Why Boards Fall Short

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Boards aren't working. It's been more than a decade since the first wave of post-Enron regulatory reforms, and despite a host of guidelines from independent watchdogs such as the International Corporate Governance Network, most boards aren't delivering on their core mission: providing strong oversight and strategic support for management's efforts to create long-term value. This isn't just our opinion. Directors also believe boards are falling short, our research suggests.

A mere 34% of the 772 directors surveyed by McKinsey in 2013 agreed that the boards on which they served fully comprehended their companies' strategies. Only 22% said their boards were completely aware of how their firms created value, and just 16% claimed that their boards had a strong understanding of the dynamics of their firms' industries.

More recently, in March 2014, McKinsey and the Canada Pension Plan Investment Board (CPPIB) asked 604 C-suite executives and directors around the world which source of pressure was most responsible for their organizations' overemphasis on short-term financial results and underemphasis on long-term value creation. The most frequent response, cited by 47% of those surveyed, was the company's board. An even higher percentage (74%) of the 47 respondents who identified themselves as sitting directors on public company boards pointed the finger at themselves.

Those are shocking results. How can companies strengthen boards' knowledge and help directors build, maintain, and refine a long-term mindset? Clearly the answer is not to impose yet another round of good-governance box checking and hoop jumping. The lack of improvement that approach has produced speaks for itself.

A good first step might be to help everyone firmly grasp what a director's "fiduciary duty" is. Most legal codes stress two core aspects of it: loyalty (placing the company's interests ahead of one's own) and prudence (applying proper care, skill, and diligence to business decisions). Nothing suggests that the role of a loyal and prudent director is to pressure management to maximize short-term shareholder value to the exclusion of any other interest. To the contrary, the logical implication is that he or she should help the company thrive for years into the future. At times that mission may require pushing management to challenge the status quo, ideally before the market signals that change is desirable. At other times it may require ignoring market pressures and backing a credible corporate strategy that will take years to bear fruit. (For example, many leading U.S. multinationals have taken nearly a decade to turn a profit in China, a market vital to their long-term success.)

If directors can keep their fiduciary duty firmly in mind, big changes in the boardroom should follow. They will spend more time discussing disruptive innovations that could lead to new goods, services, markets, and business models; what it takes to capture value-creation opportunities with a big upside over the long term; and shutting or selling operations that no longer fit. And they will spend less time talking about meeting next quarter's earnings expectations, complying with regulations (although that, of course, must be done), and avoiding lawsuits.

Companies in emerging markets appear to be ahead of their Western rivals in adopting this mindset. A McKinsey study that compared 41 multinationals based in emerging markets with 303 based in developed economies found that from 1999 to 2008, the emerging market firms often had much more of a long-term orientation than the Western firms, paid out far less, on average, in dividends (39% versus 80%), and reinvested in fixed assets at a rate roughly twice as high. If companies in the West followed suit, it could unlock trillions of dollars sitting in corporate cash reserves and help reignite the global economy's persistently subpar growth.

The mental discipline of keeping long-term value creation foremost in mind would help clarify choices and reform board behaviors. To see how, let's look at four familiar areas where change is essential.

Selecting the Right People

From January 2010 to September 2013, the number of interventions by activist shareholders (challenges seeking board representation, share buybacks, CEO removal, and the like) increased an astonishing 88%, according to research conducted by Activist Insight for the global law firm Linklaters. Claims Stephen Murray, the president and CEO of CCMP Capital, a major private equity firm: "The whole activist industry exists because public boards are often seen as inadequately equipped to meet shareholder interests." Consider one more damning data point: Only 14% of 692 directors and C-suite executives surveyed by McKinsey in September 2014 picked "a reputation for independent thinking" as one of the main criteria that public company boards consider when appointing new directors.

In addition, public company boards—unlike general partners in the private equity world or successful family-owned companies—often do not think enough about attracting the right business expertise. Having a diversity of perspectives and proven experience in building relevant businesses, as well as deep functional knowledge, is critical. But if our surveys are any indication, too many directors are generalists. And as Don Lindsay, the CEO of Teck Resources, a large Canadian mining company, told us: "One of the big problems with generalist directors who don't have a natural interest in the business is that it can take a long time to convince them to make important decisions."

That is indeed a problem. Former IBM CEO Lou Gerstner recently observed in the McKinsey Quarterly that the willingness to tackle outmoded orthodoxies decisively is crucial to sustained value creation. "In anything other than a protected industry, longevity is the capacity to change, not to stay with what you've got," he said. Companies that last 100 years are never truly the same company, he noted. "They've changed 25 times or 5 times or 4 times over that 100 years."

However, recent McKinsey research has shown that during a 20-year period, the majority of 1,500-plus U.S. companies were content to maintain the status quo and dole out roughly the same amount of capital to business units that they did the previous year. These businesses moved forward in low gear as a result. By contrast, the most aggressive reallocators—companies that shifted more than 56% of their capital across business units over that period—delivered 30% higher total returns to shareholders. Boards that combine deep relevant experience and knowledge with independence can help companies break through inertia and create lasting value.

True, remaking boards in this fashion is standard counsel these days. But if you truly get the importance of thinking and acting long-term, you'll do whatever it takes to attract these people.

Klaus Kleinfeld, the CEO of Alcoa, told us that he deliberately seeks directors who have substantial real-life experience, have worked through difficult times, and also have a strong feel for the kind of long-cycle investment-and-return rhythms that apply to his industry. Kleinfeld also believes mandatory retirement rules need to be applied intelligently to achieve the optimal balance between refreshing the board and retaining valuable experience.

To ensure that it can see around corners, Mars, the privately held food-and-drink powerhouse, has created a five-member advisory group of external experts to complement its three family board members. Each adviser is an expert on a specific driver of company value, from demographic health concerns to food safety regulations, and regularly addresses how trends in these areas may affect the firm's strategy and priorities with the board and senior executives. For executives serious about creating long-term value, injecting more of these kinds of informed perspectives into the conversation at public company boards is not optional; it's imperative.

Spending Quality Time on Strategy

"The first question I would ask boards is whether they are spending enough time and effort assessing the organization's long-term strategy," Sir David Walker, the chairman of the board at Barclays and a noted authority on corporate governance in the United Kingdom, told us. "If they are honest, the answer will almost always be no."

Most governance experts would agree that public company directors need to put in more days on the job and devote more time to understanding and shaping strategy. Some recommendations get quite specific. Robert C. Pozen, a senior lecturer at Harvard Business School and the former chairman of MFS Investment Management, says that directors of large, complex firms should spend at least two days a month, or 24 days a year, on board responsibilities, in addition to attending regular board meetings. Others suggest that the appropriate number is as many as 54 days a year, the standard for directors of companies owned by private equity firms, according to a McKinsey study in the United Kingdom. The notion of regular group outings for directors—holding board meetings in, say, retail stores or new R&D facilities, or asking members to tag along on sales calls—is also now in vogue.

While we recommend that directors dedicate at least 35 days a year to the job, in our view the precise number of days a board meets or the mix of field trips isn't the main issue. If the aim is fostering the proper long-term view, what matters most is the quality and depth of the strategic conversations that take place.

Consider Interbrew (now part of Anheuser-Busch InBev). When the Belgium-based company decided to explore the China market in the early 1990s, it invited the entire board to join the executive team on a weeklong trip there. Chairman Paul de Keersmaeker made it very clear in the opening meeting that the intent was to have directors learn as much as possible about the country and the market. The reason: At some point in the next few years, Interbrew was likely to make an acquisition in China, and when that happened, there wouldn't be much time for debate. The directors needed to develop views on the competitive landscape and operating environment before then so that when the time came, Interbrew could move quickly to acquire its target.

Such serious, unstructured exploration of a long-term opportunity is one way to avoid a trap that many buttoned-down board off-sites fall into, according to Pozen: "If trips go as planned, the directors hear and see what management wants them to hear and see." (See "The Case for Professional Boards," HBR, December 2010.) In Interbrew's case, a more open approach paid off: In 1997 it successfully entered China with the acquisition of two local breweries. Just six years later, it had become the third-largest brewer in the country, with a 9% market share.

As we argued in our HBR piece "Focusing Capital on the Long Term" (January–February 2014), boards also need to do more to develop and communicate nonfinancial metrics that will help guide strategy, especially when income statements don't capture the emerging story. The board of Tullow Oil, a multinational oil- and gas-exploration company headquartered in the United Kingdom, does this well. To measure the company's performance, it uses a balanced scorecard of financial and nonfinancial objectives—which include progress in carrying out key development activities; implementing capital spending plans; achieving environmental, health, and safety goals; and maintaining a healthy, well-funded balance sheet.

But we're not fans of the practice of creating focused strategy committees on the board that are similar to the committees on audit or risk. We agree with Walker, who told us: "Strategy is the fundamental challenge of the organization, and it should engage the entire board." That collective effort is critical to ensuring the right long-term debates and decisions.

Engaging with Long-Term Investors

While boards may be guilty of pushing executives to maximize short-term results, we have no doubt where that pressure really originates: the financial markets. That's why in "Focusing Capital on the Long Term," we insisted that it was essential to persuade institutional investors, whose ownership position makes them the cornerstone of our capitalist system, to be a counterforce.

Boards can and should be far more active in facilitating a dialogue with major long-term shareholders. Certainly many investors would welcome such engagement. BlackRock, the world's largest asset manager (with more than $4.5 trillion in holdings), already strives for what CEO Larry Fink calls "robust, ongoing communication" with both the management and the board at many companies it holds stakes in. "That doesn't mean that we want to tell companies what to do," Fink told us. "We do, however, want to make sure there is a high-quality board and management team in place, and that we have ready access" in order to serve both the long-term interests of the company and "the long-term interests of our clients."

Happily, this is an idea whose time appears to be coming. Organizations like Shareholder-Director Exchange, a group that includes BlackRock and State Street, have been working to ensure that public companies disclose how their directors interact with shareholders and have been compiling best practices for, among other things, preparing board members for such conversations. That trend underscores long-term investors' growing interest in learning from and exchanging ideas with smart, engaged directors. Currently, however, too much of this dialogue focuses on investor pressures to have a "say on pay" and similar single-minded governance issues. The more powerful discussions occur when companies strive to communicate their strategies for longer-term growth and their key metrics for it.

When Unilever famously decided five years ago to end traditional quarterly earnings guidance, it found that having a board member who understood the strategy and could explain it to key investors was invaluable. Bank of Montreal, one of the largest banks in Canada, encourages shareholders to directly contact its independent directors, in particular about such topics as succession planning, corporate governance practices, and disclosure. And the board of Kinross Gold, one of the world's largest gold-mining companies, holds regular one-on-one and group meetings with representatives of its institutional shareholders, who are encouraged to provide feedback. The company has adopted a policy that explicitly states what topics are suitable for directors to discuss (board structure and composition, CEO performance, material strategic decisions, overall corporate performance), and the independent chairman serves as the point of contact between shareholders and the board. (To allow this kind of exchange, institutional investors with a long-term focus should be more willing to lock up their shares—by agreeing not to buy or sell them in the public markets for a period of at least two to three years. This would give them the ability to adopt insider status, excusing them from certain disclosure restrictions that apply to other public investors.)

We believe more companies should and will adopt this approach. Fifty percent of the sitting directors who responded to our September 2014 survey agreed that regularly communicating the company's long-term strategy and performance to key long-term shareholders would be one of the most effective ways to alleviate the pressure to maximize short-term returns and stock prices. But if these conversations are to give directors the context and confidence to carry out their fiduciary duty, they must be dialogues, not one-way communications.

Paying Directors More

Good capitalists believe in incentives. If we are going to ask directors to engage more deeply and more publicly, to spend a lot more time exploring and communicating long-term strategy, and to take on any attendant reputational risk, then we should give them a substantial raise. There is a growing consensus that directors should sit on fewer boards and get paid more—substantially more than the current average annual compensation of $249,000. We fully agree, but the even more important issue is how that pay is structured. A number of companies have already shifted the mix toward longer-term rewards.

A few years ago, Johnson & Johnson established minimum ownership guidelines for nonexecutive directors to better align their interests with shareholders'. J&J requires each director to retain the company shares issued upon election to the board and to own shares equal to five times his or her annual cash retainer. Coca-Cola grants nonoption stock awards that become available only after a director has left the board. General Electric follows a similar scheme.

We'd go one step further: To really get directors thinking and behaving like owners, ask them to put a greater portion of their net worth on the table. This could be achieved by giving them a combination of incentive shares, a portion of which vests only some years after directors step aside, and requiring incoming directors to purchase equity with their own money. We'd favor encouraging companies to implement this requirement on their own rather than imposing it on them as a rule—especially since the precise share of net worth would need to vary by company size and industry. That said, the overarching goal should be to insist on a "material" investment that more strongly ties a director's financial incentives to the company's long-term performance. In some cases this could mean putting as much as 10% of a director's net worth at risk.

While the thrust of each of these broad changes is relatively simple to articulate, none is easy to make. All of them must fit the company and industry context. Introducing them—and making them stick—will require deft handling by board chairs or lead directors, working alongside CEOs. But in total they could bring about a deep shift in the culture, behavior, and structure of public company boards. Over time nothing else will do more to ensure that these core institutions of our capitalist system deliver the kind of sustained value creation that long-term shareholders expect and that our society deserves.