.

Second, the specificity of role requirements for Company X encouraged a more objective view of incumbent managers. Rigorously assessing incumbents against value-linked role requirements typically leads a company to realize that 20 to 30 percent of those in critical roles are not well matched. The data-driven process makes it hard to ignore the uncomfortable realizations that some incumbents might not be up to the future demands of the job and that leaving them in place would put a significant amount of value at risk.

Over time, some organizations come up against a happy problem: unexpected value that was not part of the strategic plan starts emerging. For instance, a product might enjoy a serendipitous viral uptake or a new service might enable the delivery of breakthrough customer experiences that shake up the competitive balance. Fortuitous, big moves such as these, which both reflect and necessitate strategic flexibility, also reinforce the power of linking talent to value (for more on what it takes to make breakout moves, see "Eight shifts that will take your strategy into high gear," on page 88).

How so? For starters, once a new source of value becomes clear, the company's understanding of its value agenda can shift to mine the potential of this new source—a move accompanied by a corresponding shift in the company's talent priorities. For example, a senior vice president of supply chain might have been reliable for years, but can he or she quickly activate the new set of reliable suppliers needed to get that unexpectedly hot product from R&D into the market as soon as possible? The discipline of understanding the requirements of key roles throughout a company helps give the CEO the agility to respond to such questions with alacrity.

The concept of matching talent to value is often a precursor to breakthroughs. These innovations commonly occur in contexts deliberately set up to enable them. Consider Tesla's effort to create a culture of fast-moving innovation, Apple's obsessive user-experience focus, and Corning's goal of easing "barriers to creativity and serendipitous advances."[3] These cultural priorities are at the core of these companies' value agendas. The roles created to turn such priorities into value are often related to R&D (such as the chief technical officer, chief design officer, and chief technologist) and filled with talented, creative people, such as Apple's Jony Ive, who thrive in the freedom of those particular roles.

The linking-talent-to-value process at Company X did more than just put the best people in critical roles. As the CEO tried to match the company's existing talent to these roles, she and other leaders realized that the company needed to retool its leadership development. Future leaders would have to develop the expertise (such as global line management or cross-functional collaboration) that would be high priorities in the new roles. Furthermore, these new leaders would need the mind-set and determination to accelerate breakthrough innovation. As often happens, the rigorous effort to match talent to value led the company's top executives to a deeper understanding of their business.

OPERATIONALIZE AND MOBILIZE

Linking talent to value is not a process that stops when roles are identified and matched to the appropriate top talent. To garner the expected value, leaders must manage these roles as assiduously as they do capital investments and use real-time critical metrics. An HR-leadership team might meet monthly to identify trends across business units—for example, the lag of certain role-specific KPIs, such as digital fluency. Working alongside business

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[3] See Dr. Waguih Ishak, "Creating an innovation culture," *McKinsey Quarterly*, September 2017, McKinsey.com.

leaders, the team might also assess changes in the performance of individuals in critical roles, asking questions such as, "Is this individual delivering the value expected? What interventions (for instance, coaching or better-aligned incentives) can support this individual?" The leadership team might even meet daily or weekly to manage real-time talent crises, such as a moment when people-analytics software identifies an immediate risk of attrition in a critical role.

Companies must also examine whether the HR team is up to the task of managing talent as rigorously as the finance team deploys financial capital. The following questions can help make this determination:

- Does the HR group have sufficient analytics capability?

- Can the department mine data to hire, develop, and retain the best employees more effectively?

- Do the HR team's business partners consider themselves internal service providers, or are they value coaches ensuring a high return on human-capital investment and driving outcomes for the external customer?

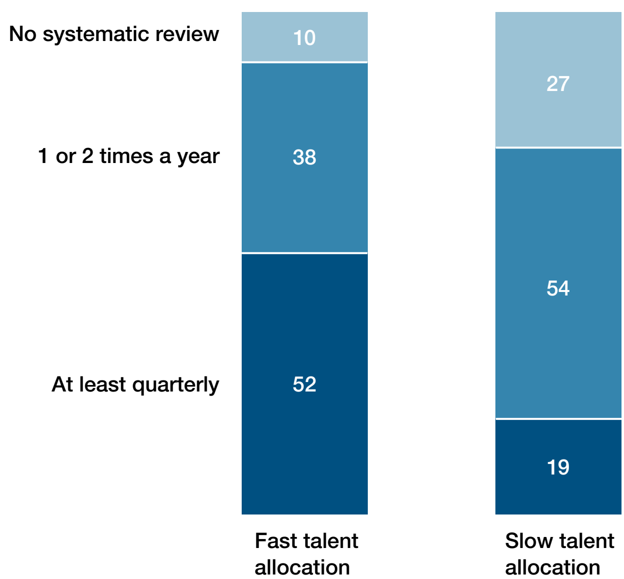
At one company that exemplifies the necessary rigor for matching talent to value, the HR team plans to develop semiautomated data dashboards that track the most important metrics for critical roles. Each critical role will have a customized dashboard to trace progress on relevant operational and financial KPIs (for example, segmented earnings before interest, taxes, depreciation, and amortization) against development activities (for instance, an instructional course). The metrics will tie to back-end organizational data, resulting in a mixture of automated and manual updating. The HR leadership team is learning how to use these dashboards to engage business leaders in regular talent reviews. Such a data-driven and technologically enabled review should ensure that the HR group provides targeted support through value-centered talent management.

Company X's CEO knows that her job is not complete. Talent and overall strategic planning must have a tighter link. Talent evaluation must be constant rather than sporadic. Her organization must learn to flex its new muscle linking talent to value continuously. At her company and every company, the set of critical roles is dynamic rather than a "one and done" process—it must be reevaluated each time strategic imperatives change. Talent management must become a frequent, agile process in which the CEO and executive-leadership team participate as actively as they do in financial-investment

Exhibit 2

About half of the companies identified as fast talent allocators review talent placement at least quarterly.

Frequency of talent-allocation review,
% of respondents (n = 628)



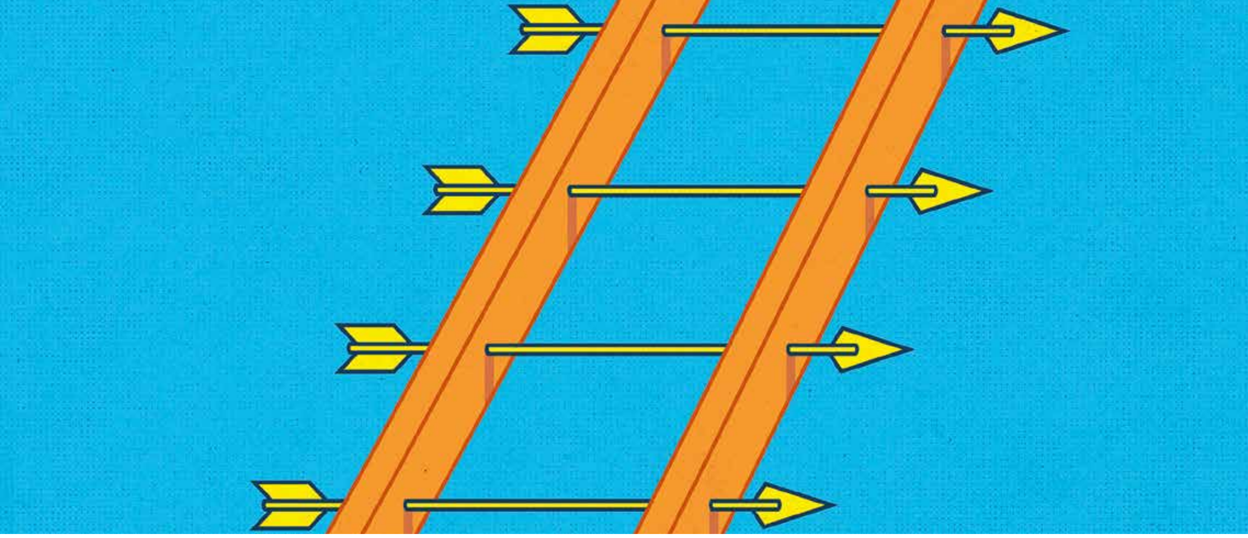
Source: 2017 McKinsey Global Survey on companies' talent-management practices

decisions. In the aforementioned survey of more than 600 respondents, we found that in a majority of companies identified as fast talent allocators, top business leaders met at least quarterly to review talent placement (Exhibit 2).

Even though its talent-to-value effort is a work in progress, Company X is better positioned than ever to achieve aggressive growth aspirations. Its ambitious plans have a much better chance of succeeding now that the company's leaders have done the difficult work of identifying where future value is at risk and mitigating that risk through more value-centric talent management. They are augmenting their strategic vision with a clear understanding of the kinds of leaders they will need to meet their goals. This kind of proactive linkage of talent to value must be the new normal for business leaders. Q

Mike Barriere is a partner in McKinsey's New York office, **Miriam Owens** is a consultant in the Chicago office, and **Sarah Pobereskin** is an associate partner in the London office.

The authors wish to thank Rahul Mathew for his contributions to this article.



The fairness factor in performance management

Many systems are under stress because employees harbor doubts that the core elements are equitable. A few practical steps can change that.

by Bryan Hancock, Elizabeth Hioe, and Bill Schaninger

The performance-management process at many companies continues to struggle, but not for lack of efforts to make things better. Of the respondents we surveyed recently, two-thirds made at least one major change to their performance-management systems over the 18 months prior to our survey.[1] With growing frequency, human-resources departments are dispensing with unpopular "forced curve" ranking systems, rejiggering relatively undifferentiated compensation regimes, and digging deeply into employee data for clues to what really drives motivation and performance. (For a look at how Microsoft CEO Satya Nadella is innovating with a system that uses hard and soft performance measures to reshape the culture, see "Metrics and meaning at Microsoft," on page 55.)

Yet companies don't seem to be making much headway. Employees still complain that the feedback they get feels biased or disconnected from their work. Managers still see performance management as a bureaucratic, box-checking exercise. Half of the executives we surveyed told us that their evaluation and feedback systems have no impact on performance—or even have a negative effect. And certain experiments have gone awry: at some companies, eliminating

[1] See Sabrin Chowdhury, Elizabeth Hioe, and Bill Schaninger, "Harnessing the power of performance management," April 2018, McKinsey.com.

annual performance reviews without a clear replacement, for example, has led employees to complain of feeling adrift without solid feedback—and some employers to reinstate the old review systems.

Amid ongoing dissatisfaction and experimentation, our research suggests that there's a performance-management issue that's hiding in plain sight: it's fairness. In this article, we'll explain the importance of this fairness factor, describe three priorities for addressing it, and show how technology, when used skillfully, can reinforce a sense of fairness.

THE FAIRNESS FACTOR

When we speak of fairness, we're suggesting a tight definition that academics have wrestled with and come to describe as "procedural fairness."[2] It's far from a platonic ideal but instead addresses, in this context, the practical question of whether employees *perceive* that central elements of performance management are designed well and function fairly. This eye-of-the-beholder aspect is critical. Our survey research showed that 60 percent of respondents who perceived the performance-management system as fair also stated that it was effective.

More important, the data also crystallized what a fair system looks like. Of course, a host of factors may affect employee perceptions of fairness, but three stood out. Our research suggests that performance-management systems have a much better chance of being perceived as fair when they do these three things:

1. transparently link employees' goals to business priorities and maintain a strong element of flexibility

2. invest in the coaching skills of managers to help them become better arbiters of day-to-day fairness

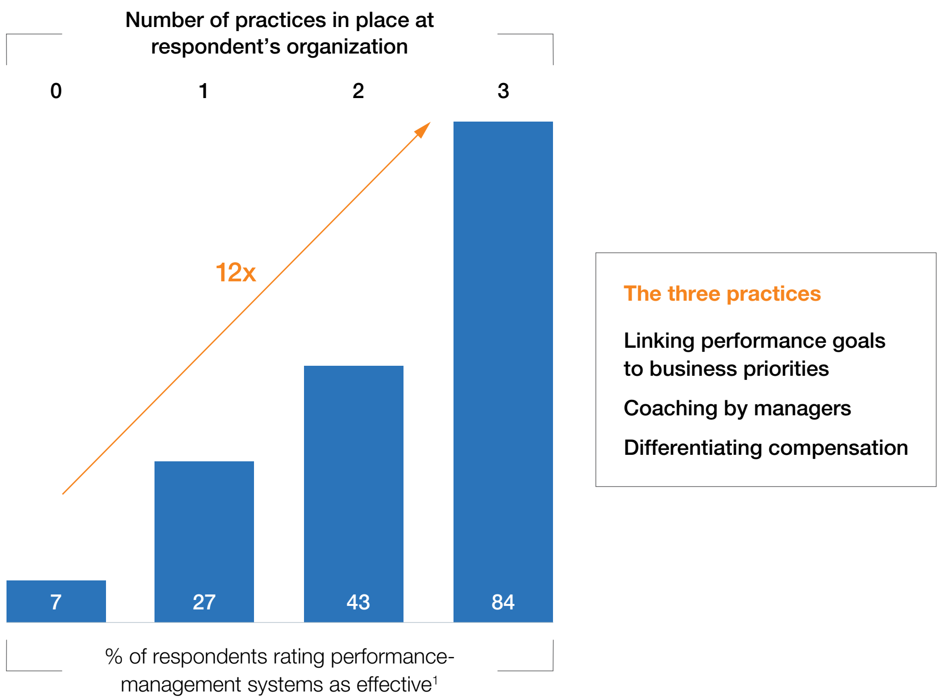
3. reward standout performance for some roles, while also managing converging performance for others

Such factors appear to be mutually reinforcing. Among companies that implemented all three, 84 percent of executives reported they had an effective performance-management system. These respondents were 12 times more likely to report positive results than those who said their companies hadn't implemented any of the three (exhibit).

[2] For additional research and insights into fairness in the organization, visit EthicalSystems.org.

Exhibit

Among a host of factors that may affect employee perceptions of fairness in performance management, three stood out.



[1] That is, having a positive impact on individual employees' performance and on their organizations' overall performance.
Source: McKinsey Global Survey of 1,761 executives on performance management, July 2017

Our research wasn't longitudinal, so we can't say for sure whether fairness has become more important in recent years, but it wouldn't be surprising if it had. After all, organizations are demanding a lot more from their employees: they expect them to respond quickly to changes in a volatile competitive environment and to be "always on," agile, and collaborative. As employers' expectations rise and employees strive to meet them, a heightened desire for recognition and fairness is only natural. And while embattled HR executives and business leaders no doubt want to be fair, fairness is a somewhat vague ideal that demands unpacking.

WINNING THE BATTLE OF PERCEPTIONS

In working with companies pushing forward on the factors our research highlighted, we have found that these require much greater engagement with employees to help them understand how their efforts matter, a lot more coaching muscle among busy managers, and some delicate recalibration of established compensation systems. Such shifts support a virtuous cycle that helps organizations get down to business on fairness.

1. Linking employees' goals to business priorities

Building a foundation of trust in performance management means being clear about what you expect from employees and specific about how their work ultimately fits into the larger picture of what the company is trying to accomplish. Contrast that sense of meaning and purpose with the situation at many organizations where the goals of employees are too numerous, too broad, or too prone to irrelevance as events change corporate priorities but the goals of individuals aren't revisited to reflect them. A typical ground-level reaction: "Managers think we aren't sophisticated enough to connect the dots, but it's obvious when our goals get disconnected from what really matters to the company."

Give employees a say and be flexible. Connecting the dots starts with making employees at all levels feel personally involved in shaping their own goals. Mandating goals from the top down rarely generates the kind of employee engagement companies strive for. At a leading Scandinavian insurer, claims-processing operations were bogged down by surging backlogs, rising costs, and dissatisfied customers and employees. The company formed a working group of executives, managers, and team leaders to define the key areas where it needed to improve. Those sessions served as a blueprint: four overarching goals, linked to the problem areas, could be cascaded down to the key performance indictors (KPIs) at the business-unit and team level and, finally, to the KPIs of individual employees. The KPIs focused on operational measures (such as claims throughput and problem solving on calls), payout measures (like managing contractors and settlement closures), customer satisfaction, and employee morale and retention.

The company took a big further step to get buy-in: it allowed employees to review and provide feedback on the KPIs to assure that these fit their roles. Managers had observed that KPIs needed to vary even for employees in roles with seemingly similar tasks; phone calling for a targeted auto claim is different from skills needed to remedy damage to a factory. So the insurer gave the managers freedom to adjust, collaboratively, the KPIs for different roles while still ensuring a strong degree of consistency. A performance dashboard allowed an employee's KPIs to be shared openly and daily with team members, making transparent both the teams' overall progress and the efforts of motivated, top performers.

For the vast majority of traditional roles, this collaborative approach to KPI design is fairly straightforward. For more complex roles and situations—such as when tasks are deeply interdependent across a web of contributors—

it can be more challenging to land on objective measurements. Such complex circumstances call for even more frequent feedback and for getting more rigorous about joint alignment on goals.

Adapt goals as often as needed. In today's business environment, goals set at a high level in the strategy room are often modified in a few months' time. Yet KPIs down the line are rarely adjusted. While we're not suggesting that employees' goals should become moving targets, they should certainly be revised in response to shifting strategies or evolving market conditions. Revisiting goals throughout the year avoids wasted effort by employees and prevents goals from drifting into meaninglessness by year-end, undermining trust. Of respondents who reported that their companies managed performance effectively, 62 percent said that those organizations revisit goals regularly—some on an ad hoc basis, and some twice a year or more. Managers must be on point for this, as we'll explain next.

2. Teaching your managers to be coaches

Managers are at the proverbial coal face, where the hard work of implementing the performance requirements embodied in KPIs gets done. They also know the most about individual employees, their capabilities, and their development needs. Much of the fairness and fidelity of performance-management procedures therefore rests on the ability of managers to become effective coaches. Less than 30 percent of our survey respondents, however, said that their managers are good coaches. When managers don't do this well, only 15 percent of respondents reported that the performance-management system was effective.

Start with agility. In a volatile business environment, good coaches master the flux, which means fighting the default position: goal setting at the year's beginning ends with a perfunctory year-end evaluation that doesn't match reality. At the Scandinavian insurer, team leaders meet weekly with supervisors to determine whether KPI targets and measures are in sync with current business conditions. If they aren't, these managers reweight measures as needed given the operating data. Then, in coaching sessions with team members, the managers discuss and adjust goals, empowering everyone. Even when things aren't in flux, managers have daily check-ins with their teams and do weekly team-performance roundups. They review the work of individual team members monthly. They keep abreast of the specifics of KPI fulfillment, with a dashboard that flashes red for below-average work across KPI components. When employees get two red lights, they receive written feedback and three hours of extra coaching.

Invest in capabilities. The soft skills needed to conduct meaningful performance conversations don't come naturally to many managers, who often perform poorly in uncomfortable situations. Building their confidence and ability to evaluate performance fairly and to nudge employees to higher levels of achievement are both musts. While the frequency of performance conversations matters, our research emphasizes that their *quality* has the greatest impact.

One European bank transformed its performance-management system by holding workshops on the art of mastering difficult conversations and giving feedback to employees who are missing the ball. To ready managers for impending steps in the performance-management cycle, the bank requires them to complete skill-validation sessions, moderated by HR, with their peers. Managers receive guidance on how to encourage employees to set multi-year stretch goals that build on their strengths and passions. Just before these goal-setting and development conversations with employees take place, managers and peers scrum it out to test each other's ideas and refine their messages.

Make it sustainable. At the European bank, the support sessions aren't one-off exercises; they have become a central element in efforts to build a cadre of strong coaches. That required some organizational rebalancing. In this case, the bank restructured aspects of HR's role: one key unit now focuses solely on enhancing the capabilities of managers and their impact on the business and is freed up from transactional HR activities. Separate people-services and solutions groups handle HR's administrative and technical responsibilities. To break through legacy functional mind-sets and help HR directors think strategically, they went through a mandated HR Excellence training program.

The Scandinavian insurance company chose a different road, seeking to disseminate a stronger performance-management culture by training "champions" in specific areas, such as how to set goals aligned with KPIs. These champions then ran "train the trainer" workshops to spread the new coaching practices throughout the organization. Better performance conversations, along with a growing understanding of how and when to coach, increased perceived fairness and employee engagement. Productivity subsequently improved by 15 to 20 percent.

3. Differentiating compensation

Capable coaches with better goal-setting skills should take some of the pain out of aligning compensation—and they do to an extent. However, new organizational roles and performance patterns that skew to top employees add to the challenges. Incentives for traditional sales forces remain pretty intuitive: more effort (measured by client contacts) brings in more revenue and, most likely, higher pay. It's harder to find the right benchmarks or to differentiate among top, middle, and low performers when roles are interdependent, collaboration is critical, and results can't easily be traced to individual efforts. The only way, in our experience, is to carefully tinker your way to a balanced measurement approach, however challenging that may be. Above all, keep things simple at base, so managers can clearly explain the reasons for a pay decision and employees can understand them. Here are a few principles we've seen work:

Don't kill ratings. In the quest to take the anxiety out of performance management—especially when there's a bulge of middle-range performers—it is tempting to do away with rating systems. Yet companies that have tried this approach often struggle to help employees know where they stand, why their pay is what it is, what would constitute fair rewards for different levels of performance, and which guidelines underpin incentive structures. Just 16 percent of respondents at companies where compensation wasn't differentiated deemed the performance-management system effective.

Dampen variations in the middle. With middle-of-the-pack performers working in collaborative team environments, it's risky for companies to have *sizable* differences in compensation among team members, because some of them may see these as unfair and unwarranted. Creating the perception that there are "haves" and "have-nots" in the company outweighs any benefit that might be derived from engineering granular pay differences in the name of optimizing performance.

Cirque du Soleil manages this issue by setting, for all employees, a base salary that aligns with market rates. It also reviews labor markets to determine the rate of annual increases that almost all its employees receive. It pays middling performers fairly and consistently across the group, and the differences among such employees tend to be small. Managers have found that this approach has fostered a sense of fairness, while avoiding invidious pay comparisons. Managers can opt not to reward truly low performers. Cirque du Soleil (and others) have also found ways to keep employees in the middle range of performance and responsibilities whose star is on the rise happy: incentives that are not just financial, such as explicit praise, coaching, or special stretch assignments.

Embrace the power curve for standout performers. Research has emerged suggesting that the distribution of performance at most companies follows a “power curve”: 20 percent of employees generate 80 percent of the value. We noted this idea in a previous article[3] on performance management and are starting to see more evidence that companies are embracing it by giving exceptional performers outsized rewards—typically, a premium of at least 15 to 20 percent above what those in the middle get—even as these companies distribute compensation more uniformly across the broad midsection.

At Cirque du Soleil, managers nominate their highest-performing employees and calibrate pay increases and other rewards. Top performers may receive dramatically more than middle and low performers. In our experience, employees in the middle instinctively get the need for differentiation because it’s no secret to them which of their colleagues push the needle furthest. Indeed, we’ve heard rumblings about unfair systems that *don’t* recognize top performers. (For a counterpoint to radical performance differentiation, see “Shared rewards at Hilcorp,” on page 57, where CEO Greg Lalicker explains how the oil and gas producer sets exacting production standards and then—if they’re met—gives every employee a power-curve bonus.)

Innovate with spot bonuses. Recognizing superior effort during the year can also show that managers are engaged and that the system is responsive. Cirque du Soleil rewards extraordinary contributions to special projects with a payment ranging from 2 to 5 percent of the total salary, along with a letter of recognition. In a recent year, 160 of the company’s 3,500 employees were recognized. Spot bonuses avoid inflating salary programs, since the payments don’t become part of the employee’s compensation base.

TECHNOLOGY’S ROLE

Digital technologies are power tools that can increase the speed and reach of a performance-management transformation while reducing administrative costs. They’re generally effective. Sixty-five percent of respondents from companies that have launched performance-related mobile technologies in the past 18 months said that they had a positive effect on the performance of both employees and companies. A mobile app at one global company we know, for example, makes it easier for managers and employees to record and track goals throughout the year. Employees feel more engaged because they know where they stand. The app also nudges managers to conduct more real-time coaching conversations and to refine goals throughout the year.

[3] See Boris Ewenstein, Bryan Hancock, and Asmus Komm, “Ahead of the curve: The future of performance management,” *McKinsey Quarterly*, May 2016, McKinsey.com.

Does technology affect perceptions of fairness? That depends on how it's applied. When app-based systems are geared only to increase the *efficiency* of a process, not so much. However, when they widen the fact base for gauging individual performance, capture diverse perspectives on it, and offer suggestions for development, they can bolster perceived fairness. We have found that two refinements can help digital tools do a better job.

Sweat the small stuff

In an attempt to move away from a manager-led performance system, German e-commerce company Zalando launched an app that gathered real-time performance and development feedback from a variety of sources. The company tested behavioral "nudges" and fine-tuned elements of the app, such as its scoring scale. Yet it found that the quality of written development feedback was poor, since many employees weren't accustomed to reviewing one another. The company solved this problem by redesigning the app's interface to elicit a holistic picture of each employee's strengths and weaknesses, and by posing a direct question about what, specifically, an employee could do to stretch his or her performance. The company also found that feedback tended to be unduly positive: 5 out of 5 became the scoring norm. It did A/B testing on the text describing the rating scale and included a behavioral nudge warning that top scores should be awarded only for exceptional performance, which remedied the grade inflation.

Separate development from evaluative feedback

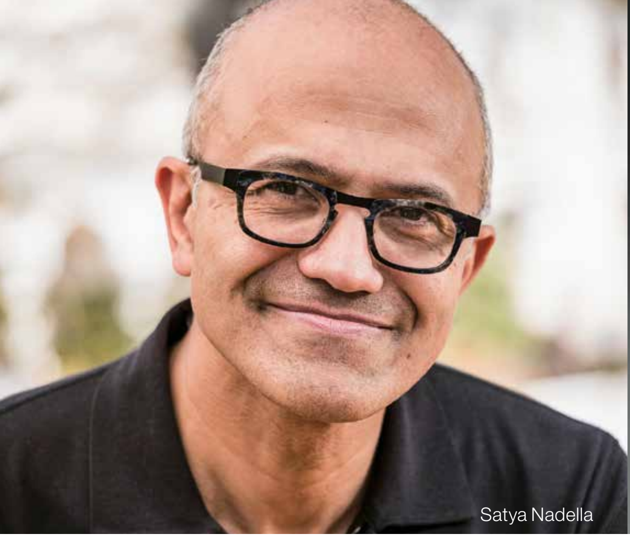
Digitally enabled, real-time feedback produces a welter of crowdsourced data from colleagues, and so does information streaming from gamified problem-solving apps. The data are powerful, but capturing them can trigger employees' suspicions that "Big Brother is watching." One way to address these fears is to distinguish the systems that evaluate employees from those that help them develop. Of course, it is tempting to make *all* the data gathered through these apps available to an employee's manager. Yet when employees open themselves to honest feedback from their colleagues about how to do their jobs better, they're vulnerable—particularly if these *development* data are fed into *evaluation* tools. That also undercuts the purpose (and ultimately the benefits) of digitally enabled feedback. Apps should be designed so that employees can decide which feedback they ought to share during their evaluations with managers.

To broaden adoption of the system, Zalando stressed that the app was to be used only for development purposes. That helped spur intense engagement, driving 10,000 users to the app and 60,000 trials in the first few months. Employees reacted positively to sharing and evaluating data that would help them cultivate job strengths. With that base of trust, Zalando designed a performance dashboard where all employees can see, in one place, all the quantitative and qualitative feedback they have received for both development and evaluation. The tool also shows individuals how their feedback compares with that of the average scores on their teams and of people who hold similar jobs.

The many well-intentioned performance-management experiments now under way run the risk of falling short unless a sense of fairness underpins them. We've presented data and examples suggesting why that's true and how to change perceptions. At the risk of oversimplifying, we'd also suggest that busy leaders striving to improve performance management listen to their employees, who have a pretty good idea about what fair looks like: "Just show us the link between what we do and what the company needs, make sure the boss gives us more coaching, and make it all pay." In our experience, when leaders understand, address, and communicate about the issues at this level, employees see performance management as fair, and the reform efforts of their companies yield better results. Q

Bryan Hancock is a partner in McKinsey's Atlanta office, **Elizabeth Hioe** is an alumna of the New Jersey office, and **Bill Schaninger** is a senior partner in the Philadelphia office.

The authors would like to thank Sabrin Chowdhury for her contributions to this article.



How we do it: Performance-management tips from the top

Microsoft CEO Satya Nadella and Hilcorp CEO Greg Lalicker describe incentive systems that encourage fairness and shared rewards.

Creative experimentation with performance management is underway at a wide range of companies. How wide? Consider these reflections by the CEO of one of the world's largest public technology companies on changes afoot at Microsoft, and the CEO of Hilcorp, a privately owned oil and gas company, on an innovative system for sharing the success one barrel at a time.

METRICS AND MEANING AT MICROSOFT

The *Quarterly*: *What can you tell us about the changes you've made related to performance management?*

Satya Nadella: One of the big things that we have done at the leadership level is to focus on shared metrics. We make a distinction between what we call "performance metrics" and "power metrics." Performance metrics are in-year revenue and profit and things of that nature. Power metrics are about future-year performance. They are leading indicators of future success and are more about usage and customer love or satisfaction. We have a blend

> “Work is a large part of what we do in life. If it was only about achieving some scorecard metrics, I don’t think that would be enough of a deep meaning.”
>
> — Satya Nadella, CEO of Microsoft

of metrics that are few but shared. A large part of the compensation for me and my leadership team is fundamentally based on that.

The *Quarterly*: *So that scorecard has been reconfigured during your tenure?*

Satya Nadella: Correct. In fact, a lot of our own tools have become instruments of changing culture. We track metrics such as monthly actives, monthly active versus daily active ratios, consumption, consumption growth. These are all the things that we measure as much as we measure any end-quarter revenue or profit by segment. And these are tied to compensation. Also, it’s not just the leadership team. In the field, our sales culture has changed a lot because we have put a lot of the sales-compensation levers to also go from just the one-time license or bookings to actual consumption, which means it aligns us much better with our customers and their success in using the products and getting benefits out of them.

I do believe that if you just talk about culture change and customer obsession without tying it to some of these core levers of how you measure performance, the entire program can come to a knot. In our case, we have been able to take action on all of those levers.

The *Quarterly*: *You’ve talked a lot about the need for a culture of greater empathy because it’s only through empathy that you can really understand the unmet needs of customers. Some of these forward-looking metrics feel almost like “empathy metrics”: Are products getting traction? Do customers love them? Are they using them?*

Satya Nadella: That's correct. All of us are human. However, when you think about culture as all about business and metrics and scorecards, you can get a lot but it just doesn't invoke that real, innate capability that we all have. Work is a large part of what we do in life. If it was only about achieving some scorecard metrics, I don't think that would be enough of a deep meaning.

The reason I talk about empathy is that I believe this is the leading indicator of success. Innovation comes only when you are able to meet unmet, unarticulated needs—and this comes from a deep sense of empathy we all have. But you can't go to work and, say, "turn on the empathy button." Your life's experience will give you that passion and understanding for a particular customer, a particular use case. How you can connect [your life experience] to your work is what we want to invoke in the 100,000 people who work at Microsoft. All these metrics, which are real compensation drivers, do relate to this. But I don't think we make decisions thinking that these two things are connected.

We as humans all have bounded rationalities, Herbert Simon would say. Therefore, it might, in theory, be correct, but in practice, none of us make decisions thinking of this as connected.

Read the full interview, "Microsoft's next act," conducted by McKinsey Publishing's Simon London, on McKinsey.com—or subscribe to the *McKinsey Podcast* on iTunes to hear the audio version.

SHARED REWARDS AT HILCORP

The *Quarterly*: *How does Hilcorp use its performance-management system to encourage organizational alignment?*

Greg Lalicker: We want it to be in everybody's best interest that Hilcorp succeeds and, when we do succeed, that everybody shares in the rewards equitably. This alignment helps motivate everyone making the 10,000 little decisions to do the right thing.

So Hilcorp sets company-wide targets over a series of five-year periods with incentives for all employees if Hilcorp achieves the goals. The effect is to ensure that everyone makes decisions in the interests of meeting those company-wide targets. From 2006 to 2011, for example, the target was to double the production rate from 40,000 barrels of oil equivalent per day (boe/day) to 80,000 boe/day, to double reserves from 125 million boe to 250 million boe, and to double the value of the business from $1 billion to $2 billion.

The *Quarterly*: *And the link to incentives?*

Greg Lalicker: When the 2011 goal was met, every employee got $50,000 to spend on a car—the same amount for everyone who was here the whole five years. Our 2011 to 2015 target was to reach 120,000 boe/day, 500 million boe, and $6 billion value, and the reward was $100,000 cash per employee. Now the latest target is 275,000 boe/day. The reward will be the cash equivalent of one boe for every day a person was employed at Hilcorp during those five years. Depending on prices, that will come out to $50,000 to $75,000 for anyone who was employed for the entire five years. Operations people like the idea that the first barrel they produce each day is theirs—as long as the company meets its targets.

The *Quarterly*: *Is that it, or are there other forms of alignment through incentives?*

Greg Lalicker: Hilcorp pays *annual* bonuses linked to overall company performance—production rate, midstream income, reserves, and operating cost. The annual bonus payout is up to 60 percent of salary and is the same number for every employee—no team component, no individual component—one number for the entire organization. We also have a program that ensures that employees own a synthetic working interest in the fields: they get to effectively buy into the assets on the same basis that Hilcorp itself bought in.

On the other hand, we target our base compensation at Hilcorp to be roughly average for the relevant job market. It is only through achieving success that people can earn significantly more. Initially, some staff might take a cut in base pay, so they have to believe that the upside potential is real.

The *Quarterly*: *I notice that incentives are linked to production, reserves, and value—but not safety . . .*

Greg Lalicker: That's right. Safety is too important to be in the incentive program. Safety is a requirement, not an upside. If people aren't working hard to operate safely, then they are fired.

The *Quarterly*: *What are the challenges here in this model of incentive and compensation?*

> "We want it to be in everybody's best interest that Hilcorp succeeds and, when we do succeed, that everybody shares in the rewards equitably."
>
> —Greg Lalicker, CEO of Hilcorp

Greg Lalicker: One challenge we have to watch out for is the "free rider" problem [employees not pulling their weight but profiting from the company's performance]. It is pretty simple to deal with: our people are expected to succeed in their job, and if they don't, then we coach them and try to help them improve. If that doesn't work, we look to see if they could succeed someplace else in the company. And if they don't succeed there, then they are out.

The *Quarterly*: *Do individual freedom and team autonomy come as a shock to new arrivals? How do you imbue the Hilcorp culture in new recruits?*

Greg Lalicker: It often takes about two years before new staff fully gets how the company works. It can be a bit of a shock. It's hard for people to realize they have the freedom to do something until they see that people don't get chewed out for making reasonable mistakes. New employees usually need to see us set the plan, create the bonus program, and actually pay out before they fully believe in the model. Once they get it, most of them like it—our turnover for staff who have been here more than two years is extremely low. Q

Read the full interview, "Digging deep for organizational innovation," conducted by McKinsey's Peter Lambert, on McKinsey.com.

SPOTLIGHT ON LEADERSHIP

Illustrations by webuyyourkids

In this package

Leading with inner agility

Disruptive times call for transformational leaders with a knack for addressing complex problems. To navigate effectively, we must learn to let go—and become more complex ourselves.

by Sam Bourton, Johanne Lavoie, and Tiffany Vogel

We live in an age of accelerating disruption. Every company is facing up to the profound changes wrought by digitization. Industry boundaries have become permeable. Data, algorithms, and artificial intelligence are changing the nature of forecasting, decision making, and the workplace itself. All this is happening at once, and established companies are responding by rethinking their business models, redesigning their organizations, adopting novel agile-management practices, and embracing design thinking.

We've had a front-row seat at many such transformation efforts. Their importance, and the challenge they pose for institutions, has been well documented by management writers. But comparatively little attention has been paid to the cognitive and emotional load that change of this magnitude creates for the individuals involved—including the senior executives responsible for the success or failure of these corporate transformations. What makes the burden especially onerous is the lack of clear answers: the very nature of disruption means that even the best, most prescient leaders will be steering their company into, and through, a fog of uncertainty.

You aren't alone if you feel threatened by this—everyone does, whether consciously or subconsciously. Even seasoned leaders internalize the acute stress of such moments—so much so that their judgment and decision-making skills seem insufficient. The result? They fall back on old habits, which, unfortunately, are almost always out of sync with what the current context demands.

The *problem* isn't the problem; our *relationship* to the problem is the problem. In other words, we have many of the skills needed to handle what's being thrown at us. But when faced with continual complexity at unprecedented pace, our survival instincts kick in. In a mental panic to regain control, we fight, flee, or freeze: we act before thinking ("we've got to make some kind of decision, *now*!"), we analyze an issue to the point of paralysis, or we abdicate responsibility by ignoring the problem or shunting it off to a committee or task force. We need inner agility, but our brain instinctively seeks stasis. At the very time that visionary, empathetic, and creative leadership is needed, we fall into conservative, rigid old habits.

You can't steer your company through constant change if you are relying on the safety of your own cruise control. To spot opportunities—and threats—in this environment, we must teach ourselves how to have a more comfortable and creative relationship with uncertainty. That means learning how to relax at the edge of uncertainty, paying attention to subtle clues both in our environment and in how we experience the moment that may inform unconventional action.

Developing this kind of inner agility isn't easy. In some ways, it goes against our very nature, which wants to simplify a problem by applying our expert mind-set and best practices. To address complex problems, we need to become more complex ourselves. We need to recognize and appreciate emergent possibilities. That's how the complexity we face can become manageable, even exciting.

In our experience, five personal practices can meaningfully contribute to the mind-set needed for leadership effectiveness during transformative times. They are extensions of timeless principles of centered leadership; taken together, they can be the building blocks of your personal inner agility:

1. *Pause to move faster.* Pausing while remaining engaged in action is a counterintuitive step that leaders can use to create space for clear judgment, original thinking, and speedy, purposeful action.

2. *Embrace your ignorance.* Good new ideas can come from anywhere, competitors can emerge from neighboring industries, and a single technology product can reshape your business. In such a world, listening—and thinking—from a place of *not* knowing is a critical means of encouraging the discovery of original, unexpected, breakthrough ideas.

3. *Radically reframe the questions.* One way to discern the complex patterns that give rise to both problems and windows of emergent possibilities is to change the nature of the questions we ask ourselves. Asking yourself challenging questions may help unblock your existing mental model.

4. *Set direction, not destination.* In our complex systems and in this complex era, solutions are rarely straightforward. Instead of telling your team to move from point A to point B, join them in a journey toward a general direction. Lead yourself, and your team, with purposeful vision, not just objectives.

5. *Test your solutions—and yourself.* Quick, cheap failures can avert major, costly disasters. This fundamental Silicon Valley tenet is as true for you as it is for your company. Thinking of yourself as a living laboratory helps make the task of leading an agile, ever-shifting company exciting instead of terrifying.

To be clear, these steps are not panaceas but a set of interrelated touchstones. Nor are they trivial to tackle. (See sidebar, "Micropractices that help you find stillness.") But with conscious, disciplined practice, you stand a better chance of rising above the harried din of day-to-day specifics, leading your team effectively, and surveying your company and its competitive landscape with creative foresight. Let's look now at how this played out in some real-life examples, starting with two leaders who were trying to save a merger that had unfolded in unpredictable, troubling ways.

1. PAUSE TO MOVE FASTER

Anticipating tough questions at an upcoming board meeting, the CEO and CFO of a global manufacturer met to review the status of a substantial merger they had engineered about 12 months earlier. It wasn't a pretty picture. Despite following the integration plan closely, despite intensive scenario planning, and despite clear, achievable targets, productivity was falling. The more the two dug into the results of their grand plan, the more heated the discussion. The CFO wanted to shutter a dozen factories in the company's expanded portfolio. The CEO, who had promised that the merger would lead to bold innovation, wanted to increase funding of those very plants, since they were making the ambitious products the company would need in the long run. Despite having worked together for quite a while, the two men had such differing views that neither knew how to move forward together.

Micropractices that help you find stillness.

The five practices described in our main story are only the starting point for developing inner agility, and they require sustained commitment. It's easy to slip back into the groove of old habits, particularly when uncertainty inspires fear. Here is a short list of cognitive, centering micropractices—muscle builders, you might call them—that can help you stay on track.

The four-breath pause

Sometimes, when we're afraid of not knowing, we try to rush to some kind of answer. To slow down the process and gain some perspective, count through four breaths, paying attention to nothing but your inhaling and exhaling air. That's a quick way to give yourself a break from the chaos around you.

Grow roots

Leaders need the mindfulness to be both part of and yet separate from their context. One helpful way of doing this during a meeting is to put both feet on the floor and visualize roots extending from your soles down through the surface below. This centering practice can quiet overthinking, making you more receptive to new ideas.

Take ten minutes (or even one)

Meditation isn't a panacea, but many executives find it helpful. Attention management is a must for executives overloaded with information. As one leader told us, "Without those ten minutes, I have no stillness." Others make a point of grabbing one minute of stillness between meetings. "It gives me a sense of spaciousness," one CEO explained.

Listen from a place of not knowing

Listening well is an underappreciated art and a requirement for any leader faced with today's widening range of threats and opportunities. You must put aside preconceptions to truly hear what someone else has to say. In conversation, Pixar president Ed Catmull never responds until the other person has finished speaking. This enables him to appreciate the other's full thought, and to respond articulately.

Draw a bigger weather map

Feeling overwhelmed in the face of uncertainty is like looking out your window onto a thunderstorm—you're socked in, and there's no way you're going to venture out. At times like this, it helps to expand the boundaries of your mental weather map to see the weather patterns (business trends) that created the thunderstorm (your current business dilemma). Taking the long view can diminish the anxiety caused by near-term worries.

The stakes were highly personal. The CFO feared that the board and his executive colleagues would blame him for failing to identify the true cost structure of the combined companies. He gave serious thought to resigning. The CEO feared that the board would begin to doubt his strategic rationale for the merger. With their competence threatened, each had reverted to fallback positions, insisting that their own experience justified the solution they proposed. That's why their two days of nonstop meetings had led to an impasse.

Then they agreed to temporarily halt their discussions. Given the urgency each man felt, this was not an easy decision. But they believed they had no other choice—they weren't going to arrive at a solution by continuing to butt heads. They agreed to cut off their conversation for a week and committed to spending the time investigating the productivity failure on their own, hunting for clues they might have missed.

The two leaders had decided to pause, in order to move faster. This kind of pause isn't an abdication; it isn't even a concession that finding an answer will take a long time. Instead, it's a real-time pause that allows you to decouple from the immediate challenge so that you can find new ways of responding. Instead of being limited by old habits, you're trying to give yourself greater freedom of choice.

Most executives have trouble pulling back from obsessive engagement with the issue at hand; for many, in fact, that focus has been a key to success. But trying to survive one crisis after another by relying on the tried and true isn't enough these days. Pausing in the chaos of great change is a counterintuitive action that can lead to greater creativity and efficiency. It carves out a safe space for self-awareness, for recentering yourself, for something new to emerge.

Claiming this space is hard, and there are no silver bullets. Some CEOs like daily meditation. We know one CEO who takes a ten-minute walk through the neighborhood around his office—leaving his cell phone on his desk. Others regularly catch a minute's worth of deep breathing between meetings. The repetition of such practices helps them pause in the moment, interrupt well-grooved habits that get triggered under duress, and create space to practice something different.

Pausing requires substantial self-awareness, and you may not get immediate results. Every bit of benefit counts, though, and if you don't start the journey of learning how to decouple from your context and the immediate response it provokes, you'll find it harder and harder to be open to new ideas, or to become a better listener—both traits that are critical at moments where your own vision is clouded.

2. EMBRACE YOUR IGNORANCE

During their week apart, the CEO and the CFO dug around for answers. The CFO met with plant managers, who described a pattern of project delays caused by costly reworking of product designs. Several HR leaders told the CEO that people at all levels—hourly workers, supervisors, and managers—were frustrated. Trying to meet the unrealistic assumptions made during the merger process, managers were serving up impossible and confusing directives to supervisors, who in turn were leaning heavily on workers.

The information was interesting. But the CEO and CFO agreed that they were still largely in the dark. They decided that they would next meet with all the members of the executive team. They needed the help of many voices.

With the whole team gathered, the CEO and the CFO listed their assumptions about what might have caused the productivity slump. Then they went around the room, asking questions: How may we be wrong? What else is happening? Who sees this differently? The chief human-resources officer, a quiet fellow during most discussions about operations, spoke up to say that absenteeism was at an all-time high. The vice president of marketing mentioned that the company's largest customer had complained recently about the call center. As more managers weighed in, patterns started to emerge, patterns that had nothing to do with numbers. The vice president of strategy, who was in the process of moving into a new house with her new husband and children, said, "This reminds me of my kids. Joe and I were so focused on making the move happen efficiently that we completely missed the fact that our kids were anxious. They needed to be reassured, not told they were moving into the perfect room! I wonder if fears and anxieties in our employee base could be driving this." Together, the managers came to a jarring realization: they had failed to reassure employees about this massive change in their lives.

The CEO and CFO would never have uncovered this answer without acknowledging their own ignorance, and without listening carefully and openly. Furthermore, as everyone around the table acknowledged, their conclusion raised a whole set of new questions, some potentially more important than the productivity problem. How could the executive team have missed this? How could they have been so wrong? Even more broadly, what kind of culture were they creating at this company? A productivity problem had become an existential question about the mental health of the company. Sometimes, ignorance can push you further than expertise. In fact, ignorance is a necessary asset in this age of disruption. Expecting that you can know everything is a hubristic concept of the past.

But embracing your ignorance is hard. Letting go of your need to know means challenging your own identity as exceptionally competent. One CEO we know pretends to have a long dinosaur tail that represents all her life experience. In meetings, she imagines that she tucks it away beneath her. It's comforting that it's there. It allows her to lean back and access a sense of self-sufficiency that can be summed up by the thought, "I am enough." That comfort shifts her into a deeper listening mode, where she's unencumbered by the urge to provide a quick answer. She feels that she's able to hear not just the words and ideas of others, but the subtext of conversations. Since adopting this practice, she's received feedback that people feel more empowered and creative when meeting with her.

A dinosaur tail isn't for everyone. Another CEO makes a conscious practice of listening with his heart instead of listening with logic. He finds himself more fully digesting what the other person is saying. His curiosity is piqued as he pays better attention to their concerns, needs, and ideas. He believes he has become more patient, which has created more space for creative dialogues.

The embrace of ignorance cuts against the grain for most of us and can take a lifetime to master. To get started, ask yourself some probing questions. First: "Do I suspend judgment and listen for what is below the words, or do I listen for what I already know or believe?" If it's the latter (as it is for so many of us), go on to this second one: "What would I have to let go of to truly listen?" Third: "What is the very worst that could happen?" The answer to that can help you find the hidden fear that you may need to befriend. And, finally, there's a fourth: "Am I the leader I want to be?" If the answer is "not yet," then you know why embracing ignorance must become a priority. Asking these questions may not dissolve the reactive habits that hold us back, but they can begin a process of letting go to find new capacities within ourselves.

3. RADICALLY REFRAME YOUR QUESTIONS

The CEO and CFO of our global manufacturer could have reacted in two ways to that boardroom discussion. They might have said, "Let's get back to basics and just attack productivity. After all, *that* is the problem we set out to solve." But they chose to pursue a bigger question: "What kind of culture do we want to create?"

After the meeting with the executive team, the CEO and CFO set out on a "listening tour"—a valuable executive response that becomes even more important as technology increases the clock speed of our lives. For ten days, the two leaders toured plants and visited regional offices, listening to shop-floor workers, managers, division-level HR executives, and operations specialists. They didn't go in with predetermined questions. Instead, they posed open-ended questions designed to surface multiple, and often hidden, perspectives. They relentlessly asked, "and what else?" to unearth viewpoints that had gone untapped for so long.

Then the CEO and CFO again assembled the executive team. Now, armed with a panoply of varied, often colliding perspectives, the team could dig into the root causes of those productivity decreases. This wide-open, wide-ranging dialogue reset the direction of the merger. New goals were set on new timetables, based on a better understanding of what employees needed and the way employee networks in the merged company fed off one another. The CEO and other leaders revived the sense of purpose that employees had felt for so long by transparently recentering the company's transformation on the customer. They also empowered a set of shop-floor change agents to drive the shift through every layer of the company. It wouldn't be hyperbole to say that answering the bigger question—what kind of culture do we want to create?—saved the merger.

Radically reframing the question isn't just good for the company. It's a critical skill for any modern executive, and it takes time to build. Start by challenging yourself. Revisit the diversity of your personal network, which for many of us looks too familiar, too much like *us*, to provide significant exposure to alternative viewpoints. Another useful prod is asking yourself challenging questions, such as, "What is wrong with my assumption? What am I missing? Am I expanding the boundaries of the problem, to allow for unexpected factors?" Identify those who most oppose your view, and understand the story from their point of view. These kinds of questions and conversations take you into the unknown, which is where you'll find the most valuable answers.

When you step into the unknown, you also boost your odds of getting a glimpse of "inner blockers" that can inhibit you from leading with inner agility. The CFO realized that his initial stubbornness was driven by a deep fear of failure that had been with him for years. The CEO came to understand his own actions in very personal ways. Ever since he was 16, when his father had passed away, he had assumed responsibility for providing for his mother and for his extended family. Providing for those around him was a value that carried through to his work life and had helped him succeed. But in this case, he had been *over*protective. Too focused on his own need to deliver on his promises, he hadn't listened carefully and openly to his people. After working his way through this crisis, he would never infantilize his workforce again. Since then, his people have become his most important source of innovation and ideas.

4. SET DIRECTION, NOT DESTINATION

Let's turn to another situation. The new CEO of a supplier to a major manufacturing sector wanted to signal quickly and clearly where the company was headed. The 150-year-old company had lost ground to overseas competitors, so he believed a transformation was in order, and fast. He replaced 60 percent of his executive staff with newcomers from entrepreneurial companies and announced that the company would be the low-cost provider of its most important part. He dubbed it the "three-dollar plan." He was sure that this clear, concrete plan would pay off in many ways: existing customers would be pleased, new ones would be won, profits would rise, and employees would be cheered by the turnaround.

One year later, however, the numbers told a different story. Expected cost savings from manufacturing efficiencies weren't showing up. Profits and sales were flat. Employee engagement, as measured by participation in the annual survey, had dropped by 20 percent. Uncertain about how to respond, he took a step back: he and some top advisors began asking a lot of questions of people at all levels of the company.

As he listened, he came to understand his big mistake: instead of sharing a vision of the general direction for the company, he had pointed employees to a destination, and given them no context for his decision. The company had long been admired for its great customer service, and many longtimers didn't understand how the "three-dollar plan" could coexist with that reputation. His clarity had denied their creativity: they saw the plan for what it was, a productivity goal, not a vision that demanded their best work and thinking. Without a supportive, engaged workforce, the plan had failed.

Fast forward to today: two years after that realization, pride in the work has been reestablished, and the company is on solid financial ground. What changed?

The CEO changed. As he was reflecting on why his staff had lost motivation, several family portraits that adorned his office caught his eye. Family was important to him, and he suddenly realized that he managed that part of his life very differently from his company. He didn't give deterministic outcomes to his children. Instead, he tried to point them in certain values-based directions and give them the tools to succeed, knowing that the outcome would depend much more on their talents than his dictates. He accepted his children's independence, but not his workers'. He determined to manage his company the way he parented. He engaged the staff in determining the direction of the company; he tasked a diverse group of employees with figuring out whether the three-dollar plan could coexist with the customization that had given the company such a great reputation for customer service and innovation. They came to believe it could, and even developed a tagline that nodded to the past while pointing to a new direction: "Building the business together for the next 150 years on a proud heritage."

We'd be the first to acknowledge that applying techniques from the home front won't work for everyone: after all, some executives are more autocratic at home than in the office! Still, we think any leader of a business that depends on the creativity of its people will find value in bringing this directional mind-set into the office.

Setting a direction that is rooted in purpose and meaning can inspire positive action and invite others to stretch out of their comfort zone. Make it personal by starting with your own personal vision: What really matters for you? What do you want to create through your leadership? What do you want to be remembered for? What do you want to discover? These are the kinds of questions that help you set a meaningful, values-based direction, for yourself and others.

5. TEST YOUR SOLUTIONS, AND YOURSELF

Developing inner agility is a process of accepting less control than makes you feel safe. But that doesn't mean you're embracing chaos.

Most Silicon Valley companies are networks, designed so that ideas will spark from many different corners of the organization. How do they surface the best ones? By testing often, creating "safe to fail" experiments and then rewarding learning. Testing fast and small is critical for agile companies. It ensures that you can respond quickly to technological shifts or changed market conditions. And microfailures reduce the chance of macrofailures.

Applying this testing concept to yourself is a critical part of developing inner agility. Try to create mindful experiments for yourself. A baby step: ditch your slideshow presentation for an important meeting, and instead try to stimulate unconventional thinking by telling a story. You may bomb, but that's OK—you're starting to learn how to unearth new viewpoints. Using everyday leadership situations as a practice ground can help you build comfort with uncertainty and develop the learning mind-set needed to provide leadership at a time when, as Andy Grove once said, "None of us have a real understanding of where we are heading."[1]

Testing and experimentation is tightly intertwined with the other four practices of inner agility. The experiments we conduct move us in the direction we have set, while the process of setting a direction that's rooted in purpose helps us build the courage to experiment. Pausing helps us to decouple from our context and develop comfort with *not* knowing, a necessary condition for any meaningful experiment. And reframing and expanding the questions we ask ourselves gives us the broad perspective we need to create experiments that will move us in the right direction.

In times of complexity and high stress, we find our sense of our own competence (and sense of self!) continually challenged. We have two choices: try to reduce discomfort by falling back on trusted habits, or embrace the complexity and use it to learn and grow. Bold leaders will develop a new relationship to uncertainty. We must grow more complex from within. Taken together, the five practices we have discussed here are the foundation of a mind-set that is comfortable with leading despite, and through, uncertainty. The more you practice these steps, the more you will develop inner agility, tap into creativity, and enjoy the ride! Each small failure will teach you something, and each success will help confirm that it is possible to lead effectively without having all the answers. Today's leaders must be like eagles, who don't flap their wings harder or strain against the wind stream when they encounter great turbulence. Instead, they become even more still, knowing that they have the agility and self-possession to soar even higher. Q

[1] See Jeffrey Pfeffer and Robert I. Sutton, *Hard Facts, Dangerous Half-Truths, and Total Nonsense: Profiting from Evidence-Based Management*, first edition, Boston, MA: Harvard Business School Publishing, 2006, p. 201.

Sam Bourton is the cofounder and chief technology officer of QuantumBlack, a McKinsey company, and is based in McKinsey's London office; **Johanne Lavoie** is a partner in the Calgary office and coauthor of *Centered Leadership: Leading with Purpose, Clarity, and Impact* (Crown Business, 2014); and **Tiffany Vogel** is a partner in the Toronto office.

Will artificial intelligence make you a better leader?

Agile leadership and AI both depend on a willingness to be more flexible and adaptive.

by Sam Bourton, Johanne Lavoie, and Tiffany Vogel

Consider this real-life scene: Reflecting on the difficult moments of his week, the new CEO of a UK manufacturer felt angry. His attention kept going back to the tension in several executive-team meetings. He had an urge to shake the team and push several of its members, who were riven by old conflicts, to stop fighting and start collaborating to solve the company's real problems. He also sensed, though, that a brute-force approach was unlikely to get very far, or to yield the creative insights that the company desperately needed to keep up with its fast-changing competitive environment. Instead, he calmed himself, stopped blaming his team, and asked himself whether he could break the logjam by pursuing truly new approaches to the company's problems. It was then that his mind turned to, of all things, artificial intelligence.

Like many leaders, the CEO was struggling to cope with the stress induced by uncertainty, rising complexity, and rapid change. All of these are part and parcel of today's business environment, which is different enough from the one many of us grew up with to challenge our well-grooved leadership approaches. In a companion article, we describe five practices that can help you step back from the tried and true and become more inwardly agile (see "Leading with inner agility," on page 61). Here, we want to describe the relationship between some of those ideas and a technology that at first glance seems to add complexity but in fact can be a healing balm: artificial intelligence (AI), which we take to span the next generation of advanced data and analytics applications. Inner agility and AI may sound like strange bedfellows, but when you consider crucial facts about the latter, you can see its potential to help you lead with clarity, specificity, and creativity.

The first crucial fact about AI is that you don't know ahead of time what the data will reveal. By its very nature, AI is a leap of faith, just as embracing your ignorance and radical reframing are. And like learning to let go, listening to AI can help you find genuinely novel, disruptive insights in surprising and unexpected places.

A second fact about AI is that it creates space and time to think by filtering the signal from the noise. You let the algorithms loose on a vast landscape of data, and they report back only what you need to know and when you need to know it.

Let's return to the CEO above to see an example of these dynamics in action. The CEO knew that his company's key product would have to be developed more efficiently to compete with hard-charging rivals from emerging markets. He urgently needed to take both cost and time out of the product-development process. The standard approach would have been to cut head count or invest in automation, but he wasn't sure either was right for his company, which was exhausted from other recent cost-cutting measures.

All this was on the CEO's mind as he mused about the problematic executive dynamics he'd been observing—which, frankly, made several of his leaders unreliable sources of information. It was the need for objective, creative insight that stoked the CEO's interest in AI-fueled advanced data analytics. A few days later, he began asking a team of data-analytics experts a couple broad and open-ended questions: What are the causes of inefficiencies in our product design and development workflow? What and where are the opportunities to improve performance?

The AI team trained their algorithms on a vast variety of data sources covering such things as project life-cycle management, fine-grained design and manufacturing documents, financial and HR data, suppliers and subcontractors, and communications data. Hidden patterns in the communication networks led to a detailed analysis of the interactions between two key departments: design and engineering. Using aggregated data that didn't identify individual communications, the team looked at the number of emails sent after meetings or to other departments, the use of enterprise chat groups and length of

AI can help you find genuinely novel, disruptive insights in surprising and unexpected places.

chats, texting volume, and response rates to calendar invites and surfaced an important, alarming discovery. The two departments were barely collaborating at all. In reality, the process was static: designers created a model, engineers evaluated and commented, designers remodeled, and so on. Each cared solely about its domain. The data-analytics team handed the CEO one other critical fact: by going back five years and cross-referencing communications data and product releases, they provided clear evidence that poor collaboration slowed time to market and increased costs.

By liberating the AI team to follow a direction and not a destination, the CEO's original question, "How do we improve productivity?" became a much more human, "How are we working as a team, and why?" Based on this new empirical foundation, he enlisted the engineering and design leaders to form a cross-disciplinary team to reimagine collaboration. Working with the data scientists, the team was able to identify and target a 10 percent reduction in time to market for new-product development and an 11 percent reduction in costs. But the CEO didn't stop there. He also used the experience to ask his executive team to develop a new agility. The previously fractured team worked hard to build a foundation of trust and true listening. Regular check-ins helped them pause, formulate new questions, invite healthy opposition, and ask themselves, "What are we really solving for?" The team was growing more complex to address the company's increasingly complex challenges.

In our experience, AI can be a huge help to the leader who's trying to become more inwardly agile and foster creative approaches to transformation. When a CEO puts AI to work on the toughest and most complex strategic challenges, he or she must rely on the same set of practices that build personal inner agility. Sending AI out into the mass of complexity, without knowing in advance what it will come back with, the CEO is embracing the discovery of original, unexpected, and breakthrough ideas. This is a way to test and finally move on from long-held beliefs and prejudices about their organization, and to radically reframe the questions in order to find entirely new kinds of solutions. And the best thing about AI solutions is that they can be tested. AI creates its own empirical feedback loop that allows you to think of your company as an experimental science lab for transformation and performance improvement. In other words, the hard science of AI can be just what you need to ask the kind of broad questions that lay the foundation for meaningful progress. Q

Sam Bourton is the cofounder and chief technology officer of QuantumBlack, a McKinsey company, and is based in McKinsey's London office; **Johanne Lavoie** is a partner in the Calgary office and coauthor of *Centered Leadership: Leading with Purpose, Clarity, and Impact* (Crown Business, 2014); and **Tiffany Vogel** is a partner in the Toronto office.

The leadership journey of Abraham Lincoln

Hear the call to action contained in Abraham Lincoln's story, and get to work. The world has never needed you and other real leaders more than it does now.

by Nancy Koehn

Many years ago, I made a short film for the Harvard Business School about the lessons that Abraham Lincoln's life offered for modern leaders. I interviewed a range of CEOs, asking them what they'd learned from the 16th president. Their responses were wide-ranging and profound; many continue to influence my work on leadership.

I was particularly struck by what A. G. Lafley, CEO of Procter & Gamble at the time, said about how leaders are made. He pointed to three main ingredients. The first is an individual's strengths and weaknesses and the cumulative experience a person acquires walking his or her path. The second is that an individual recognizes a moment has arrived that *demands* his or her leadership. The third is that the individual has to consciously decide "to embrace the cause and get in the game."

Making oneself into a courageous leader, in the way Lafley describes, is perilous, compelling, and exhausting work. It also is some of the most satisfying one can do, and it could not be more important today. Like the turbulent Civil War that Lincoln found himself at the center of, the early 21st century cries out for effective, decent leaders. People of purpose and commitment who want to make a positive difference and who choose to rise: first within themselves, by claiming their better selves, and then on the larger stage, by staking out the higher ground.

Abraham Lincoln has something to offer each of us right now as we try to craft lives of purpose, dignity, and impact. Are you ready to hear the call to action contained in his story?

DISCERNMENT

Lincoln had humble roots and no formal education. By age 25, he also had a growing interest in politics, and needed a career to feed that interest while helping him improve his lot. Lincoln began borrowing the law books of a mentor from the Illinois state militia who was an accomplished attorney and state legislator. He studied by himself. A neighbor remembered Lincoln "was so absorbed that people said he was crazy. Sometimes [while he was studying he] did not notice people when he met them."

We do not know exactly how Lincoln sustained his determination to succeed. What we *do* know is that from an early age he practiced great discipline in relation to the things that mattered. Some of the discipline was focused on practical ends: toward preparing himself to be a lawyer or bettering himself intellectually. Some of it was directed at managing his emotions. As his prospects expanded, he worked to comport himself with greater dignity and forbearance.

He earned a reputation as an attorney who was skilled before a jury. Not because he mastered the laws of evidence or finer points of precedents; he did neither. Instead, this reputation rested on his ability to concentrate a jury's attention on the few essential points of a case while conceding the less important issues to his opponent.

Lincoln's ability to relate to juries provides a useful lesson about *discernment*. Leaders trying to accomplish a worthy mission have to cultivate the ability to identify the one, two, or three essential issues facing them at a given moment. It is never five or ten. It is always one or two—maybe three—issues that really matter. Having identified these, leaders must let the remaining concerns go, either by giving themselves permission to turn their attention away from all that is not central to their purpose or by handing peripheral issues to others, including an adversary. Being able to do this—to concentrate on the most important issues while relinquishing the rest—depends on a leader's willingness to recognize two things: first, he or she cannot do it all, and second, by saying no to that which is not mission critical, one is actually saying yes to that which is.

DISAPPOINTMENT

Lincoln, like many other leaders, didn't blaze onto the larger stage at a young age. And even when he began to build a legal and political career, his path was marked by as many failures as successes. The making of courageous leaders is rarely swift and smooth. Indeed, the setbacks and the times that Lincoln spent *not* being able to gratify his ambitions were important ingredients in the wisdom, resilience, and empathy that he nurtured and then used so successfully.

In 1846, for example, Lincoln was elected to the US House of Representatives by a large majority. During his first year in Washington, he devoted most of his attention to attacking Democratic president James Polk's prosecution of the Mexican-American War. When his term in office ended in March 1849, Lincoln returned to Illinois. There, he discovered that his political stock was lower than when he had left. His party had failed to elect its candidate to the congressional seat that Lincoln was vacating, and many of his supporters blamed him and his unpopular position on the Mexican-American War for the defeat. Lincoln fell into a depression.

Although he returned to the practice of law, Lincoln found the allure of politics irresistible and set about helping to organize the young Republican Party in the state of Illinois. The central element of the Republican platform was opposition to slavery's extension. Within Illinois, Lincoln became a leading spokesman for this position (while accepting its legality where it already existed). In contrast, many Democrats, such as the US senator from Illinois, Stephen Douglas, supported slavery's expansion.

In 1858, Lincoln challenged Douglas for his US Senate seat. The race attracted national interest, partly because Illinois was regarded as a battleground state—not only in skirmishes between Democrats and Republicans, but also between supporters and opponents of slavery. Lincoln lost, and was deeply disappointed.

TRIUMPH AND TRAGEDY

Late in 1859, newspapers began mentioning Lincoln as a potential presidential candidate in the 1860 election. At the Republican Convention in Chicago, no candidate won a majority of the votes on the first ballot. Support for Lincoln grew as the convention progressed, and on the third ballot, cast on May 18, he won 364 of 466 possible votes, becoming the Republican nominee for president. A month later, the Democrats met to select a nominee. Party delegates split, with Northern members backing Stephen Douglas and Southern delegates supporting John Breckinridge. This splintering of the Democratic party greatly increased the odds of a Republican victory in the general election on November 6.

At about two in the morning on November 7, Lincoln learned that he'd been elected president. As he walked back home in the wee hours, Lincoln did not exult. Recalling the moment two years later, he said he slept little before dawn. "I then felt, as I never had before, the responsibility that was upon me."

Lincoln's election precipitated a national crisis. Convinced that the president-elect would try to abolish slavery, many Southern leaders believed the only way to protect the institution—and the way of life that rested on it—was to leave the United States and establish their own country. In early February 1861, representatives of South Carolina, Mississippi, Florida, Alabama, Georgia, Louisiana, and Texas met in Montgomery, Alabama, to form a new nation, the Confederate States of America, and adopt a constitution.

On March 4, 1861, before a crowd of 50,000, Lincoln delivered his inaugural address on the steps of the US Capitol. He knew the fate of the upper Southern states of Virginia, Arkansas, Tennessee, and North Carolina, which had not yet seceded, might depend on what he said, and he took pains to reassure Southerners that he would leave slavery alone in the states where it already existed.

In spite of Lincoln's efforts, tensions between North and South escalated. These came to a head with the president's decision on Fort Sumter, a federal garrison in the harbor of Charleston, South Carolina. Government soldiers inside the fort were running out of food. But sending provisions into what was now hostile territory risked Confederate attack. For weeks, Lincoln agonized over what to do. He did not want his administration to appear weak by not resupplying the fort and thus effectively surrendering it. But he also did not want to initiate open warfare.

After many sleepless nights and conversations with his cabinet, Lincoln ordered government forces to sail for Charleston Harbor with food, but no arms. On April 12, 1861, with the federal fleet nearby, Confederates bombarded the garrison with shells and gunfire. Within 36 hours, the commanding officer of the fort surrendered to Southern forces. The Civil War had begun.

LONELINESS

From the start, the Civil War defied Americans' expectations. Following Fort Sumter, for example, many Northerners and Southerners believed that victory was imminent for their respective side, and that few lives would be lost. But after the Battle of Bull Run near Manassas, Virginia, in July 1861, in which almost 5,000 Union (northern) and Confederate troops were killed or wounded, it became clear that the war would be longer and bloodier than most had anticipated. The day after the battle, Lincoln called for 500,000 volunteers; within days, Congress authorized an additional half million troops.

By late 1861, the Union's general in chief, George McClellan, had reorganized troops around Washington, but then refused to move them south to attack Confederate forces. His Army of the Potomac—some 120,000-men strong—remained in and near the capital without seeing any kind of battle.

Worried about the general's inaction, Lincoln began visiting McClellan at home during the evenings. On November 13, the president and one of his secretaries, John Hay, called at the general's house. McClellan was not in, and the two decided to wait. When the general arrived an hour later, he hurried upstairs, ignoring his visitors. The president and his secretary remained where they were for 30 minutes before Lincoln sent word up that he was still downstairs. McClellan sent his own message back, saying he had gone to bed. Hay was appalled at the general's insolence, voicing this to the president as they walked back to the White House. "It was better at this time," Lincoln responded, "not to be making points of etiquette & personal dignity." As he came to understand, not all issues—including personal slights and insults—that came before him were of equal importance. Lincoln realized he had to keep his eye (not to mention his emotional energy) on what was central to his mission and not become distracted by what we would today label "sweating the small stuff."

The president began to teach himself military strategy, borrowing textbooks from the Library of Congress, poring over field reports, and conferring with military officers. As he did this, it became clear to him that a Union victory depended on the North's ability to exploit its greater resources—human and economic—in a series of interrelated attacks on the Confederacy. But how could he make his generals execute this strategy? McClellan effectively ignored Lincoln's orders. Other commanders, often acting without top-level coordination, followed their own plans or simply waited.

It was a lonely time. Some of Lincoln's loneliness flowed from the authority and responsibility he carried. The president knew that saving the Union rested critically on his shoulders—on *his* ability to simultaneously lead on many fronts against many obstacles. This heavy realization isolated Lincoln from family, friends, and colleagues. Not only could these people not fully grasp what he was dealing with; not only did he have to be careful about entrusting his thoughts and feelings to others; but Lincoln also likely understood that no one else could travel the *internal* path he was taking as a leader. None could see the things he was discovering about himself and his impact, see the ways he was changing as the war stretched on, or, finally, experience his doubts and fears. These were essential aspects of his leadership, and they were his alone.

Virtually every leader will know real loneliness. This is intrinsic to the work; it can rarely be avoided or wiped away by specific action. Instead, effective leaders learn to accept such moments of isolation, using them in service to their larger mission by keeping their own counsel, reflecting carefully on a particular issue, or grappling with their thoughts and feelings.

GETTYSBURG

In early July 1863, the Army of the Potomac, now under the leadership of General George Meade, won a decisive battle in Gettysburg, Pennsylvania, repulsing Robert E. Lee's Army of Northern Virginia as it attempted to invade the North. It was a critical victory that came at a fearsome cost. At the opening of the confrontation, a total of 160,000 troops from both sides had poured into the Pennsylvania hamlet. When the smoke cleared three days later, 51,000 Americans were dead, wounded, or missing; 23,000 of these men were federal soldiers, 28,000 were Confederates.

Nonetheless, peace did not come. The war raged on—with seemingly no end in sight. Why, the president asked himself, could he not bring the conflict to a close? Why was it proving so violent? In early November, when he received an invitation to deliver "a few appropriate remarks" at the dedication of a new national cemetery at Gettysburg, Lincoln saw an opportunity to give voice to the larger issues he'd been wrestling with. His remarks totaled only 272 words. It took him less than three minutes to deliver them:

> *Four score and seven years ago our fathers brought forth on this continent, a new nation, conceived in Liberty, and dedicated to the proposition that all men are created equal.*
>
> *Now we are engaged in a great civil war, testing whether that nation, or any nation so conceived and so dedicated, can long endure. We are met on a great battle-field of that war. We have come to dedicate a portion of that field, as a final resting place for those who here gave their lives that that nation might live. It is altogether fitting and proper that we should do this.*

But, in a larger sense, we can not dedicate—we can not consecrate—we can not hallow—this ground. The brave men, living and dead, who struggled here, have consecrated it, far above our poor power to add or detract. The world will little note, nor long remember what we say here, but it can never forget what they did here. It is for us the living, rather, to be dedicated here to the unfinished work which they who fought here have thus far so nobly advanced. It is rather for us to be here dedicated to the great task remaining before us—that from these honored dead we take increased devotion to that cause for which they gave the last full measure of devotion—that we here highly resolve that these dead shall not have died in vain—that this nation, under God, shall have a new birth of freedom—and that government of the people, by the people, for the people, shall not perish from the earth.

Lincoln's speech is a first-rate example of a leader framing the stakes of the change. In hindsight, we can see that he used the dedication ceremony to connect the continuing turbulence—the Civil War—with the history and mission of the enterprise—the American polity and its central proposition. He then led his audience to the present moment, relating their action to "the unfinished work" in which they and all other Americans were involved. He laid down the gauntlet for every citizen who supported the Union: "it is rather for us to be here dedicated to the great task remaining before us—that from these honored dead we take increased devotion to that cause for which they gave the last full measure of devotion."

In saying this, Lincoln presented the trade-offs of committing to the mission: a great civil war, a testing struggle, and thousands of deaths. He concluded by stating that as formidable as these costs were, they were the price of a mighty end, one with lasting significance: "that this nation, under God, shall have a new birth of freedom—and that government of the people, by the people, for the people, shall not perish from the earth."

Every modern leader navigating through a crisis can learn from the Gettysburg Address. We are unlikely to approach the eloquence and power of Lincoln's language. But we can take from his leadership the critical importance of framing the stakes of a particular moment. This means connecting current change efforts to the history and future of the enterprise, locating these efforts in the arc of ongoing events, explaining each stakeholder's role in the process, identifying the specific trade-offs of making the change, and understanding these costs in relation to the ultimate goal. The more turbulent the world becomes in the early 21st century, the more vital it is for leaders to interpret and frame this volatility in relation to a worthy purpose.

TRANSFORMATIONAL CHANGE

Lincoln had no silver bullets to save the Union. This was difficult to accept. But as the war stretched on, he began to understand that the complexity of the conflict and the magnitude of its stakes made a single, clear-cut way to end it virtually impossible.

This is an insight for today's leaders. We are under pressure to move fast, leap tall buildings in a single bound, and make a big impact. But the reality of trying to accomplish something real and good gives lie to the seductive notion that there is one simple solution. Almost anything along our life journeys that is worth investing in, worth fighting for, and worth summoning our best selves for has no silver bullet. The bigger the issue, the less likely it is that a leader can resolve it in one or two swift strokes. Understanding this means abandoning the quest for *the single definitive answer*. Letting go of this quest frees leaders—emotionally and practically—to focus on the many possible approaches and actions needed to make a meaningful difference.

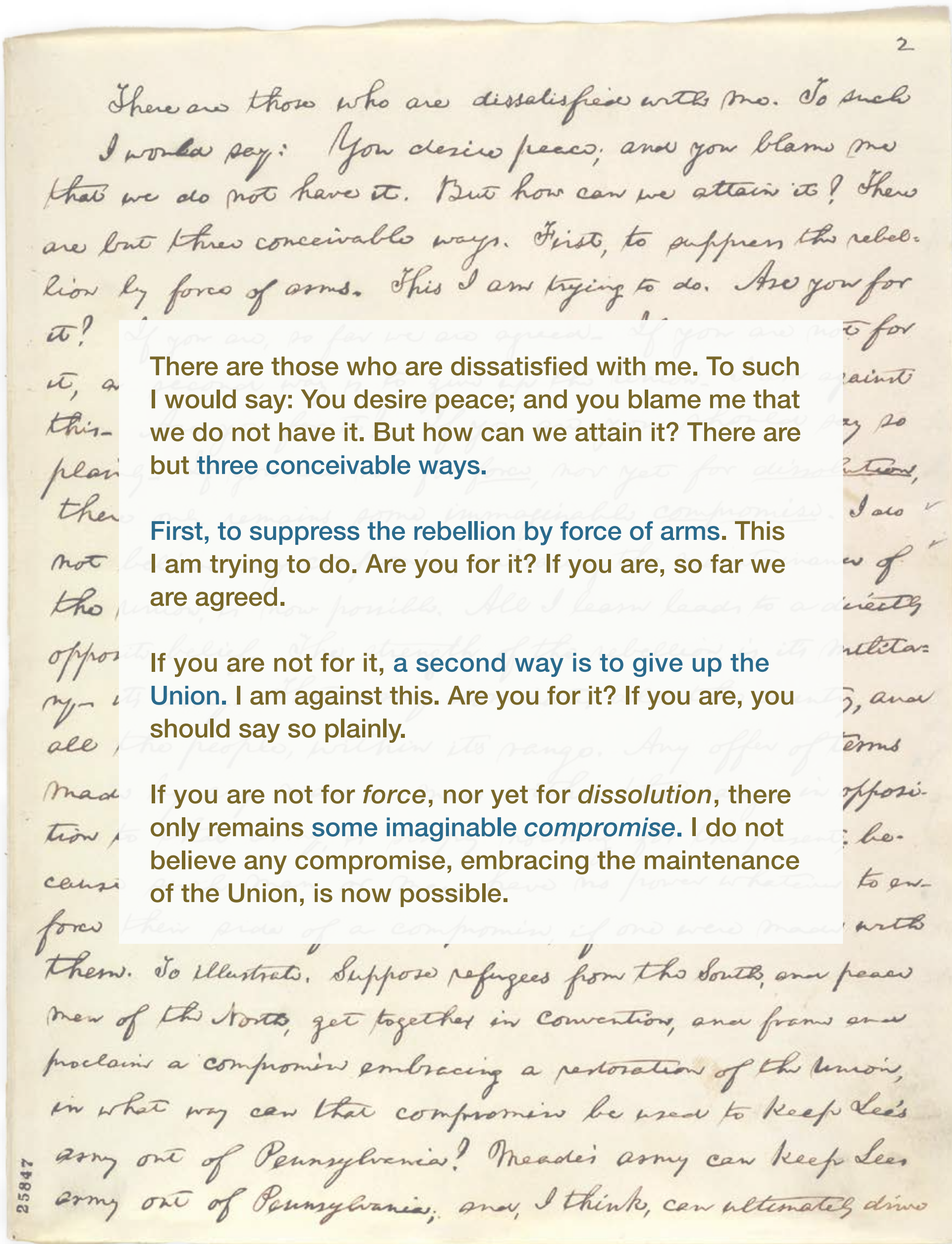
In the aftermath of the battle at Gettysburg, appalled by the human carnage, many Northerners thought the government should stop fighting and seek a settlement with the rebel states, one that recognized the legality of slavery. Against this backdrop, in mid-1863, Lincoln accepted an invitation from his old friend James Conkling to address a large meeting of Union supporters in Springfield, Illinois. As the speech grew closer, pressing responsibilities prevented the president from leaving Washington. So instead of returning to his hometown, he wrote a letter for Conkling to present at the gathering.

The letter, which was published in newspapers across the country, laid out the principal arguments of the peace faction and Lincoln's careful response to these. Looking back, we can see that Lincoln was doing more than making the case for his policies. As any serious leader engaged in large-scale change must, he was also trying to keep the relevant lines of communication open. He understood that widespread transformation always unleashes waves of collective fear, discontent, and doubt—emotions that often translate into vocal, and potentially more destructive, opposition. He also knew that if left unacknowledged, adversaries have the power to derail even the worthiest attempts at reform, and thus it is a leader's responsibility to identify and, when necessary, neutralize his or her most powerful critics.

But how is the person at the center of the change to do this without appearing weak, creating additional enemies, or potentially legitimating the very attacks he or she is trying to mitigate? These are complicated issues, so it is not surprising that leaders often avoid head-on engagement with their

Abraham Lincoln did not shy away from engaging his most powerful critics.

Lincoln's letter to James C. Conkling, August 26, 1863



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There are those who are dissatisfied with me. To such I would say: You desire peace; and you blame me that we do not have it. But how can we attain it? There are but three conceivable ways. First, to suppress the rebel- lion by force of arms. This I am trying to do. Are you for it?

them. To illustrate. Suppose refugees from the South, and peace men of the North, get together in Convention, and frame and proclaim a compromise embracing a restoration of the Union; in what way can that compromise be used to keep Lee's army out of Pennsylvania? Meade's army can keep Lee's army out of Pennsylvania, and, I think, can ultimately drive

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There are those who are dissatisfied with me. To such I would say: You desire peace; and you blame me that we do not have it. But how can we attain it? There are but three conceivable ways.

First, to suppress the rebellion by force of arms. This I am trying to do. Are you for it? If you are, so far we are agreed.

If you are not for it, a second way is to give up the Union. I am against this. Are you for it? If you are, you should say so plainly.

If you are not for *force*, nor yet for *dissolution*, there only remains some imaginable *compromise*. I do not believe any compromise, embracing the maintenance of the Union, is now possible.

Source: Library of Congress, Manuscript Division, Abraham Lincoln Papers challengers, hoping instead that the rallying cry of the mission and the enthusiasm of supporters will overwhelm naysayers.

This is a risky strategy, especially when the stakes are high. It was to Lincoln's credit that he understood the power of Northern elites, who did not want to fight a war to end slavery. The president also realized that to defuse this "fire in the rear," he had to speak directly to the American public, and he had to do this by addressing the specific arguments his opponents were making against him. Finally, he had to explain his actions in terms of his larger purpose. Lincoln did all of this in the speech for James Conkling. Seen from the perspective of a change leader effectively communicating with relevant stakeholders and trying to alleviate serious threats to the broader transformation, the president's letter was a tour de force.

WILLPOWER

As the summer of 1864 wore on, without a Union military victory in sight, Northern morale collapsed. Politicians and journalists called for an immediate end to the war, with many predicting that Lincoln would lose the upcoming presidential election. "The people are wild for Peace," said New York politician Thurlow Weed. They won't support the president, he added, because they are told he "will only listen to terms of peace on condition [that] slavery be abandoned."

The commander in chief began to waver. Perhaps, he told himself as he paced the White House hallway late at night, he should enter into peace talks with Southern leaders. On August 19, he drafted a potentially momentous letter to a Democratic politician and newspaper editor, ending the communication with this proposition: "If Jefferson Davis wishes . . . to know what I would do if he were to offer peace and re-union, saying nothing about slavery, let him try me."

Having written these words, Lincoln paused. He did not send the letter; instead, he stored it in his desk while he thought about what to do. Two days later, when the escaped slave and abolitionist Frederick Douglass visited Lincoln at the White House to discuss helping slaves reach Union military lines, the president read the letter aloud to him. The black activist strongly urged the chief executive to keep it to himself. If he sent it, Douglass said, the missive would be interpreted "as a complete surrender of your anti-slavery policy, and do you serious damage."

Lincoln returned the letter to his files. With renewed confidence, the president decided emancipation would remain an essential condition of any negotiations with the Confederacy. For a few days during the long, hot summer of

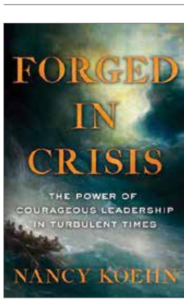
1864, Lincoln had considered backing away from his mission. But in the end—at the moment it really mattered—he did not. He held the line.

Historians and biographers have pointed to a number of Lincoln's strengths and their role in his leadership. But one of the most significant of these strengths is not often mentioned, and this is that Lincoln simply kept going. Once he made a crucial decision, he saw it through, even when virtually everything around him seemed stacked against such a commitment. This adherence was not the result of stubbornness or self-righteousness. Rather, it came from the care that Lincoln exercised in making choices, including the slowness with which he acted when the stakes were high; from his growing depth as a moral actor; and from his sheer will to get up each morning and do what he could in service of his mission.

The Civil War ended more than 150 years ago. But we, it seems, are not finished with the man who led the country through it. Not by a long shot. Lincoln's journey was one of learning by doing, ongoing commitment to bettering himself, keen intelligence harnessed to equally acute emotional awareness, and the moral seriousness into which he grew as he attained immense power. It was also an all-too-human path marked by setbacks, derailments, and disappointments.

Abraham Lincoln *was made into an effective leader*—first from the inside out and then from the outside in—as he developed and changed throughout his life. That, as president, he refused to ignore the larger consequences of his actions on men and women who had little or no agency, that he saw beyond the immediate moment and owned the responsibility of affecting a vast future, and that he rejected an ethical callousness about the choices he made are demonstrations of leadership that we yearn for today. May all who aspire to lead with worth and dignity learn from the life and leadership of Abraham Lincoln. Q

Nancy Koehn is the James E. Robison Professor of Business Administration at the Harvard Business School.



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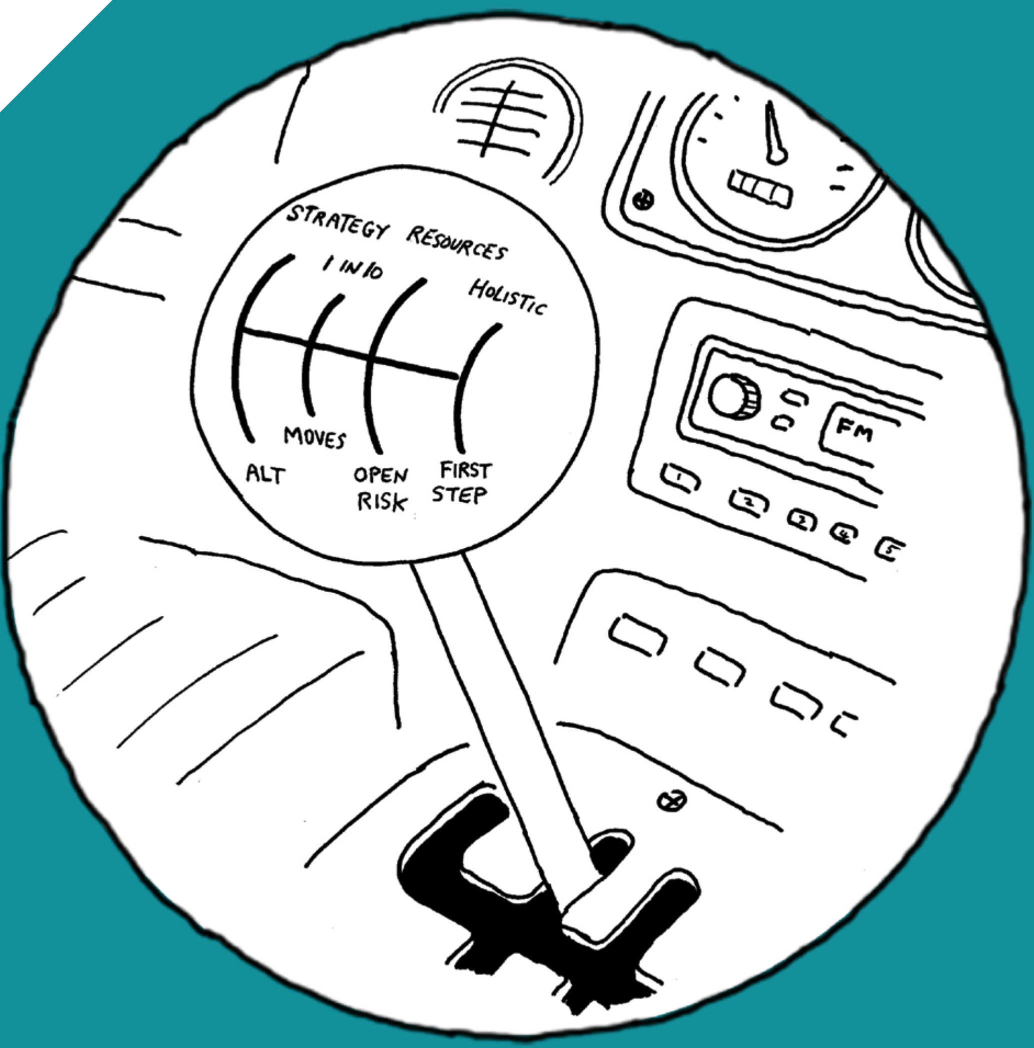


Cartoons by Jeremy Banks (Banx)

Eight shifts that will take your strategy into high gear

Developing a great strategy starts with changing the dynamics in your strategy room. Here's how.

by Chris Bradley, Martin Hirt, and Sven Smit

Many strategy planning processes begin with a memo like the one on the following page. Such missives lead managers to spend months gathering inputs, mining data, scanning the marketplace for opportunities and threats, and formulating responses. In the strategy meetings that follow, the CEO leads discussions, executives jockey for resources, and a strategy emerges that confidently projects future growth. The budget is set—and then nothing much happens.

So much activity, so little to show for it. Our book, *Strategy Beyond the Hockey Stick* (Wiley, 2018), explores in depth the social dynamics that undermine strategic dialogue and breed incrementalism. It also underscores the real, and very challenging, odds of crafting strategies that will lead to dramatic performance improvement. For example, over a decade, only 8 percent of companies manage to jump from the middle of the pack—the roughly 60 percent of the world's largest corporations that barely eke out any economic profit—to the top quintile, where almost all the economic profit accrues. Underpinning many of those successful strategies, our research shows, are big moves such as dramatic resource reallocation, disciplined M&A, and radical productivity improvement.

We summarized many of those core findings in a recent *McKinsey Quarterly* article, "Strategy to beat the odds." What we did not explore in depth there were the practical steps executive teams can take to catalyze big, trajectory-bending moves while mitigating the social side of strategy arising from corporate politics, individual incentives, and human biases. Our research and experience suggest that eight specific shifts can dramatically improve the quality of your strategic dialogue, the choices you make, and the business outcomes you experience. These are moves that you can start implementing Monday morning. Together, the eight shifts will enable you to change what is happening in your strategy room—and eradicate memos like this one:

To: Leadership Team

CC: Corporate Staff

Re: Strategy Process 2018

SM

Dear Leadership Team,

With this note, we kick off the strategy cycle of 2018, building on the great work in 2017. We will run the process in three steps:

1. Market analysis due March

2. Key issues due May

3. Full 5-year plan due June

In August, we will discuss the fully integrated plan with the board, from which we will launch the 2019 Annual Operating plan.

We have limited the template to about 50 pages and would hope you have a 10-page Executive Summary in each session so we can focus the conversation on the important topics.

Very much looking forward to our discussions.

S. Miller
Susan Miller, Chief Executive Officer

Templates for our discussions:
["Market Analysis"] ["Key issues"] ["Full 5-year plan"]

1. FROM ANNUAL PLANNING TO STRATEGY AS A JOURNEY

Messy, fast-changing strategic uncertainties abound in today's business environment. The yearly planning cycle and the linear world of three- to five-year plans are a poor fit with these dynamic realities.[1] Instead, you need a rolling plan that you can update as needed.

In our experience, the best way to create such a plan is to hold regular strategy conversations with your top team, perhaps as a fixed part of your monthly management meeting. To make those check-ins productive, you should maintain a "live" list of the most important strategic issues, a roster of planned big moves, and a pipeline of initiatives for executing them. At each meeting, executives can update one another on the state of the market, the expected impact on the business of major initiatives underway, and whether it appears that the company's planned actions remain sufficient to move the performance needle. In this way, the strategy process becomes a journey of regularly checking assumptions, verifying whether the strategy needs refreshment, and exploring whether the context has changed so much that an entirely new strategy is necessary.

To grasp what this process looks like in action, consider the experience of a global bank whose competitive context dramatically changed following the financial crisis. The CEO realized that both the bank's strategy and its approach to refining the strategy over time as conditions changed needed revamping. He instituted biweekly meetings with the heads of the three major lines of business to identify new sources of growth. After making a set of "no regrets" moves (such as exiting some noncore businesses and focusing on balance-sheet optimization), the bank's strategy council devoted subsequent meetings to confronting decisions whose timing and sequencing demanded close evaluation of market conditions. The top team defined these choices as "issues to be resolved," regularly reviewed them, and developed a process for surfacing, framing, and prioritizing the most time-sensitive strategic challenges. In doing so, the team not only jump-started its new strategy but launched an ongoing journey to refine it continually.

2. FROM GETTING TO 'YES' TO DEBATING REAL ALTERNATIVES

The goal of most strategy discussions is to approve or reject a single proposal brought into the room. Suggesting different options, or questioning the plan's premise and therefore whether it should even be under consideration, is often unwelcome. Without such deeper reflection, though, you are less likely to make hard-to-reverse choices about how to win—which is problematic, because those choices are the essence of real strategy, and the planning process should be geared to shining a spotlight on them.

[1] For information on the more journey-oriented approach to strategy long advocated by our retired friend and the former leader of our Strategy Practice, Lowell Bryan, see Chris Bradley, Lowell Bryan, and Sven Smit, "Managing the strategy journey," *McKinsey Quarterly*, July 2012, McKinsey.com.

The conversation changes if you reframe it as a choice-making rather than a plan-making exercise. To enable such discussion, build a strategy decision grid encompassing the major axes of hard-to-reverse choices. Think of them as the things the next management team will have to take as givens. Then, for each dimension, describe three to five possible alternatives. The overall strategic options will be a few coherent bundles of these choices. Focus your debate—and your analysis—on the most difficult choices. One company we know recently brought two very different plans into its strategy discussion: the first plan assumed the present, low level of resourcing, and the second one represented a "full potential" growth scenario, which necessitated dramatically higher investment levels. The latter option was a new possibility resulting from a positive demand shock. Alongside one another, the two plans stimulated vigorous debate about the company's road ahead and what its posture toward the business should be.

If you want real debate, you also need to calibrate your strategy. As we show in our book, the odds of a strategy leading to dramatic performance improvement are knowable based on analysis of your company's starting endowment, the trends it is riding, and the moves you are planning. If your odds are poor, you should consider alternatives, which often will require making bigger moves than you made in the past. Forcing discussion about real strategic alternatives—such as different combinations of moves and scenarios with different levels of resources and risk—help you move away from all-or-nothing choices, as well as from those 150-page decks designed to numb the audience into saying "yes" to the proposal.

Even a simple calibration can stimulate debate about whether a strategy has a realistic chance of getting you where you want to go. Consider the experience of a consumer-goods client with $18 billion in revenue and the aspiration of achieving double-digit growth. The company did a great deal of planning, and the aspiration, which rested on a bottom-up aggregation of each business unit's plans, looked reasonable. However, publicly available information showed that among industry peers within the same revenue range, only 10 percent generated sustained, double-digit growth over ten years. The questions became: Is our strategy better than 90 percent of our peers? Really? What makes us stand out, even though we have performed like an average company over the prior five years? These questions were uncomfortable but important, and they contributed to a strategic reset for the company.

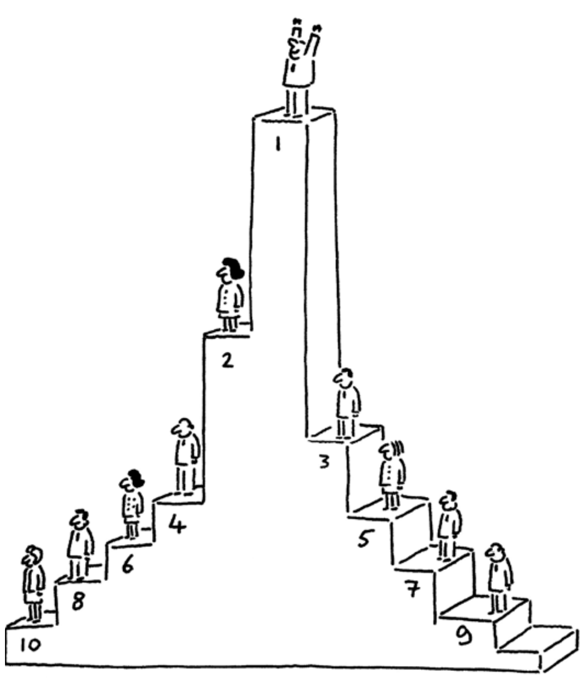
3. FROM 'PEANUT BUTTER' TO ONE-IN-TEN WINS

It is nearly impossible to make the big moves that successful strategies require if resources are thinly spread across all businesses and operations. Our data show that you are far more likely to achieve a major performance improvement when one or two businesses break out than when every business improves in lockstep. You have to identify those breakout opportunities as early as possible and feed them all the resources they need.

Identifying those winners is easier than you might think. If you were to ask your management team to pick them, they would probably agree strongly on number one and maybe number two—much less so on, say, numbers seven and eight. The difficulty starts when discussion shifts to resource allocation. In fashion, movies, oil exploration, and venture capital, people understand that it's the one-in-ten win that matters, but most other businesses do not have this "hit mentality."

To stop spreading resources too thinly, you and your management team need to focus on achieving a few breakout wins and then work to identify those potential hits at a granular level. Excessive aggregation and averaging into big profit centers can prevent you from seeing the true variance of opportunity. One CEO we know had traditionally framed strategy discussions around growth of 4 to 6 percent and accordingly meted out resources to divisions. One year, he did a much more granular analysis and realized that one geography—Russia—was growing at 30 percent. He swamped the Russian operations with resources, created a more favorable environment, and subsequently enjoyed even faster growth from that unit.

We've seen many senior teams move away from "peanut buttering" by using some form of voting to pick priorities. In some cases, that's a secret ballot in envelopes. In others, CEOs set up a matrix showing all the opportunity cells and let executives allocate points to various initiatives by applying stickers to the matrix. Such a matrix can help you look at the market in ways that are different from how your organization is structured—which boosts the odds of achieving radical resource shifts. One company, for example, recently decided to examine plans one level down from the business unit and created a detailed curve of 50 or so specific, investible opportunities. The result was a much bigger shift in resources to the best opportunities.



4. FROM APPROVING BUDGETS TO MAKING BIG MOVES

The social side of strategy often makes the three-year plan a cover for the real game: negotiating year one, which becomes the budget. Managers tend to be interested in years two and three but absolutely fascinated by year one, because that is where they live and die. You need to put an end to the strategy conversation being little more than the opening act to the budget.

One of the worst culprits in these budget-driven discussions is the "base case": some version of a planned business case anchored in various (largely opaque) assumptions about the context and the company strategy. The base case might obscure the view of where the business actually stands, which could make it hard to see which aspirations are realistic and, certainly, which strategic moves could deliver on those aspirations.

A practical way to avoid this trap is to build a proper "momentum case." This is a simple version of the future that presumes the business's current performance will continue on the same trajectory—the highly probable outcome absent any new actions. In this way, you get a sense of how much impact your moves need to deliver to change that trajectory.

It is also critical to understand explicitly why your business is making money today. At a retail bank in Australasia, for instance, the leaders wanted to expand into overseas markets. The logic was, "We are very successful, so we must be better operators than our competitors. We will move into other markets, where the operations are not nearly as efficient as in our home markets, and we will clean up." When the team looked at how the bank really made money, however, the operating metrics were unimpressive. The company's success was largely due to its product strategy: the bank had a big exposure to residential mortgages, for which demand was very strong in Australasia at the time. Another big source of profit was the bank's excellent record of picking branch locations. But those choices were made by two people at the head office, so there was no reason to suspect that they would be as successful in Indonesia or other new countries.

The bank gained these insights by doing a "tear down" of its results. This is a crucial part of sharpening the dialogue around big moves, and it is not that hard to do. Simply take the business's past performance and build a "bridge," isolating the different contributions that explain the changes. Most CFOs regularly do this for factors such as foreign-exchange changes and inflation. The bridge we are talking about considers a broader array of factors, such as average industry performance and growth, the impact of submarket selection, and the effect of M&A.

Armed with a thorough, unbiased understanding of where your business stands and what has been driving performance, you can focus on what it would take to change your trajectory. Instead of asking for a target or a budget in the strategy meeting, ask for the 20 things each of your business leaders wants to do to produce a series of big moves over the coming period. Then debate the moves rather than the numbers expected to result from them. Why should we do this big move? Why shouldn't we? How different does the company look depending on what risk and resource thresholds we set for it? Above all, talk about moves first, budgets second. Over time, your managers will come to recognize that if they do not have any ideas for big moves or cannot inspire confidence about their ability to pull off big moves, they will lose resources accordingly.

5. FROM BUDGET INERTIA TO LIQUID RESOURCES

The handover between strategy and execution happens when the resources are made available to follow through on the big moves you identify. Execution can then begin, and managers can be held accountable.

To mobilize resources and budgets, a company needs a certain level of resource liquidity. And you have to start early—the date your fiscal year begins. That is when serious productivity-improvement initiatives should be under way to free resources by the time allocations are decided later in the year. Then you must hold onto those freed resources so they will be available for reallocation, which requires determination. As soon as an engineer has time, your R&D organization will have creative new product ideas; the sales organization will identify attractive new business opportunities as soon as a productivity program has freed up part of the sales force. You need to be incredibly clear about separating the initiatives that free up resources from the opportunities to reinvest them if you hope to make big moves.

Another way to enable resource reallocation is to create an "80 percent–based" budget: a variant on zero-based budgets in which you make a certain sliver (say, 20 percent) of the budget contestable every year, so money is forced into a pot that is available for reallocation when the time comes. Yet another option is to place an opportunity cost on resources that seem free but are not. You identify scarce resources, such as shelf space for retailers, and make sure they are measured and managed with the same rigor as conventional financial metrics, such as the sales and gross margins for which many retail managers are held accountable. This can be as simple as shifting to ratios (such as sales per square foot and returns on inventory for a retailer) that encourage managers to cut back on lower-value uses for those resources, thereby freeing them up for other opportunities.

US conglomerate Danaher strongly emphasizes resource liquidity and reallocation. Originally a real-estate investment trust, the company now manages a portfolio of science, technology, and manufacturing companies across the life sciences, diagnostics, environmental and applied solutions, and dental industries. To avoid budget inertia, senior management at the company spends half its time reviewing and recutting the portfolio—much like private-equity firms do. The company even has a name for its approach: the "Danaher Business System." Under this approach, which is based on the kaizen philosophy of continuous improvement, Danaher has institutionalized the resource liquidity required to chase the best opportunities at any point in time. It systematically identifies investment opportunities, makes operational improvements to free up resources, and builds new capabilities in the businesses it acquires. Over the past decade, the company has dynamically pursued a range of M&A opportunities, organic investments, and divestments—big moves that have helped the company increase economic profits and total returns to shareholders.

6. FROM SANDBAGGING TO OPEN RISK PORTFOLIOS

When business units develop strategic plans, they often set targets that they can be sure of reaching or exceeding. As you aggregate these plans on a corporate level, the buffers add up to a pretty big sandbag. The mechanism of aggregating business-unit strategies also explains why we see so few big moves proposed at the corporate level: individual unit heads tend to view M&A initiatives and other bold programs as too risky, so these moves never make the final list they bring into the strategy room.

To make strides against sandbagging, you need to manage risks and investments at the corporate level. In our experience, a key to doing this effectively is replacing one integrated strategy review with three sequential conversations that focus on the core aspects of strategy: first, an improvement plan that frees up resources; second, a growth plan that consumes resources; and third, a risk-management plan that governs the portfolio.

This approach triggers a number of shifts. People can lay out their growth plans without always having to add caveats about eventualities that could hamper them. You could ask everyone for growth or improvement plans, possibly insisting on certain levels to make sure everyone is appropriately imaginative and aggressive. Only after executives put their best ideas on the table do you even begin to discuss risk. By letting business leaders make risk an explicit part of the discussion, you change their perception that their heads alone will be on the block if the strategic risk cannot be mitigated. They will share what they know of their risks rather than hiding them in their plans—or not showing you an initiative at all because they deem the personal risk to be too high.

Consider the experience of a retailer whose traditional strategy approach was to roll up the plans of each of its different brands. One year, the company instead racked up the full set of about 60 investible opportunities and assessed them against one another, regardless of the brand or business unit with which they were connected. The dispersion between opportunities was striking. A portfolio-level view also led to a different answer about the right risk/return threshold than had emerged from assessments made earlier by individual divisional leaders. It turned out, perhaps counter-intuitively, that there was too much capital going to the smaller businesses, while the biggest business had major, underfunded opportunities.

7. FROM 'YOU ARE YOUR NUMBERS' TO A HOLISTIC PERFORMANCE VIEW

Whatever shifts you make, you cannot make them alone; you need to bring your team along. We often see managers being pushed to accept "stretch targets"—with perhaps a 50 percent chance of being achieved, what we would call a "P50" plan—only to have these low, up-front probabilities ignored when it comes to the performance review at year end. People know that they "are their numbers," and they react accordingly to attempts to set aggressive targets.

Bringing probabilities to the fore can reset these dynamics. You need to have a sense of whether you are looking at a P30, a P50, or a P95 plan if you hope to have a reasonable, ex post conversation about whether the result was a "noble failure" or a performance failure. You also need to dig down on what drove the outcomes. Although you don't want to punish noble failures, you don't want to reward dumb luck, either. Rather, you want to motivate true high quality of effort. At W. L. Gore, maker of Gore-Tex, teams get data on performance and vote on whether the team and its leader "did the right thing." This vote is often closer to the truth of what happened than the data itself.

Ultimately, you also need a sense of shared ownership in the company's fortunes and a clear alignment of incentives to get the full commitment of your team to the big moves you need to make. To deliver the message that people will not be punished simply because a high-risk plan did not pan out, we suggest developing an "unbalanced scorecard" for incentive plans that has two distinct halves. On the left is a common set of rolling financials with a focus on two or three (such as growth and return on investment) that connect to the economic-profit goals of the division and enterprise. On the right is a set of strategic initiatives that underpin the plan. The hard numbers on the left help establish a range for incentives and rewards, and the strategic initiatives on the right can be a "knockout" factor, with P50 plans getting treated more softly on failure than P90 moves. In other words, the way you get the results matters as much as the results themselves.

Playing as a team counts here, too. The right thing to do at a portfolio level does not always mean every individual "scoring the goal." For example, it's a good idea to have fire stations strategically located throughout your city, but you don't heap rewards on the one fire station that happened to be near the big conflagration. You look at the performance of the system as a whole. The urge to push individual accountability can actually be counterproductive when it comes to strategy, which is really a team sport.

8. FROM LONG-RANGE PLANNING TO FORCING THE FIRST STEP

We see it all the time: big plans that excite leaders with grand visions of outcomes and industry leadership. The problem is that there is no link to the actual big moves required to achieve the vision—and, in particular, no link to the first step to get the strategy under way. Most managers will listen to the visions, then develop incremental plans that they deem doable. Often, those plans get the company onto a path—but not one that reaches the vision or exploits the full potential of the business.

That is why the first step is crucial. After identifying your big moves, you must break them down into what strategy professor Richard Rumelt calls

"proximate goals"[2]: missions that are realistically achievable within a meaningful time frame—say, 6 to 12 months. Work back from the destination and set the milestone markers at 6-month increments. Then test the plan: Is what you need to do in the first 6 months actually possible? If the first step isn't doable, the rest of the plan is bunk. One insurance CEO worked on a vision with his team that concluded there would be no paper in the insurance business in ten years. But when he asked for the plan for the upcoming year, paper consumption was set to increase. So, he asked, "To connect to our vision, would it be viable to be flat in paper next year and go down in the next?" Of course, the team had to say yes. By framing a first-step question, the CEO forced the strategy.

Pursuing these shifts should increase your chances of making big, strategic moves, which, in turn, increases your likelihood of jumping from the middle tier into the elite ranks of corporate performance. In fact, our research shows that making one or two big moves more than doubles your odds (to 17 percent, from 8 percent) of achieving such a performance leap. Making three moves boosts these odds to 47 percent.

But keep in mind that the eight shifts are a package deal—if you don't pursue all of them together, you open the field to new social games—and that it takes a genuine intervention to jolt your team into this new way of thinking. How? Here's an idea: Create a new strategy process that reserves ten days per year for top-team conversations and introduce the shifts one meeting at a time. If things go wrong in a meeting, they go wrong only in one place, and you can "course correct" for the next conversation. And if you discover at the end of the ten days that you have not been able to free up all the resources you feel are needed, that's OK. Take the resources you *were* able to free up by the end of this first planning cycle and allocate them to the highest priorities that emerged from it. You will have made progress, and, more importantly, your team will now understand what this new process is all about. That is a first step in its own right, and if you want to boost the odds of creating a market-beating strategy, it's probably the most valuable one you can take. Q

[2] Richard P. Rumelt, *Good Strategy/Bad Strategy: The Difference and Why It Matters*, New York, NY: Crown Publishing, 2011.

Chris Bradley is a partner in McKinsey's Sydney office, **Martin Hirt** is a senior partner in the Greater China office, and **Sven Smit** is a senior partner in the Amsterdam office. This article is adapted from their book, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* (Wiley, 2018).

Digitizing dairy in China

The CEO of China's second-largest dairy company describes how data and artificial intelligence are shaking up how he does business.

Twenty kilometers outside of central Beijing sits the sprawling headquarters of China Mengniu Dairy, China's second-largest dairy company. It might not boast the same glossy exterior as China's colossal technology companies' campuses, and CEO Jeffrey, Minfang Lu admits that the dairy industry suffers from a less-than-innovative image, but behind modest doors lies a rapidly modernizing business.

Armed with more data than its people can currently compute, Mengniu Dairy is embarking on an effort to bring the centuries-old industry up to date through the use of artificial intelligence (AI) in China and beyond. As it does, the company hopes to innovate across everything from manufacturing and supply chains to product development and marketing.

As with everything in China, the scale of the ambition is huge. Each year, the company sells 12 billion packets of product, chiefly milk and yogurt products, which are produced across 58 manufacturing sites and more than 1,000 manufacturing lines in China. In addition to the impressive scale of production, the company has access to 20 million "active" consumers who share information about their product preferences and lifestyle habits through e-commerce and social channels. Mengniu Dairy's product-development, forecasting, manufacturing, and marketing teams interpret these data, albeit not fast enough.

By tapping into consumer trends that extend beyond the immediate product, Mengniu Dairy hopes to make milk and yogurt more appealing among a younger, savvier Chinese consumer. A recent, and notable, example saw milk products featured in a kung fu film alongside Alibaba CEO Jack Ma and kung fu star Jet Li. China is in the midst of a transition from a country of people who do not drink much milk and have perceptions of lactose intolerance to one where consumption catches up with the research showing that 80 percent of Chinese people can drink 200 milliliters of milk at a meal without adverse reaction. Plans are afoot to expand Mengniu Dairy's physical footprint, too, beyond China's borders and into Southeast Asia to capitalize on the government's Belt and Road Initiative.

In December 2017, Mr. Lu sat down with *McKinsey Quarterly* to share more about the company's digital-transformation plan and how he hopes technology can help its leaders better understand ever-changing Chinese consumption habits.

The *Quarterly*: *How are some of the well-documented changing consumer habits shaping your business?*

Mr. Lu: One of the big changes is that consumers are more mobile than before. People are on the move, they are traveling, and they have a mobile phone wherever they go. We need to really take this seriously and see how it will impact our model, and our route to market, and the way we communicate with customers. In the past, you will see consumers go to a supermarket, buy enough stock for one month, and go back each month, and your job is done. This is no longer going to happen. Consumers have more choice. They can go to a small convenience store; they can use their mobile apps and have a product delivered to their home.

The *Quarterly*: *How are you using digital technology to tap into the changing consumer behavior?*

Mr. Lu: The new environment is all about data. If you look at our industry, you will see a very long supply chain all the way from grass to glass. You can collect data from farms and even from individual cows. When you go into the supply-chain side and into manufacturing, you have much more data. When you look at our logistics, we have a huge amount of milk, which is transported across the nation. And then, on the consumer side, you see consumers buying our products online, communicating with us online—and so there is a lot of consumer transactional and interaction data.

Across our entire chain of our business, data are available for us to translate into knowledge about our business. But it's all about how to use this data to empower our decision making across our business activities.

More and more, this is about using AI to help us to improve our ability to do further analysis. Our capability to calculate and to analyze this data relies on us using the newest knowledge.

Just for example, at Mengniu, we collect four million tons of milk each year. We sell 12 billion packs of product to our consumer, and we have 58 manufacturing sites, more than 1,000 manufacturing lines, more than 2,000 SKUs. If you put everything together, honestly, humans cannot do this analysis anymore.

So today, we have kicked off some big projects—with Alibaba, for example—to use AI to analyze our supply chain, to tell us where we should manufacture products, to tell us where we should collect the milk, and to tell us how we can transport these products to our customers so that we get the maximum efficiency out of all this data.

JEFFREY, MINFANG LU

Education

Earned a BA from Fudan University

Career highlights

China Mengniu Dairy
(2016–present)
CEO and executive director

Yashili International Holdings
(2016–present)
Chairman and nonexecutive director

(2015–16)
CEO

Danone

Has served with Danone and Dumex Baby Food for more than ten years and is currently vice president and nonexecutive chairman, Greater China, of Danone Early Life Nutrition, Greater China

The *Quarterly*: *That's a great example of how data are helping you tackle productivity challenges internally. Can you talk about any other initiatives that will help you better understand your customers?*

Mr. Lu: On the consumer side, we built an internal capability to get the consumer data out of a huge database. We have 20 million consumers who are actively talking to us in our data bank monthly. We know exactly who they are, how they behave, and how they interact with us, and we use this to adjust our product and adjust our formulation in order to meet their needs.

At the same time, consumers are also able to get access to more of the services and products that we are offering, either through an online channel or through membership interaction or through a microcommunity.

So again, this gives a lot more transparency over how we run our business. We can forecast for the next day instead of a month later. And we can read consumer trends—whether they like more sugar, less sugar. They may also tell us where they go in terms of what entertainment programs, dramas, and movies they are watching. This provides a lot of possibility for us to get the access to our consumer but also to give our consumer the ability to access us.

The *Quarterly*: *How do you see the changes you have been describing playing out over the next few years?*

Mr. Lu: We need to see how we can use these changes in the market to actively engage with our consumers, to provide personalized, individualized products for the young and old, because they all have different needs.

For example, we are working on how to get our product to be more interesting and to have a different taste profile that appeals to a younger audience. How can we give consumers much more than nutrition? We need to give them enjoyment. We need to give them excitement.

We also want to work on the image of Mengniu, to become younger looking and more fashionable. We cannot blame consumers for not liking milk or our packaging. If we do these two things right, then I think we will be part of a consumer's healthy enjoyment of life rather than just a pack of milk sitting in the fridge.

“If you look at our industry, you will see a very long supply chain all the way from grass to glass. You can collect data from farms and even from individual cows.”

The *Quarterly*: *If China’s bold Belt and Road Initiative does indeed open the borders to increased outbound and inbound trade, what is the opportunity for Mengniu Dairy to become a global brand?*

Mr. Lu: Now, honestly, Mengniu is still very much a Chinese company. But whereas in the past, the Chinese government or Chinese companies were very good in terms of exporting machine equipment and infrastructure capabilities, today we find, given the One Belt, One Road strategy, there is opportunity for a consumer-goods company like us. We are expanding into markets like Hong Kong, Macau, Singapore, Malaysia, Myanmar, and Bangladesh; we find huge opportunity in these markets.

For example, I was in Indonesia recently. It’s amazing because in Jakarta, an area of 15 million people, we know the consumers and they like our product. If we take our product there, we will find out that there are a lot of similar products and that they have the same preference [as Chinese consumers]. We have tested two products in this market and got very, very good feedback.

It also gives us opportunities to expand our products. In Southeast Asia, ice cream is a very important category because, unlike China, you have no seasonality. You can eat ice cream every day. And the same thing for the fresh dairy products. Some of these markets are like China 20 years ago, like in Myanmar and Bangladesh. We understand the consumer and the category trends as well as the country trends.

With One Belt, One Road, there is support from the local countries that are more open to a Chinese company running business there. Alibaba is there.

We can see Jingdong is there. We can see also Xiaomi and Vivo—they are all there. This is a different ecosystem today than in the past.

The *Quarterly*: *Can you explain the motivation behind your recent film collaboration with Alibaba and Jack Ma?*

Mr. Lu: It was interesting because the motivation for the film came from Alibaba—and from Jack Ma, who wanted to change the impression of kung fu to make it fun, interesting, and part of modern Chinese culture and bring it to the front of the consumer mind. This was the purpose of the film, and that also resonates with what we at Mengniu want to do as well. We are not just a milk manufacturer telling you what we can do; we want to be part of your life. Q

Jeffrey, Minfang Lu is the CEO and executive director of China Mengniu Dairy. This interview was conducted by **Lois Bennett,** a member of McKinsey Publishing who is based in McKinsey's Shanghai office.

Illustration by Kotryna Zukauskaite

Still looking for room at the top: Ten years of research on women in the workplace

What we know—and what everyone needs to know—about the quest for equality.

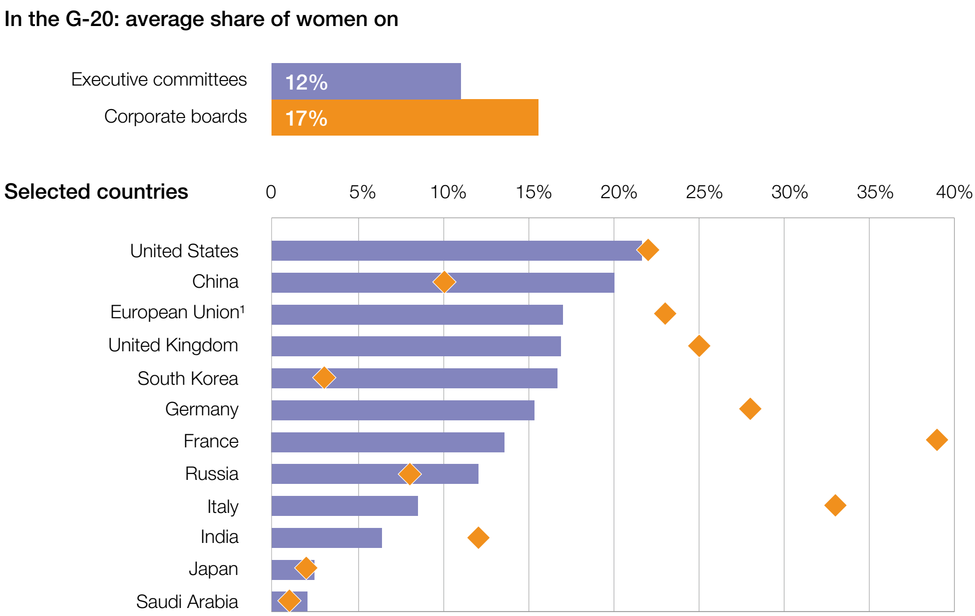
by Sandrine Devillard, Vivian Hunt, and Lareina Yee

In 2007, when women held 11 percent of seats on the executive committees of Europe's leading companies, McKinsey published its first *Women Matter* report. It not only argued for greater gender diversity in corporate management but also suggested how to achieve that goal.

Since then, we have vastly extended the scope of our research, publishing more than 20 reports that have shaped the debate on gender equality in the workplace around the world. But there remains an uncomfortable truth. While progress has occurred in the intervening years, it remains too slow. In 2017, on average, women accounted for 12 percent of executive-committee members and 17 percent of corporate-board members in the top 50 listed G-20 companies (Exhibit 1). Even more worrying, perhaps, is that many people are content with the status quo. According to our *Women in the Workplace 2017* study, conducted with LeanIn.Org and one of the largest of its kind, almost 50 percent of men think that it is sufficient when just one in ten senior leaders in their company is a woman. One-third of women agree.

Exhibit 1

In 2017, representation of women on corporate boards and executive committees is still far from parity, although it varies widely by country.



[1] Estimated based on G-20 countries.

Source: Top-listed companies of the relevant stock-market reference index; McKinsey analysis

Despite this slow progress, our understanding of the challenge has forged ahead. Of the lessons learned, at the top of the list must surely be how hard the problem is to crack. To help concentrate efforts and encourage the many companies striving to make progress on diversity, this article summarizes what our decade of research has taught us about the case for change, the barriers that prevent it, and the solutions required for achieving it.

THE CASE FOR CHANGE

Our research has examined both the impact of having more women in senior-management positions on business performance and the potential for greater female participation in the workforce to unlock growth in the global economy.

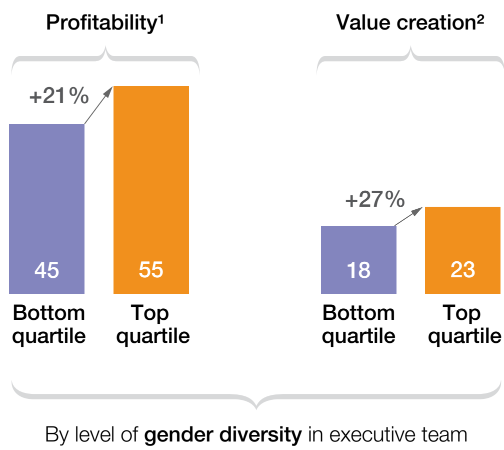
Correlations with company performance

Many companies strive for gender equality because it is the right thing to do, a point made most recently in our 2017 report *Women Matter: Time to accelerate—Ten years of insights into gender diversity*, by Janina Kugel, a member of the managing board of Siemens. "It is important to clearly state that discrimination is neither accepted nor tolerated, and to leave no room

Exhibit 2

Companies in the top quartile for gender diversity in executive teams were more likely to outperform on profitability and value creation.

Likelihood of financial performance above national industry median, %



[1] Average EBIT margin (earnings before interest and taxes), 2011–15.
[2] Average economic-profit margin, 2011–15. Sample = 991 companies.

for ambiguity," she says. But McKinsey also put forward a business case in its early research. A global survey of 279 companies conducted in 2010 found that those with the greatest proportion of women on their executive committees earned a return on equity 47 percent higher than did those with no female executive members.[1]

Of course, a correlation does not prove causation, and some academics[2] have disputed what they regard as the intuitive appeal of a link between diversity and performance. Nevertheless, a growing body of research by McKinsey and others continues to strengthen that link. Our 2018 *Delivering through diversity* study of more than 1,000 companies in 12 countries found a correlation between diversity at the executive level and not just profitability but also value creation. Those companies in the top quartile for gender diversity were 27 percent more likely to outperform their national industry average in terms of economic profit—a measure of a company's ability to create value exceeding its capital cost—than were bottom-quartile companies (Exhibit 2). There was also a penalty for lack of diversity more

[1] See Georges Desvaux, Sandrine Devillard, and Sandra Sancier-Sultan, *Women Matter 2010: Women at the top of corporations: Making it happen*, October 2010, McKinsey.com.

[2] See Katherine Klein, "Does gender diversity on boards really boost company performance?," Knowledge@Wharton, May 18, 2017, knowledge.wharton.upenn.edu.

broadly. Companies in the bottom quartile on both gender and ethnic diversity were least likely to record higher profits than the national industry average (Exhibit 3).

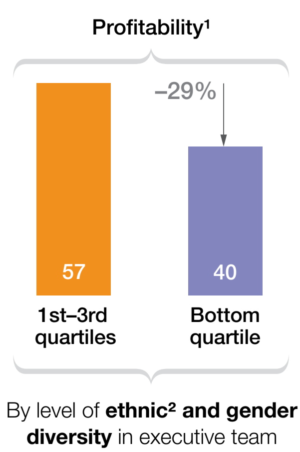
Women lead in different ways than men do

Early in our research, we suggested that one of the reasons that companies with a higher proportion of senior women in their ranks might perform better was that men and women display different, but equally valuable, leadership behaviors. Drawing on research in behavioral psychology and what McKinsey calls the "organizational health" of a company, we showed that women tend to encourage a more participatory decision-making process, such as improving the "working environment" component of organizational health. Men, meanwhile, tend to take corrective action more frequently when objectives are not achieved to bolster the "coordination and control" component of organizational health. Not all women and men can fall into these categories, of course. Nevertheless, McKinsey has shown a strong correlation between the organizational health of a company and financial performance.

Exhibit 3

Lack of gender and ethnic diversity in executive teams was associated with relatively weaker profitability.

Likelihood of financial performance[1] above national industry median, %



[1] Average EBIT margin (earnings before interest and taxes), 2011–15.
[2] Analysis of ethnic diversity based on 589 companies with relevant data.

Source: Company websites; McKinsey Diversity Matters database

The risk of our research into leadership behavior was that it would be seen as stereotyping women and men, unhelpfully accentuating differences at a time when many women were struggling to establish themselves in the workplace by emphasizing that they were no different. But the corporate world now embraces the notion of diversity and acknowledges the value of different perspectives, backgrounds, experience, and even leadership styles. Iris Bohnet, professor of public policy at the John F. Kennedy School of Government at Harvard University, puts it like this in our latest *Women Matter* report: "The evidence is very strong that diverse teams outperform homogeneous teams, whether these are all-male or all-female teams. This occurs across all kinds of different dependent variables, from creative problem solving to analytical tasks to communication skills. Diversity helps because we have a complementarity of different perspectives, or what we call 'collective intelligence.'"

Global economic potential

If women equally participated in the global economy, they could generate additional GDP worth $28 trillion by 2025. That amount is roughly equivalent to the size of the Chinese and US economies combined.

The McKinsey Global Institute made that finding in 2015, when it widened the lens and showed the enormous macroeconomic opportunity that lies in greater gender equality in the workforce. In a study of 95 countries, MGI found that women generated just 37 percent of the GDP, even though they accounted for approximately 50 percent of the working-age population. Lower workforce participation explained most of the gap. But the fact that women often work part time and in less productive areas of the economy, such as agriculture, also counts.

To be clear, the report recognizes that for a variety of reasons, not least cultural norms, women are unlikely to participate equally in the economy in the foreseeable future. But it nevertheless indicates the potential prize, even with only moderate progress. That prize is likely to be particularly valuable in countries where population aging threatens economic growth. A "best in region" scenario, where countries match the rate of improvement of the fastest-improving country in their region, could add as much as $12 trillion, or 11 percent, to the annual 2025 GDP.

THE BARRIERS TO CHANGE

What do we now know about why inequality persists in the workplace? The MGI study tracked ten indicators of women's position relative to men in society, such as education, health, safety, political voice, and financial and digital inclusion, as well as five indicators of equality in the world of work. Broadly speaking, the better their standing in society, the better their relative situation in the workplace. There is almost no country in the world where equality in the workplace outstrips that of women in society. This fact highlights the power governments have to instigate change, be it by introducing laws that protect women's rights, ensuring that girls have a good education, or offering financial support in the form of paid maternity leave, publicly funded childcare, or tax incentives to encourage both partners in a family to work. Much of McKinsey's work, however, has sought to understand the specific barriers to female leadership within business and hence the actions corporations can take to help lower them.

Not just a glass ceiling

Female representation, we have found, is not just a problem at the top. It remains an issue at each stage of the corporate pipeline, with the odds stacked particularly highly against Asian, black, and Latina women, as well as other women of color.

Early efforts by companies to improve female leadership focused on appointing more female board members. Yet our research quickly established that addressing women's absence at the top could only occur by looking at their career progression. It turns out that the underrepresentation of women is already a factor at the outset of their careers, and their representation diminishes with further progression along the pipeline. The odds of progression differ by industry. Some industries, such as technology, are particularly poor at hiring women in the first place. In others, women tend to get stuck at middle- or senior-management level. The overall picture is nevertheless clear. Our 2017 research on women in the workplace—which looked at 222 companies in the United States employing more than 12 million people in total—found that, on average, women held just 22 percent of senior vice president roles. No wonder the odds of reaching the very top are so slim. Disturbingly, women of color fare even worse (Exhibit 4).

Lack of promotion

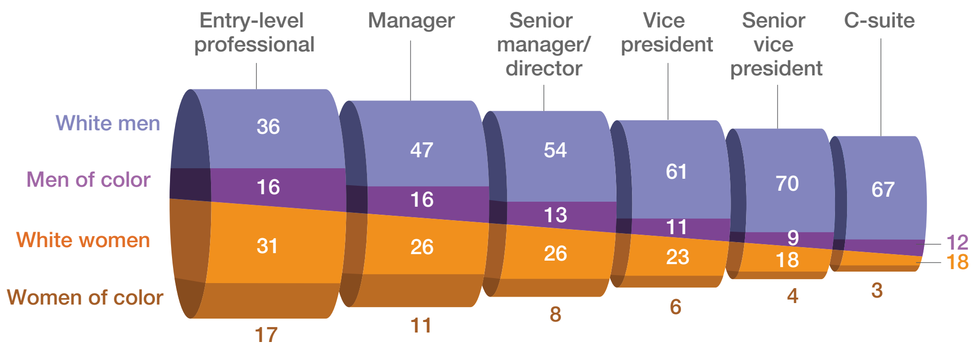
Some things change. In 2007, we cited research suggesting that women fail to make headway in their careers because they are less ambitious, do not seek promotion, or choose to drop out of the corporate pipeline. Subsequent research has quashed those ideas. In 2013, we found the great majority of mid- and senior-level women interviewed for a global survey (79 percent) were keen to reach a top-management position—much the same proportion as men. And our *Women in the Workplace 2016* report showed that in the United States, 74 and 80 percent of women and men, respectively, want promotion to the next level. That said, women are markedly less confident of fulfilling their ambitions, and perhaps justifiably so. They are less likely than men to receive promotions, even though they ask for promotions at similar rates. Getting on the first management rung is the hardest. Entry-level women are 18 percent less likely to receive promotions than are their male colleagues, according to the *Women in the Workplace 2017* report.

One kink in the more recent findings is particularly noteworthy: fewer women than men are interested in reaching the highest corporate echelons. We can still only speculate why. Is the top job not appealing? Or is it too hard to get?

Exhibit 4

The odds of women reaching the very top are slim, and women of color fare even worse.

Corporate-talent pipeline by gender and race,[1] %



[1]Percentages by race and gender in each stage of the pipeline may not sum to overall corporate pipeline totals, as the percentages for race only include companies that were able to supply data on race. Figures may not sum to 100%, because of rounding.

Source: *Women in the Workplace 2017*, in which LeanIn.Org and McKinsey examined the employee pipeline of 222 US corporations

Domestic burden

Some things do not change. At the outset of our research in 2007, we highlighted women's double burden: their relatively greater responsibility for household chores while holding down a job. In Europe at that time, women spent twice as long on household duties as men. The women we interviewed stressed how this—coupled with the need to make themselves available anytime, anywhere to show they were serious about work—was a major barrier to their advancement. Their burden has not become much lighter. The *Women in the Workplace 2017* report found that more than half of the women surveyed do all or most of the household work. And women with children and partners are 5.5 times more likely to do all or most of the household work than are men in the same family situation. Not surprisingly, perhaps, we also found that women who do most of the housework have lower aspirations to climb to the highest rungs of the corporate ladder compared with women who share the responsibility.

Unconscious biases

In the "bad old days," many companies said a lack of high-caliber candidates explained their failure to recruit women or promote them to senior positions. This excuse no longer washes. Most people now understand that biases can undermine women's success. Our work has examined some of them. The performance-evaluation bias, for example, means men tend to be evaluated more on their potential and women more on their achievements to date. Women also tend to receive less credit than men for success and more criticism for failure. For their part, women are often less assertive than men and underplay their contributions. The maternal bias triggers assumptions that mothers have less commitment to their careers; therefore, they are held to higher standards and receive fewer leadership opportunities.

ACCELERATING CHANGE

The insights previously described have fueled the many actions that companies, including McKinsey, are taking to advance equality in the workplace. These include offering bias-training courses; taking steps to ensure that recruiting, performance, and promotion processes are fair; working to help employees balance their work and home lives, such as offering extended parental leave, flexible working conditions, and childcare support; and looking hard at the data to understand where in the pipeline women get stuck. All these actions are important to promote the kind of inclusive culture in which companies thrive, although priorities can differ in different geographies depending on sociocultural context. At this juncture, two recommendations consistently made in our ten years of research stand out as vital to accelerate change.

Tracking and accountability

Results from the eight European countries that impose female quotas on corporate boards are instructive. Female board-member representation in them today ranges between 33 and 40 percent, compared with an average of 17 percent in G-20 countries. Some observers, however, fear that quotas promote tokenism and therefore fail to build female-leadership capacity. Others have come to see quotas as uncomfortable, but necessary, transitional steps. Barbara Dalibard, CEO of technology company SITA, told us progress was inadequate: “In some technical environments, women still face the same difficulties as 25 years ago. When I was young, I was absolutely against quotas; my belief now is that if you do not have quotas, things do not change. Change in France is happening on boards because of the law. It is not happening in executive committees, because quotas do not apply there.”

In the absence of quotas, progress rests on measuring diversity, being open about progress made, and holding people accountable. Companies with the best records for female representation share their metrics with all employees, but such transparency is rare. While our latest *Women in the Workplace* study shows 85 percent of companies track female representation at each level, less than half that number say they hold senior managers accountable for improving gender metrics, and fewer still are bold enough to set targets of any description.

Leadership from the top

Senior-management leadership has been a constant theme of our ten-year journey. However, although 90 percent of companies proclaim a commitment to gender equality, the message is not getting through. Only half of the employees surveyed in the *Women in the Workplace 2017* report think their companies are highly committed to gender equality; the majority do not see senior managers taking steps to improve matters. This is bad news, as managers lower in the organization are most likely to influence women's career progression and ambition. It is they who determine how widely policies are adopted. And women are more likely to receive promotions when managers act as their advocates, give them assignments that stretch their roles, and advise them on career advancement. Given that so many managers are male, it is clear why senior leaders must encourage more men to invest in gender diversity.

The time for wavering is over; companies need leaders who are prepared to shout from the rooftops that gender diversity matters and make it happen. Q

Sandrine Devillard is a senior partner in McKinsey's Montreal office, **Vivian Hunt** is a senior partner in the London office, and **Lareina Yee** is a senior partner in the San Francisco office.

We would like to acknowledge the contributions made by numerous McKinsey colleagues in the course of our decade of research. They are too many to mention all, but their efforts in developing our understanding of gender inequality in order to promote change are deeply appreciated. Key to the latest research cited in this article include Georges Desvaux, Kweilin Ellingrud, Alexis Krivkovich, Eric Labaye, Anu Madgavkar, Kelsey Robinson, Sandrine Sancier-Sultan, and Irina Starikova.

IS THE SOLOW PARADOX BACK?

Digitization isn't stimulating productivity growth—yet.

Mekala Krishnan is a senior fellow of the McKinsey Global Institute (MGI) and is based in McKinsey's Boston office.

Jan Mischke is a partner at MGI and is based in the Zurich office.

Jaana Remes is a partner at MGI and is based in the San Francisco office.

Don't be discouraged by the anemic productivity growth that has handicapped advanced economies for more than a decade. If history is any guide, technology-enabled innovation in processes, products, and services could soon deliver a new wave of productivity growth, with major benefits accruing to players on its leading edge, and to the economy as a whole.

We've seen this movie before. Productivity growth lagged in the 1970s and 1980s, despite the computing revolution's gathering strength. Economist Robert Solow famously said in 1987 that the computer age was everywhere except for the productivity statistics. This phenomenon, which became known as the Solow Paradox, was resolved in the 1990s when a few sectors—technology, retail, and wholesale—led an acceleration of US productivity growth.

In part, the 1990s productivity boom reflected a wave of rapid, fundamental innovation in semiconductors that, along with design and manufacturing-process improvements, boosted their power exponentially in relation to their cost. Semiconductor improvements translated into surging productivity for that sector, and into higher-quality and higher-value inputs for downstream computer-equipment manufacturers, who similarly enjoyed a dramatic productivity improvement.

Also moving the needle were sectors with large labor forces such as retail and wholesale, both of whose productivity had for years been stagnant. When large-format players such as Walmart (in retail) and McKesson (in pharmaceutical wholesaling) used technology to transform supply-chain and distribution-center efficiency, they became both more productive and competitive. Other players responded in both industries, and productivity rose across the board.

The benefits spread further as rapid declines in information, communications, and technology (ICT) equipment prices encouraged an investment boom in a number of other sectors, some of which, such as telecommunications and securities trading, enjoyed rapid productivity improvements.

In short, as companies across the economy evolved business processes, often with the help of an expanding ICT services and software sector, productivity responded strongly in concentrated pockets, moving the needle for the economy as a whole either because the productivity jumps were extremely large or because they occurred in sectors of the economy (such as retail and wholesale) where employment was very large.

Today, with digitization, we are living in round two of the Solow Paradox.

By digitization, we mean the latest digital technology—such as cloud computing, e-commerce, the mobile internet, artificial intelligence, machine learning, and the Internet of Things—that is moving beyond process optimization to fundamentally transform business models, alter value chains, and blur the borders of industries.

What differentiates this latest wave is the breadth and diversity of innovation. Beyond improving existing business operations, innovation is creating new digital products and features (for example, digital books and live location tracking), introducing new ways to deliver them (for example, mobile directions and streaming video), and enabling new business models (for example, Uber and TaskRabbit).

Digitization contains the promise of significant, productivity-boosting opportunities—but the benefits have not yet materialized at scale. For example, in a recent McKinsey survey of global corporations, only a small fraction of activities and offerings were described as digitized; less than a third of core operations were automated or digitized, and less than a third of products and services were digitized. This is due to adoption barriers and lag effects, as well as transition costs. For example, in the same survey, companies with digital transformations underway said that 17 percent of their market share from core products or services was cannibalized by their own digital products or services.

Today, we find that companies are allocating substantial time and resources to the innovation and adaptation of their businesses. In doing so, many are still trying to understand how to make the most of digital technologies, which often do not yet have a direct and immediate impact on output and productivity growth. Look at some examples.

In the auto industry, opportunities exist to boost productivity through the development of value-added products such as autonomous vehicles, or through greater software content. In 2016, though, only about 1 percent of vehicles sold were equipped with basic partial-autonomous-driving technology. Fast-forward one year, and 80 percent of the top ten OEMs had announced plans for highly autonomous vehicles to be ready by 2025. If technology and regulatory hurdles are overcome, our colleagues in McKinsey's Automotive & Assembly Practice estimate that up to 15 percent of new cars sold in 2030 could be highly autonomous. That's significant penetration—but it's more than a decade out, and still just a small portion of overall sales.

In retail, while online sales are twice as productive as offline, they account for only about 10 percent of total sales today in the United States and Western Europe, according to data from Euromonitor International. Transition costs abound in the realization of productivity benefits, starting with the impact of declining foot traffic in traditional retail stores and malls. Behind the headlines about drone delivery and workerless distribution centers, retailers are working overtime to strike the right "Goldilocks" balance between offline and online retail; their quest will take time.

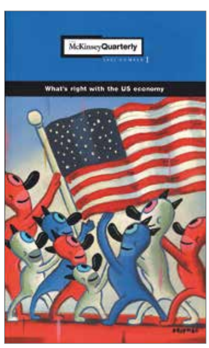
In the utilities sector, some estimates suggest that digital opportunities such as smart meters and grids, digital productivity tools for employees, and automation of back-office processes could boost profitability by as much as 20 to 30 percent. Investments in digital technologies are still subscale, though, and come with a learning curve. Renewables, too, tend to be more productive—however, wind and solar energy, for example, still comprise less than 10 percent of power generation in the United States and less than 20 percent in Europe.

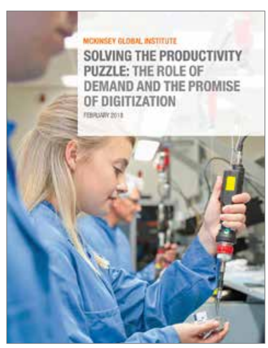
So where could all these exciting but as yet unrealized digital opportunities lead?

Adding things up for the economy as a whole, our latest research identified potential productivity growth of at least 2 percent per year over the next decade, with about 60 percent coming through digitization. That's below the roughly 2.5 percent annual rate achieved by the United States in the late 1990s and early 2000s, but well ahead of the 0.5 percent annual average in recent years.

This isn't just economic arcana. If productivity growth rates do quadruple, it will be because business innovation has caught up with the opportunities created by digitization, and leading companies are pushing the frontier. When the Solow Paradox was unwinding, companies such as AMD, Costco, Dell, Intel, McKesson, Target, Walmart, and a handful of others flourished at the same time as they drove disproportionate, economy-wide productivity improvement. The potential for outsize gains could be even greater this time around because of the scale and network effects associated with digital technologies. That raises the stakes for today's executives—but it's also good news. The size of the prize means productivity rates won't stay low forever. And as they rise, so will a new generation of leading companies.

Revisiting the Solow Paradox





The McKinsey Global Institute (MGI) first tackled the Solow Paradox in a report featured on the cover of *McKinsey Quarterly* in 2002. A recent MGI report, *Solving the productivity puzzle: The role of demand and the promise of digitization*, updates the story in the context of today's digital trends.

Still looking in the rearview mirror?

A narrow view of strategy rooted in past performance—both your company's and your competitors'—won't cut it in today's dynamic environment.

"We're going to exceed last year's performance by doing everything exactly the same."

Put the pedal to the metal: see "Eight shifts that will take your strategy into high gear," on page 88, which is adapted from *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* (Wiley, 2018), by Chris Bradley, Martin Hirt, and Sven Smit.

Highlights

An agenda for the talent-first CEO

Eight shifts that will take your strategy into high gear

Leading with inner agility: Learning to love complexity

The fairness factor in performance management—plus reflections from the CEOs of Microsoft and Hilcorp

Still looking for room at the top: Ten years of research on women in the workplace

The unintended consequences of the booming urban knowledge economy

From grass to glass: How China Mengniu Dairy uses data analytics and AI to transform its business

The leadership journey of Abraham Lincoln

How AI can help you navigate in a disruptive environment

The Solow Paradox redux: Will digitization usher in a new wave of productivity?

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