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Yuval Atsmon

How nimble resource allocation can double your company's value

Strategy August 2016

Companies that actively and regularly reevaluate where resources are allocated create more value and deliver higher returns to shareholders.

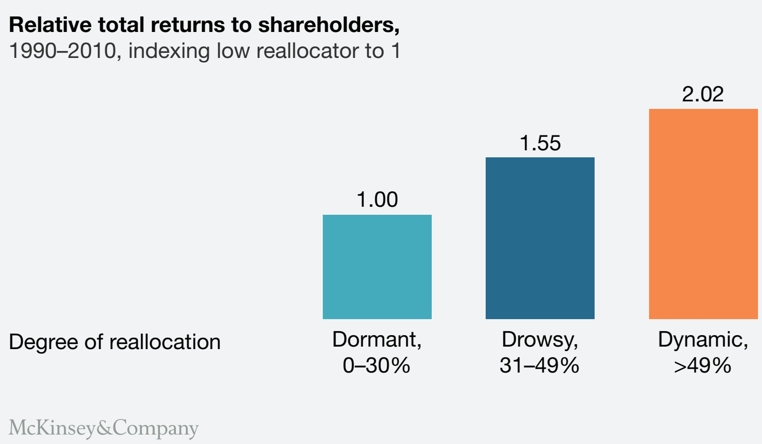
"Dynamic resource reallocation" is a mouthful, but its meaning is simple: shifting money, talent, and management attention to where they will deliver the most value to your company. It's one of those things, like daily exercise, that helps us thrive but that gets pushed off our priority list by business that seems more urgent.

Most senior executives understand the importance of strategically shifting resources: according to McKinsey research, 83 percent identify it as the top management lever for spurring growth—more important than operational excellence or M&A. Yet a third of companies surveyed reallocate a measly 1 percent of their capital from year to year; the average is 8 percent.

This is a huge missed opportunity because the value-creation gap between dynamic and drowsy reallocators is staggering (exhibit). A company that actively reallocates delivers,

Exhibit

Actively reallocating resources increases company value, and rewards are high.



on average, a 10 percent return to shareholders, versus 6 percent for a sluggish reallocator. *Within 20 years, the dynamic reallocator will be worth twice as much as its less agile counterpart*—a divide likely to increase as accelerating digital disruptions and growing geopolitical uncertainty boost the importance of nimble reallocation.

Why this disconnect? In my experience, executives struggle to figure out *where* they should reallocate, *how much* they should reallocate, and *how* to execute successful reallocation. Additionally, disappointment with earlier reallocation efforts can push the issue off top management's agenda.

To get real value from resource allocation, executives should follow four important principles.

1. Go granular

Beware the tyranny of averages. A single unit may have lines of business or geographic pockets with very different returns. It's not uncommon to see a 10 percent decline in one area while another is experiencing triple-digit growth. In fact, the variability is often much more significant across granular market segments within one business unit than across large business units.

Segmenting the company and defining the level of granularity can be something of an art, as top executives can't debate trade-offs across thousands of micromarkets (although some functions, such as marketing and sales, should). You need to drill down to the smallest *meaningful* business, where a shift in resources will produce a material impact for the overall company (likely more than 1 percent of total revenues). Additionally, each segment you isolate should have a distinct external market—say, premium sports cars in the United Kingdom—even if some resources are not fully divisible. For example, R&D might be shared across premium sports cars regardless of country, but not the marketing spending.

2. Focus on value creation

Sometimes investments have a direct business case and you can quantify the net present value of all future cash flows associated with it. A project to invest in a new mine, or to develop a new vehicle, may look like that. In other cases, the overall economic profit (profit created above the cost of capital) of a segment may be an excellent and more consistent method to assess ongoing value creation. Assessing which segments deserve more or less money and attention requires the right metrics.

One of my favorite and relatively simple return-on-investment (ROI) metrics is calculating cumulative expected economic profit and dividing it by the cumulative (financial) resources it will require to produce (for instance, invested capital, additional R&D, or sales and marketing). How quickly the investment pays off will vary according to the business life cycle. For example, fast-moving-consumer-goods or services companies may take fewer than three years to realize most of the returns from a major investment, whereas products that are more complex may take longer.

3. Overcome biases

Start by acknowledging that everyone has biases. Resource-allocation decisions tend to be heavily affected by these biases: executives are often overconfident, believing they can reverse and improve on past performance, and find it hard to back away from big bets, even when those investments fail to deliver. At the same time, they attribute too much risk to new opportunities and can be slow to embrace them.

Any resource-allocation exercise must be grounded in hard data so that decisions are driven by facts and logic. Some common techniques to overcome biases include these:

- forcing the prioritization of opportunities based on their value creation or ROI
- committing to a minimum annual reallocation—and moving some cash into the bank for new allocations
- role-playing scenarios that force executives to debate against their natural interest or to allocate resources to anonymous business segments that may or may not be their own

My favorite technique is reanchoring, which removes management's optimistic "hockey stick" projections of rapid improvement. This is done by building a model based on outside forecasts and assuming there will be no improvement in performance; leaders then debate whether it is still an attractive investment. If it's not attractive, it's important to test the confidence that a big improvement is achievable before continuing to invest.

4. Be agile

In this volatile business environment, resource allocation should be regularly adjusted, especially when major events occur, such as June's Brexit vote or last year's sudden oil-price decline. Some businesses have a systematic stage-gating process for investments. Typically, when developing new products and services, you hold off some of the investment until there is evidence that it is yielding results. The strategic-planning process needs to recognize material uncertainties—both external (demand growth, competitive launches, regulation) and internal (new technology, changes in talent)—and establish clear threshold levels at which decisions on resource deployment would be revisited.

Some argue that this agile approach creates too much change and does not provide enough time and commitment for new business initiatives to flourish. But by clarifying the metrics for weighing whether investments are paying off, you improve the quality of your governance, deal with genuine uncertainties, and can reevaluate quickly when unforeseen events inevitably occur. By setting clear expectations for value creation in each segment and by clarifying the major assumptions about market evolution and internal performance that underpin those expectations, you ensure that the resource-allocation process is continuous rather than cyclical.

Ultimately, even with the best intentions, resource reallocation can fall victim to organizational inertia and internal power dynamics. In companies where unit heads run their businesses like fiefdoms, with little input from those outside the walls unless they fail to make their numbers, the challenge is particularly daunting.

Managers whose businesses are performing well will naturally resist the argument that their resources might produce even better returns elsewhere. To change the conversation, try showing them the potential impact of reallocation on share price. In one case, the chief financial officer of a large company demonstrated that just 1 percent more growth in more attractive segments could raise the share price by 30 percent. □

This article also appears on LinkedIn.

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OCTOBER 2013

Breaking down the barriers to corporate resource allocation

Most companies do far too little resource reallocation. In this video, McKinsey directors Stephen Hall and Conor Kehoe explain why, and urge executives to do more.

Actively reallocating corporate resources is important in the best of times, and even more so during economic downturns. Yet companies remain surprisingly slow to shuffle their resources, and even new CEOs have a tendency to maintain the status quo. In this video, McKinsey directors Stephen Hall and Conor Kehoe explain why changing allocation behavior is hard and advise new CEOs to take advantage of their opportunity to aggressively shift resources. What follows is an edited transcript of their remarks.

The problem of strategic inertia

Conor Kehoe: Making strategy happen is an important issue for CEOs. It really is. And they confront really two sets of barriers. One is internal barriers. And within the organization, there may be people who frankly do not want their best people reallocated to some new task in a promising market or alternatively, may want to hang onto the capital they have and not have it reallocated to a new market.

But there are also barriers coming in from the stock market. The stock market loves reallocation in the long term but actually doesn't like it in the short term because it tends to depress profits for the first couple of years. The problem isn't conceiving the strategy; the problem is implementing it—actually redeploying people and capital so that the strategy comes to life. And indeed, what we've been measuring in the research is this reallocation of capital and of people. And we're finding companies do far too little of it.

Lessons from the downturn

Stephen Hall: The data is unambiguous on the point of the reward that comes from being a more activist reallocator. There's something like a four percentage-point difference in the average return to shareholders year on year for those who are in the top third of reallocators versus those in the bottom third.

When we looked at the data through time, we expected that we would find that, in periods of economic turmoil, companies would be more activist in the way that they reallocated their resources. Those are the times when investors get nervous, when markets put pressure on CEOs, when performance starts to slip below the promises that have been made.

Interestingly, the results were the opposite of that. In other words, companies were no more active in periods of economic downturn, such as the last five years, than they were in the good times. And that tells us that despite the pressures on companies, there are a whole set of challenges that they face internally in doing what they know they need to do and what they're being pressured to do.

Conor Kehoe: This was interesting because we know from other research that this is in contrast with private-equity-owned companies who try harder and produce better results relative to their quota peers in downturns than they do during good times.

We think what's going on is that private equity is under less short-term pressure. They have about five years usually in which to make their companies work before they sell them on again, whereas the public company is under the scrutiny of quarterly-earnings reporting. And that may make CEOs hesitate—even when they're under huge pressure—to invest in new areas which may depress profits in the short term.

What CEOs should do

Conor Kehoe: For new CEOs, this research says, "Get going quickly on redeploying people and capital towards growth opportunities." So if you're a new CEO, you have a golden opportunity. You're in your honeymoon period. Do the reallocation, take the short-term hit, because you'll benefit from the long term. And don't worry about overdoing it. We haven't found anybody who's overdone reallocation. So go for it.

Stephen Hall: We looked at both how quickly new CEOs reallocated their capital and also how swiftly they made changes in their management teams. We think it's probably very tempting for a new CEO to not want to make big changes immediately but to take time, understand the business, get to know people, and only then—in a more deliberate fashion—make changes. In practice, and based on the extensive data we looked at, CEOs are much better off being bold and making changes quickly.

Making it happen

Conor Kehoe: Since nobody seems to overdo reallocation, I quite like some of the crude instruments that are used to shake things up. One of them that we've come across, which is well known, is "We'll be number one or number two in our market wherever we go." Now, there's no real evidence to suggest that in some markets being number three isn't a very profitable position, thank you very much. But think about the reallocating tendency of that statement. If you're not number one or number two, something's going to happen. So that, for me, is a wonderful tool for reallocation. We came across another company where the CEO allocates 10 percent of capital, within his own discretion. That is a pretty arbitrary number. But it does mean that things get shaken up. And since this is not a fine-tuning exercise, our data shows that nobody really does enough reallocation. A crude instrument like this is a pretty good start. It begins to shake things up and overcome the internal inertia.

Stephen Hall and **Conor Kehoe** are directors in McKinsey's London office.

OCTOBER 2013

Avoiding the quicksand: Ten techniques for more agile corporate resource allocation

Michael Birshan, Marja Engel, and Olivier Sibony

These tested ideas can help organizations overcome inertia and implement their strategies more effectively.

Insanity has been defined as doing the same thing over and over again and expecting different results. Many senior executives face exactly this situation in allocating critical corporate resources. Every year, they turn the handle on the same strategy-development, capital-planning, talent-management, and budgeting processes, and every year the outcome is only marginally different from the one they reached in the previous year and the year before that. Business leaders readily accept that strong corporate performance demands bolder shifts in resources over time; most even agree that this is one of the most important roles of a CEO and top team. Yet they remain prisoners of management processes that have evolved to deliver the exact opposite of what they are looking for.

Refocusing those processes can deliver different results. We do not yet have an exhaustive list, but we've been collecting, refining, and adapting a rich menu of ideas for shaking up the corporate status quo. Here are ten proven techniques for putting better information on the table, encouraging boldness, cutting through corporate politics, and improving accountability in this critical area.

1 **Create a corporate-resource map.** Some companies now choose to allocate resources at the level of literally hundreds of product and market "cells," such as product or geographic categories. While that's too detailed for others, the key, in any case, is to go beyond the big divisions and develop a map that's granular enough to see where resources are currently deployed. Make sure it goes beyond capital spending, to include marketing expenditures, R&D funds, and top talent. Such maps—which one company we know brings to life on a tablet app highlighting resource requirements, returns, and growth options—give corporate decision makers the visibility they need for trade-offs between activities and initiatives a level or two below the business-unit level. This detailed transparency is typically required to change the allocation of resources in organizations that have powerful divisional leaders.

Further reading

Marc Goedhart, Sven Smit, and Alexander Veldhuijzen, "Unearthing the sources of value hiding in your corporate portfolio," coming soon on mckinsey.com.

2 **Benchmark your "resource inertia."** A number of companies have begun to measure the correlation between the percentage of resources each cell in their portfolios received in the most recent year and what it received in previous years. We encourage you to do the same—like them, you'll be surprised by how often the answer is well above 90 percent. This provides a good measure for tracking whether a company really reallocates its main resources.

Further reading

Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012, mckinsey.com.

3 **Reframe budget meetings as reallocation sessions, and run them accordingly.** This may mean introducing unorthodox approaches, such as giving investment-committee participants a small pile of poker chips and asking them to "place bets" on projects they think deserve funding. Such an approach concentrates minds on the big picture, not individual silos, and makes all of the people in the room aware that a company has other priorities besides their own pet projects. Also useful is the technique of "stage gating," the common practice—in R&D- or capital-intensive organizations—of setting performance milestones and releasing additional resources only when intermediate targets are hit. This forces periodic debate when new tranches of resources must be released.

During these discussions, spend time on how you're going to make the benefits tangible and visible for employees, since that's what galvanizes support in organizations. A major Latin American oil-and-gas player reallocated 30 percent of its capital-expenditure budget in the first year of a new CEO's tenure. She believes that when people started seeing where the money was going—new service stations, smart uniforms, and more product diversity—their initial resentment of the budget cuts turned into pride about the company's fresh, service-oriented philosophy.

Further reading

Dan Lovallo and Olivier Sibony, "Taking the bias out of meetings," *McKinsey Quarterly*, April 2010, mckinsey.com.

4 **Develop a formal "counteranchor."** One common cognitive bias, known as "anchoring," is to base next year's allocation uncritically on the previous year's. Leaders can encourage debate by, for example, circulating independent analysts' reports on the growth outlook for their different markets. One consumer-goods company uses external growth and profit-potential data, down to the level of individual cities, to create a hypothetical allocation of advertising expenditures. Often, it is so different from the company's current allocation that it shifts debate from whether spending should be 110 percent or 90 percent of last year's figure to whether it should be 200 percent or 50 percent.

Further reading

Dan Lovallo and Olivier Sibony, "Re-anchor your next budget meeting," *Harvard Business Review*, March 26, 2012, blogs.hbr.org.

5 **Change your strategy-setting rhythm.** While companies rightly want their deliberations on strategy to influence resource shifts, too few allow sufficient time between the conclusion of the strategic-direction setting and the locking down of resource-allocation decisions. This approach leads to allocations that are very similar to the previous ones, because the planners then say, "Our bottom-up planning process has spoken, and it's too late to change now." Better to share unrefined strategic direction with the wider organization early on rather than wait to issue a more complete one that arrives too late to make a difference. One industrial conglomerate starts developing its strategy in May but doesn't begin the budget process until November, giving businesses ample time to reflect any strategic-priority shifts in the way they allocate their capex dollars.

Further reading

Chris Bradley, Lowell Bryan, and Sven Smit, "Managing the strategy journey," *McKinsey Quarterly*, July 2012, mckinsey.com.

6 **Build flexibility into the process.** Opportunities—whether to nurture existing businesses with additional capital or to acquire new assets at knockdown prices—often pop up once annual allocations have been locked down. One large natural-resources group allows its CEO to allocate 5 percent (in practice, usually well over $1 billion) of its capital expenditures at his own discretion. A biotech company creates two budgets, red and blue: one based on business as usual, the other ready to be implemented quickly if a pending major clinical trial has a positive outcome. It's also worth considering the creation of a separate "rolling" budget: a discretionary pool that can be allocated over the year rather than at a single point in the calendar. This flexibility is particularly important for volatile emerging markets and cyclical industries, where the benefits of moving resources quickly are often high.

Further reading

Lowell Bryan, "Dynamic management: Better decisions in uncertain times," *McKinsey Quarterly*, December 2009, mckinsey.com.

7 **Learn to let go.** One of the most difficult parts of allocating resources is getting out of businesses that have served a company well in the past but are now stagnant or worse. One useful approach is for the investment committee, once a year, to conduct a formal exercise imagining that the company isn't in any of its businesses and then to ask whether the market fundamentals would make investments in each of them compelling. As a matter of policy, one large energy group makes sure that it disposes of at least 2 to 3 percent of its portfolio every year.

Further reading

John Horn, Dan Lovallo, and S. Patrick Viguerie, "Learning to let go: Making better exit decisions," *McKinsey Quarterly*, May 2006, mckinsey.com.

8 **Make it easier to move the top 100 to 300 people.** Much management talent works in the business units, and rightly so—that's where companies create value. But many business-unit heads tend to hang on to their star executives, which complicates the people side of resource reallocation. Fighting these natural instincts requires action at the top. Several global CEOs think of their companies' top ranks as a corporate asset to be applied to opportunities that offer the highest returns. Tactics that facilitate this approach include a corporate review of all top talent, as well as standardizing job titles and role descriptions across the top 200 or so executives and compensating them on the same basis regardless of geographic location. Such ground rules make it easier for the top team to mix, match, and move top talent.

Further reading

"Tilting the global balance: An interview with the CEO of Solvay," *McKinsey Quarterly*, available on October 22, on mckinsey.com.

9 **Don't forget about time.** Even without moving capital or people, companies can shift management's emphasis dramatically by taking a clean-sheet approach to the way the top team spends its time. Some companies set a time "budget" for the top team to clarify how much leadership capacity exists to "finance" initiatives and whether management is really focused on the highest strategic priorities. Time can also feature on the resource map.

Further reading

Frankki Bevins and Aaron De Smet, "Making time management the organization's priority," *McKinsey Quarterly*, January 2013, mckinsey.com.

10 **Look back and learn.** Reviewing earlier investment decisions helps companies refine the resource-allocation process. One company responded to such a postmortem review by insisting that no future investment proposal come forward for discussion unless independent technical- and business-evaluation teams had formally signed off on it. The company also required each individual executive on the investment committee to cast a formal vote for or against every specific investment and recorded such votes for posterity.

Further reading

Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 2010, mckinsey.com.

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We don't pretend that each of these ideas for refocusing resource-allocation processes is relevant to every business. Rather, we hope that they will inspire management teams to talk through what adjustments they need to make, within their own organizations, to deliver better resource outcomes. Ultimately, it is the CEO's job to adjust a company's processes so that they truly allocate resources strategically.

The authors would like to acknowledge the contribution of Blair Warner to the development of this article.

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Never let a good crisis go to waste

Mladen Fruk, Stephen Hall, and Devesh Mittal

New research shows that actively reallocating corporate resources is even more important in a downturn than it is in good times.

The vast majority of organizations are surprisingly slow to reshuffle their resources. When we conducted a large-scale analysis of the reallocation patterns of multibusiness companies, for instance, we found that most of them awarded each business in their portfolio an unchanging percentage of total corporate capital year after year between 1990 and 2005. Yet the returns were higher and the volatility lower at organizations that reallocated more actively.

When we present these findings (which we highlighted in a previous *McKinsey Quarterly* article[1]) to senior executives, they often ask us about the impact of the financial crisis and the downturn that followed. Surely, they argue, a tougher economic environment has led to more pronounced changes in resource-allocation patterns as companies were forced to look for new sources of value.

In fact, this proves not to be true. When we extended our analysis through 2010, thereby covering a full 20 years of performance by 1,500 companies, we found that the downturn had virtually zero impact on patterns of reallocation.[2] There was apparently no

[1] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, 2012 Number 2, mckinsey.com.

[2] Resource allocation is measured as 1 minus the minimum percentage of capital expenditure received by distinct business units over the 20-year period from 1990 to 2010. We used Compustat data on 1,508 US-listed companies that reported capital expenditure in a minimum of two distinct four-digit Standard Industrial Classification (SIC) codes.

greater aggregate corporate appetite for it in the tough recent years than there had been in the previous 15.

Yet the executives' instincts are right: dynamic resource allocation became more critical than ever during the downturn. Compare the performance of companies in the top third of our pool (high reallocators) with the performance of those in the bottom third (low reallocators). As Exhibit 1 shows, the gap between the total returns to shareholders (TRS) of the high reallocators, on the one hand, and of the low reallocators, which evolved their allocations only modestly over the 20 years, on the other, increased from 2.4 percentage points to 3.9 percentage points as a result of the extra five years. That may not sound like such a big gap, but 3.9 percentage points of annual incremental returns to shareholders implies that an investor's stake in our sample's typical high reallocator was worth more than twice as much as a stake in an average low reallocator by the end of the 20-year period (assuming all dividends were reinvested).

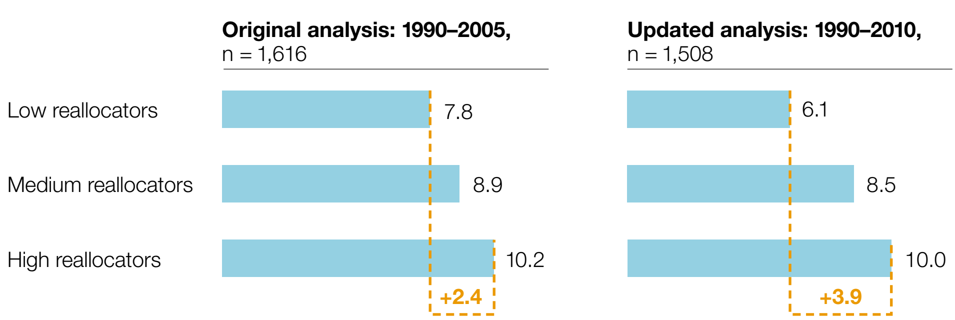
When we looked at companies sector by sector, the same broad pattern emerged: whether in basic materials, energy and utilities, information technology, or consumer products and retailing, the median TRS was consistently greater for the high reallocators than for the low ones.

A similar story is apparent in the corporate-survival statistics. Over the new, longer period of our study, the survival gap between

Exhibit 1

Companies that actively reallocated their resources continued to perform better through the 2007–10 economic downturn.

Median TRS CAGR for US companies, by degree of reallocation,[1] %



[1]TRS = total returns to shareholders; CAGR = compound annual growth rate. Degree of reallocation measures share of capital expenditure shifted between business units over given period; low reallocators = bottom third by reallocation activity, medium = middle third, and high = top third.

Source: Standard & Poor's Compustat; McKinsey analysis high and low reallocators increased to 22 percent, up from 13 percent in the original period.

In addition, since our data now cover both of the major global economic downturns of the past 20 years (for our purposes, 1999 to 2002 and 2007 to 2010), we can divide companies into those slow to respond by reallocating resources in the two crises, those that actively reallocated in only one, and those that did so in both. The results speak for themselves (Exhibit 2). On average, a company that was a high reallocator during both downturns had a TRS 3 percent greater than a company that was a high reallocator in only one and 4.5 percent greater than a company that wasn't in either.

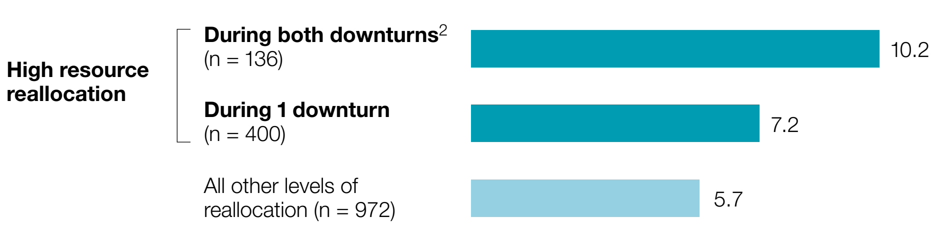
Realizing the benefits of resource reallocation during a downturn often requires shifting capital and other resources from one existing business to another: when times are tough, there is generally less new capital around, either in the form of growth in retained earnings or of new debt and equity capital. From 2007 to 2010, for example, the volume of new capital available to corporate-management teams in our sample declined by over 15 percent.

In these circumstances, it is more incumbent than ever on companies to make difficult trade-offs between the funding of promising growth opportunities (which require nurturing with more capital) and of mature or underperforming ones (which may need pruning). We found that high reallocators in our sample tended to reallocate existing and new resources equally; low reallocators, by contrast, had a much harder time taking resources away from existing lines of

Exhibit 2

Companies that reallocated their resources during tough times enjoyed significantly higher returns.

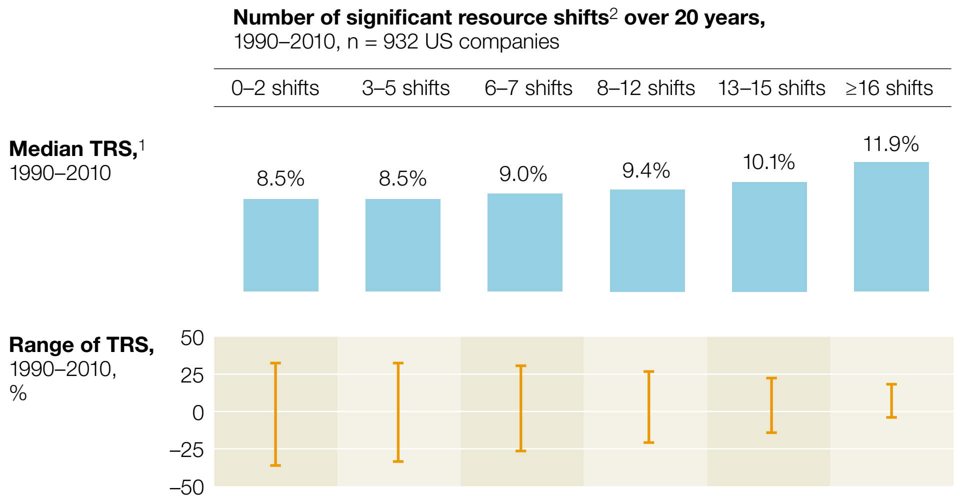
Average TRS for US companies, 1990–2010,[1] %



[1]TRS = total returns to shareholders; low reallocators = bottom third by reallocation activity, medium = middle third, and high = top third.
[2]Downturn periods defined as 1999–2002 and 2007–10.

Exhibit 3

Companies that consistently reallocated their resources experienced higher and less variable returns.



[1]TRS = total returns to shareholders.
[2]A significant shift is one that moves >5% of total capital-expenditure allotment.

business and tended predominantly to reallocate new resources. The willingness to rob Peter to pay Paul is one of the hallmarks of a dynamic top team.

This is not to say, however, that sharp, one-time swings of focus in response to a changing external environment generally make sense. Rather, our new data suggest that markets most reward companies that do not overreact to short-term signals by making large, abrupt changes in business focus but instead pursue multiple, stepwise shifts in resources, year after year, in pursuit of a clear strategy. That approach tends to produce better returns and lower volatility than one or two Herculean changes to a corporate portfolio (Exhibit 3).

These results suggest to us that resource reallocation is a muscle that requires exercising in good times and even more in bad times. Companies should be on their guard against inertia at all stages of the cycle—and may need to be particularly ruthless in a downturn, especially when new sources of capital dry up. ○

The authors would like to thank Reinier Musters for his contribution to the development of this article.

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STRATEGY PRACTICE

How to put your money where your strategy is

Stephen Hall, Dan Lovallo, and Reinier Musters

Most companies allocate the same resources to the same business units year after year. That makes it difficult to realize strategic goals and undermines performance. Here's how to overcome inertia.

Picture two global companies, each operating a range of different businesses. Company A allocates capital, talent, and research dollars consistently every year, making small changes but always following the same broad investment pattern. Company B continually evaluates the performance of business units, acquires and divests assets, and adjusts resource allocations based on each division's relative market opportunities. Over time, which company will be worth more?

If you guessed company B, you're right. In fact, our research suggests that after 15 years, it will be worth an average of 40 percent more than company A. We also found, though, that the vast majority of companies resemble company A. Therein lies a major disconnect between the aspirations of many corporate strategists to boldly jettison unattractive businesses or double down on exciting new opportunities, and the reality of how they invest capital, talent, and other scarce resources.

For the past two years, we've been systematically looking at corporate resource allocation patterns, their relationship to performance, and the implications for strategy. We found that while inertia reigns at most companies, in those where capital and other resources flow more readily from one business opportunity to another, returns to shareholders are higher and the risk of falling into bankruptcy or the hands of an acquirer lower.

We've also reviewed the causes of inertia (such as cognitive biases and politics) and identified a number of steps companies can take to overcome them. These include introducing new decision rules and processes to ensure that the allocation of resources is a top-of-mind issue for executives, and remaking the corporate center so it can provide more independent counsel to the CEO and other key decision makers.

We're not suggesting that executives act as investment portfolio managers. That implies a search for stand-alone returns at any cost rather than purposeful decisions that enhance a corporation's long-term value and strategic coherence. But given the prevalence of stasis today, most organizations are a long way from the head-long pursuit of disconnected opportunities. Rather, many leaders face a stark choice: shift resources among their businesses to realize strategic goals or run the risk that the market will do it for them. Which would you prefer?

Weighing the evidence

Every year for the past quarter century, US capital markets have issued about $85 billion of equity and $536 billion in associated corporate debt. During the same period, the amount of capital allocated or reallocated within multibusiness companies was approximately $640 billion annually—more than equity and corporate debt combined.[1] While most perceive markets as the primary means of directing capital and recycling assets across industries, companies with multiple businesses actually play a bigger role in allocating capital and other resources across a spectrum of economic opportunities.

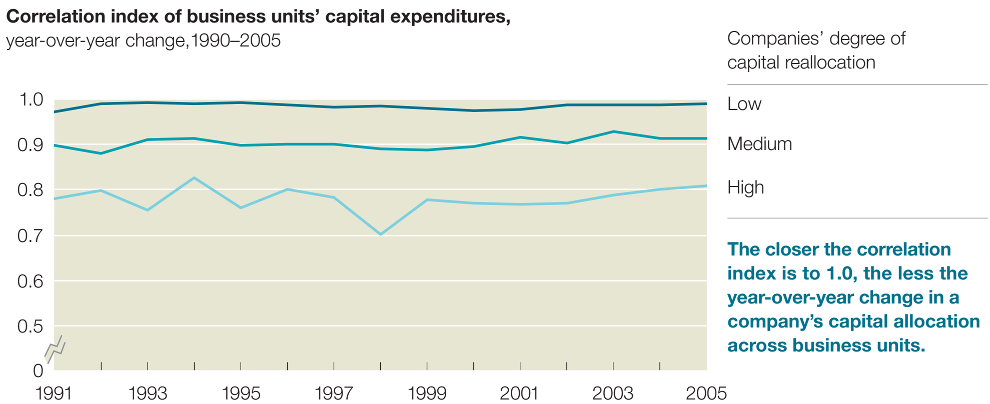
To understand how effectively corporations are moving their resources, we reviewed the performance of more than 1,600 US companies between 1990 and 2005.[2] The results were striking. For one-third of the

[1] See Ilan Guedj, Jennifer Huang, and Johan Sulaeman, "Internal capital allocation and firm performance," working paper for the International Symposium on Risk Management and Derivatives, October 2009 (revised in March 2010).

[2] We used Compustat data on 1,616 US-listed companies with operations in a minimum of two distinct four-digit Standard Industrial Classification (SIC) codes. Resource allocation is measured as 1 minus the minimum percentage of capital expenditure received by distinct business units over the 15-year period. This measure captures the relative amount of capital that can flow across a business over time; the rest of the money is "stuck." Similar results were found with more sophisticated measures that control for sales and asset growth.

Exhibit 1

Capital allocations were essentially fixed for roughly one-third of the business units in our sample.



businesses in our sample, the amount of capital received in a given year was almost exactly that received the year before—the mean correlation was 0.99. For the economy as a whole, the mean correlation across all industries was 0.92 (Exhibit 1).

In other words, the enormous amount of strategic planning in corporations seems to result, on the whole, in only modest resource shifts. Whether the relevant resource is capital expenditures, operating expenditures, or human capital, this finding is consistent across industries as diverse as mining and consumer packaged goods. Given the performance edge associated with higher levels of reallocation, such static behavior is almost certainly not sensible. Our research showed the following:

- Companies that reallocated more resources—the top third of our sample, shifting an average of 56 percent of capital across business units over the entire 15-year period—earned, on average, 30 percent higher total returns to shareholders (TRS) annually than companies in the bottom third of the sample. This result was surprisingly consistent across all sectors of the economy. It seems that when companies disproportionately invest in value-creating businesses, they generate a mutually reinforcing cycle of growth and further investment options (Exhibit 2).

- Consistent and incremental reallocation levels diminished the variance of returns over the long term.

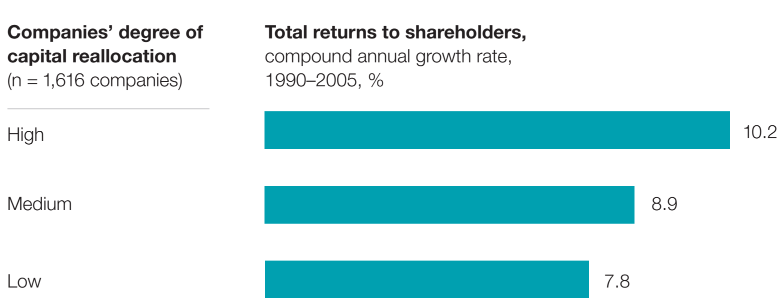
- A company in the top third of reallocators was, on average, 13 percent more likely to avoid acquisition or bankruptcy than low reallocators.

- Over an average six-year tenure, chief executives who reallocated less than their peers did in the first three years on the job were significantly more likely than their more active peers to be removed in years four through six. To paraphrase the philosopher Thomas Hobbes, tenure for static CEOs is likely to be nasty, brutish, and, above all, short.

We should note the importance of a long-term view: over time spans of less than three years, companies that reallocated higher levels of resources delivered lower shareholder returns than their more stable peers did. One explanation for this pattern could be risk aversion on the part of investors, who are initially cautious about major corporate capital shifts and then recognize value only once the results become visible. Another factor could be the deep interconnection of resource allocation choices with corporate strategy. The goal isn't to make dramatic changes every year but to reallocate resources consistently over the medium to long term in service of a clear corporate strategy. That provides the time necessary for new investments to flourish, for established businesses to maximize their potential, and for capital from declining investments to be redeployed effectively. Given the richness and complexity of the issues at play here, differences in the relationship between short- and long-term resource shifts and financial performance is likely to be a fruitful area for further research.

Exhibit 2

Companies with higher levels of capital reallocation experienced higher average shareholder returns.



Why companies get stuck

Why do so many companies undermine their strategic direction by allocating the same levels of resources to business units year after year? The reasons vary widely, from the very bad—companies operating on autopilot—to the more sensible. After all, sometimes it's wise to persist with previously chosen resource allocations, especially if there are no viable reallocation opportunities or if switching costs are too high. And companies in capital-intensive sectors, for example, often have to commit resources more than five years ahead of time to long-term programs, leaving less discretionary capital to play with.

For the most part, however, the failure to pursue a more active allocation agenda is a result of organizational inertia that has multiple causes. We'll focus here on cognitive biases and corporate politics, but regardless of source, inertia's gravitational pull is strong—and overcoming it is critical to creating an effective corporate strategy. As author and Kleiner Perkins Caufield & Byers partner Randy Komisar told us, "If corporations don't approach rebalancing as fiduciaries for long-term corporate value, their life span will decline as creative destruction gets the better of them."

Cognitive biases

Biases such as anchoring and loss aversion, which are deeply rooted in the workings of the human brain and have been much studied by behavioral economists, are major contributors to the inertia that prevents more active reallocation.[3] Anchoring refers to the tendency to use any number, even an irrelevant one, as an anchor for future choices. Judges asked to roll a pair of dice before making a simulated sentencing decision, for example, are influenced by the result of that roll, even though they deny they are.

Within a company, last year's budget allocation often serves as a ready, salient, and justifiable anchor during the planning process. We know this to be true in practice, and it's been reinforced for us recently as we've played a business game with several groups of senior executives. The game asked participants to allocate a capital budget across a fictitious company's businesses and provided players with identical growth and return projections for the relevant markets. Half of the group also received details of the previous year's capital allocation. Those *without* last year's capital budget all allocated resources in a range that optimized for the expected outlook in market growth and returns. The other half aligned capital far more closely with last year's pattern, which had little to do with the potential for future returns. And this was a game where the company was fictitious and no one's career was at risk!

[3] See Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," mckinseyquarterly.com, March 2010.

In reality, anchoring is reinforced by loss aversion: losses typically hurt us at least twice as much as equivalent gains give us pleasure. That reduces the appetite for taking risks and makes it painful for managers to give up resources.

Corporate politics

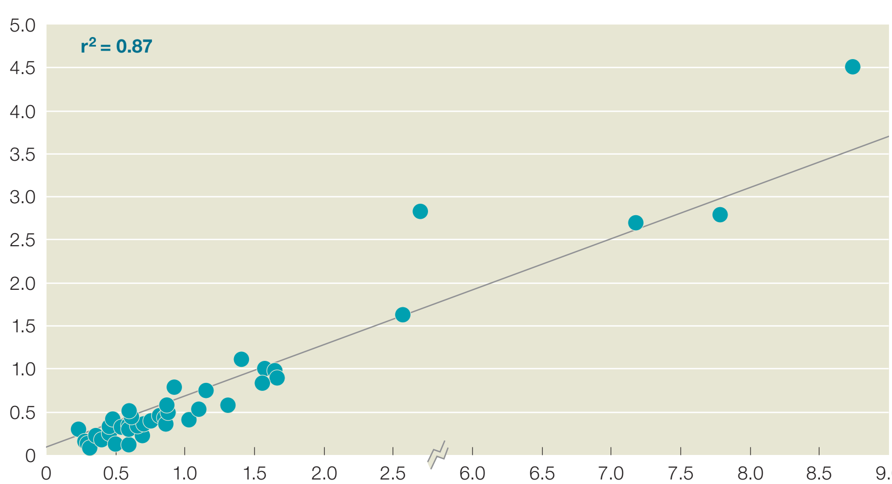
A second major source of inertia is political. There's often a tight alignment between the interests of senior executives and those of their divisions or business units, whose ability to attract capital can significantly influence the personal credibility of a leader. Indeed, because executives are competing for resources, anyone who wins less than he or she did last year is invariably seen as weak. At the extreme, leaders of business units and divisions see themselves as playing for their own "teams" rather than for the corporation as a whole, making it challenging to reallocate resources significantly. Even if a reduction in resources to their division benefits the company as a whole, ambitious leaders are unlikely to agree without a fight. As one CEO told us: "If you're asking me to play Robin Hood, that's not going to work."

Exhibit 3

Inertia may affect the distribution of other scarce resources, such as advertising spending.

Correlation between each brand's 2010 advertising budget and its average advertising budget for previous 5 years at one consumer goods company (n = 40 brands)

Average advertising spending by brand over 5 years, 2004–09, % of corporate total



Average advertising spending by brand in 2010, % of corporate total

r^2 is the measure of interdependence of 2 or more variables.

Overcoming inertia

Tempting as it is to believe that one's own company avoids these traps, our research suggests that's unlikely. Our experience also suggests, though, that taking steps such as those described below can materially improve a company's resource allocation and its connection to strategic priorities. These imperatives apply not just to capital but also to other scarce resources, such as talent, R&D dollars, and marketing expenditures (as shown in Exhibit 3, for advertising spending by one consumer goods company). All of these also are subject to the forces of inertia, which can undermine an organization's ability to achieve its strategic goals. Consider one company we know that prioritized expanding in China. It set an ambitious sales growth target for the country and planned to meet it by supplementing organic growth with a series of acquisitions. Yet it identified just three people to spearhead this strategic imperative—a small fraction of the number required, which is typical of the problems that arise when the link between corporate strategy and resource allocation is weak. Here are four ideas for doing better.

1. Have a target corporate portfolio.

There's a quote attributed to author Lewis Carroll: "If you don't know where you are going, any road will take you there." When it comes to developing an allocation agenda, it's helpful to have a target portfolio in mind. Most companies resist this, for understandable reasons: it requires a lot of conviction to describe planned portfolio changes in anything but the vaguest terms, and the right answers may change if the broader business environment turns out to be different from the expected one.

In our experience, though, a target portfolio need not be slavish or mechanistic and can be a powerful forcing device to move beyond generic strategy statements, such as "strengthen in Asian markets" or "continue to migrate from products to services." Identifying business opportunities where your company wants to increase its exposure can create a foundation for scrutinizing how it allocates capital, talent, and other resources.

Setting targets is just a starting point; companies also need mechanisms for revisiting and adjusting them over time. For example, Google holds a quarterly review process that examines the performance of all core product and engineering areas against three measures: what each area did in the previous 90 days and forecasts for the next 90 days, its medium-term financial trajectory, and its strategic positioning. And the company has ensured that it can allocate resources in an agile way by not having business units, which diminishes the impact of corporate politics.[4]

Evaluating reallocation performance relative to peers also can help companies set targets. From 1990 to 2009, for example, Honeywell reallocated about 25 percent of its capital as it shifted away from some existing business areas toward aerospace, air conditioning, and controls (for more on Honeywell's approach to resource allocation, see our interview with Andreas C. Kramvis, president and CEO of Honeywell Performance Materials and Technologies, in "Breaking strategic inertia: Tips from leaders," forthcoming on mckinseyquarterly.com). Honeywell's competitor Danaher, which was in similar businesses in 1990, moved 66 percent of its capital into new ones during the same period. Both companies achieved returns above the industry average in these years—TRS for Honeywell was 14 percent and for Danaher 25 percent. We're not suggesting that companies adopt a mind-set of "more is better, and if my competitor is making big moves, I should too." But differences in allocation levels among peer companies can serve as valuable clues about contrasting business approaches—clues that prompt questions yielding strategic insights.

2. Use all available resource reallocation tools.

Talking about resource allocation in broad terms oversimplifies the choices facing senior executives. In reality, allocation comprises four fundamental activities: seeding, nurturing, pruning, and harvesting. *Seeding* is entering new business areas, whether through an acquisition or an organic start-up investment. *Nurturing* involves building up an existing business through follow-on investments, including bolt-on acquisitions. *Pruning* takes resources away from an existing business, either by giving some of its annual capital allocation to others or by putting a portion of the business up for sale. Finally, *harvesting* is selling whole businesses that no longer fit a company's portfolio or undertaking equity spin-offs.

Our research found that there's little overall difference between the seeding and harvesting behavior of low and high reallocators. This should come as little surprise: seeding involves giving money to new business opportunities—something that's rarely resisted. And while harvesting is difficult, it most often occurs as a result of a business unit's sustained underperformance, which is difficult to ignore.

[4] For more, see James Manyika, "Google's CFO on growth, capital structure, and leadership," mckinseyquarterly.com, August 2011.

However, we found a 170 percent difference in activity levels between high and low reallocators when it came to the combination of nurturing and pruning existing businesses. Together, these two represent half of all corporate reallocation activity. Both are difficult because they often involve taking resources from one business unit and giving them to another. What's more, the better a company is at encouraging seeding, the more important nurturing and pruning become—nurturing to ensure the success of new initiatives and pruning to eliminate flowers that won't ever bloom.

Consider, for example, the efforts of Google CEO Larry Page, over the past 12 months, to cope with the flowering of ideas brought forth by the company's well-known "20 percent rule," which allows engineers to spend at least one-fifth of their time on personal projects and has resulted in products such as AdSense, Gmail, and Google News. These successes notwithstanding, the 20 percent rule also has yielded many peripheral projects, which Page has recently been pruning.[5]

3. Adopt simple rules to break the status quo.

Simple decision rules can help minimize political infighting because they change the burden of proof from the typical default allocation ("what we did last year") to one that makes it impossible to maintain the status quo. For example, a simple harvesting rule might involve putting a certain percentage of an organization's portfolio up for sale each year to maintain vibrancy and to cull dead wood.

When Lee Raymond was CEO of Exxon Mobil, he required the corporate-planning team to identify 3 to 5 percent of the company's assets for potential disposal every year. Exxon Mobil's divisions were allowed to retain assets placed in this group only if they could demonstrate a tangible and compelling turnaround program. In essence, the burden on the business units was to prove that an asset should be retained, rather than the other way around. The net effect was accelerated portfolio upgrading and healthy turnover in the face of executives' natural desire to hang on to underperforming assets. Another approach we've observed involves placing existing businesses into different categories—such as "grow," "maintain," and "dispose"—and then following clearly differentiated resource-investment rules for each. The purpose of having clear investment rules for each category of business is to remove as much politics as possible from the resource allocation process.

[5] See Claire Cain Miller, "In a quest for focus, Google purges small projects," nytimes.com, November 10, 2011.

Sometimes, the CEO may want a way to shift resources directly, in parallel with regular corporate processes. One natural-resources company, for example, gave its CEO sole discretion to allocate 5 percent of the company's capital outside of the traditional bottom-up annual capital allocation process. This provided an opportunity to move the organization more quickly toward what the CEO believed were exciting growth opportunities, without first having to go through a "pruning" fight with the company's executive-leadership committee.

Of course, the CEO and other senior leaders will need to reinforce discipline around such simple allocation rules; it's not easy to hold the line in the face of special pleading from less-favored businesses. Developing that level of clarity—not to mention the courage to fight tough battles that arise as a result—often requires support in the form of a strong corporate center or a strategic-planning group that's independent of competing business interests and can provide objective information (for more on the importance of the corporate center to resource reallocation, see "The power of an independent corporate center," on mckinseyquarterly.com).

4. Implement processes to mitigate inertia.

Systematic processes can strengthen allocation activities. One approach, explored in detail by our colleagues Sven Smit and Patrick Viguerie, is to create planning and management processes that generate a granular view of product and market opportunities.[6] The overwhelming tendency is for corporate leaders to allocate resources at a level that is too high—namely, by division or business unit. When senior management doesn't have a granular view, division leaders can use their information advantage to average out allocations within their domains.

Another approach is to revisit a company's businesses periodically and engage in a process similar to the due diligence conducted for investments. Executives at one energy conglomerate annually ask whether they would choose to invest in a business if they didn't already own it. If the answer is no, a discussion about whether and how to exit the business begins.

Executives can further strengthen allocation decisions by creating objectivity through re-anchoring—that is, giving the allocation an objective basis that is independent of both the numbers the business units

[6] See three publications by Mehrdad Baghai, Sven Smit, and S. Patrick Viguerie: "The granularity of growth," mckinseyquarterly.com, May 2007; *The Granularity of Growth: How to Identify the Sources of Growth and Drive Enduring Company Performance*, Hoboken, NJ: Wiley, 2008; and "Is your growth strategy flying blind?," *Harvard Business Review*, May 2009, Volume 87, Number 5, pp. 86–97.

provide and the previous year's allocation. There are numerous ways to create such independent, fact-based anchors, including deriving targets from market growth and market share data or leveraging benchmarking analysis of competitors. The goal is to create an objective way to ask business leaders this tough question: "If we were to triangulate between these different approaches, we would expect your investments and returns to lie within the following range. Why are your estimates so much higher (or lower)?"

Finally, it's worth noting that technology is enabling strategy process innovations that stir the pot through internal discussions and "crowdsourcing." For example, Rite-Solutions, a Rhode Island–based company that builds advanced software for the US Navy, defense contractors, and first responders, derives 20 percent of its revenue from businesses identified through a "stock exchange" where employees can propose and invest in new ideas (for more on this, see "The social side of strategy," forthcoming on mckinseyquarterly.com).

• • •

Much of our advice for overcoming inertia within multibusiness companies assumes that a corporation's interests are not the same as the cumulative resource demands of the underlying divisions and businesses. As they say, turkeys do not vote for Christmas. Putting in place some combination of the targets, rules, and processes proposed here may require rethinking the role and inner workings of a company's strategic- and financial-planning teams. Although we recognize that this is not a trivial endeavor, the rewards make the effort worthwhile. A primary performance imperative for corporate-level executives should be to escape the tyranny of inertia and create more dynamic portfolios.

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