INVESTORS WANT COMPANIES TO BE RESILIENT AND BOLD

By Julien Ghesquieres, Jeffrey Kotzen, Tim Nolan, Alexander Roos, Gregory Rice, and Hady Farag

BCG's 11th annual investor survey finds that investors remain cautious despite the strong rebound that occurred in equity markets in 2019. Investors have low expectations for total shareholder return (TSR) over the next three years and want companies to brace for short-term headwinds while boldly investing in the future.

The survey, conducted in November and December 2019, found that, on average, respondents' outlook is similar to what it was just before the market correction in late 2018. (See the sidebar.) However, although many investors believe that the current bull market is running on borrowed time, few anticipate a major market crash or deep recession.

A closer look at these findings reveals additional insights, including the following:

- Record-high valuation levels and persistent macroeconomic uncertainty are the main drivers of short-term concerns and low return expectations among investors.
- Investors want companies to invest thoughtfully to deliver sustainable organic growth. Their top priority is for companies to invest more aggressively in digital capabilities and in the enabling technology stack.
- Investors point to specific improvement opportunities that companies must address, such as broadening investor engagement and better integrating sustainability into business strategy.

These findings indicate that investors want management to have a dual focus—building resilience to prepare for the anticipated short-term headwinds and investing to create long-term value. One typical quote we heard from investors was, "I want management of the companies I invest in to run a very tight ship and reinvest the savings to win in the medium to long term." This means that a company must achieve operational excellence and tight cost control to ensure resilience while also pursuing growth opportunities. And the company must do this while navigating the complex

ABOUT THE SURVEY

BCG has surveyed investors annually since 2009 to understand their views on global equity markets and on priorities for shareholder value creation. There were 251 responses to the 2019 survey. Approximately 80% of the survey respondents were portfolio managers, and 20% were buy-side and sell-side analysts; 48% focused on the US, while most of the others focused on Europe or invested globally. Collectively, these respondents directly manage approximately $300 billion in assets and represent firms that have more than $10 trillion in assets under management. Approximately 90% of the investors surveyed reported that they ascribe to traditional investment philosophies, such as quality/alpha value, income/dividend yield, or GARP. Approximately 80% of the investors said that their typical investment horizon is longer than one year, and more than 50% said that it is longer than three years.

challenges of winning in the 2020s, which include positioning itself for success before the downturn arrives so that it can thrive as others fight to survive.

Short-Term Concerns Persist

Although equity market indices made impressive gains in 2019—the MSCI World Index rose 24%, for example, and the S&P 500 rose 29%—investors are concerned about the short-term market outlook. Nearly one-third of respondents have a bearish or very bearish view of the likely performance levels of equity markets over the next three years, while just over one-third are bullish or very bullish. This market sentiment is nearly identical to what we found in our 2018 survey, when we saw a clear shift in sentiment from bullish to bearish just before the 17% drop in the S&P 500 that occurred in the fourth quarter of 2018.

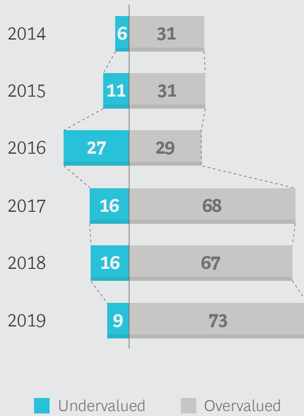
Expectations for TSR remain at historically low levels. Survey respondents' expectations for market-average annual TSR over the next three years is 5.6%. This roughly matches the TSR expectation level reported in our previous three surveys—the lowest levels we have recorded since we began tracking TSR expectations in 2010. These levels are well below longer-term historical levels of market returns (for example, the US market since 1926 has delivered an average annual TSR of 10.1%). Respondents said they expect 3.6% of the 5.6% forward TSR to come from earnings growth, along with 2.3% from dividend yield and 1.0% from share repurchases, which implies a 1.3% annual impact from declining valuation multiples over the next three years.

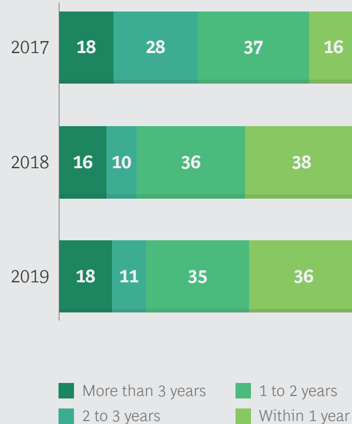
What is driving these low expectations among investors? High valuation multiples remain the number-one source of concern. Among all respondents, 73% believe that markets are overvalued, an uptick from 67% in the 2018 survey. (See Exhibit 1.) Among self-described bears in the 2019 survey, 78% cited market overvaluation as the reason for their pessimism, versus 64% in the 2018 survey. But the perceived downside appears to be limited: on average, investors viewed markets as being overvalued by 10%, an improvement from the average of 15% in the previous survey.

Expectations with regard to multiple compression have similarly declined: investors anticipate a 0.8x reduction in the market-average P/E multiple (for example, from 21.1x trailing to 20.3x for the S&P 500), versus a 1.3x reduction in the 2018 survey. So, while investors remain cognizant of the high valuation levels, their fear of a contraction may have been tempered by the swift recovery in 2019 and by diminished concerns about rising interest rates.

While most investors expect a recession to occur in the near term, they are generally not concerned that it will be severe. As shown in Exhibit 1, 71% of respondents anticipate a recession within the next two

EXHIBIT 1 | Investors View Markets as Overvalued and See High Risk of a Mild Recession





Sources: BCG's 2014–2019 investor surveys.
[1]Responses reflect respondents' views on a benchmark index representing their regional focus: S&P 500 (US and Canada), S&P Europe 350 (Europe), S&P Pan Asia BMI (Asia/Pacific), or S&P Global BMI (global or no regional focus).
[2]Real GDP falls by less than 2%.
[3]Real GDP falls by 2% or more.

years, compared with 74% in the 2018 survey. And although 46% of investors expect the anticipated recession to last more than one year, 74% expect it to be mild (less than a 2% contraction in real GDP) even if it is prolonged. This outlook is reflected in lower earnings growth expectations (3.6% per year in the 2019 survey versus 4.3% in the 2018 survey).

Bearish investors cited an array of political risks as a significant source of concern. More than one-third (37%) said their bearish outlook is motivated by the US political climate (including the 2020 election). And more than one-quarter pointed to concerns about public-sector debt and spending (28%) and the unstable geopolitical environment (26%).

Whereas in previous surveys the prospect of higher interest rates fueled bearish sentiment, in 2019 lower interest rate levels were predominantly a source of bullish sentiment. Among self-described bulls in the 2019 survey, 51% cited the persistence of historically low interest rates as a reason for their optimism. Nearly half (46%) also pointed to optimism about private-sector demand and consumption.

The bottom line: investors are clearly concerned about high valuation levels, and they expect a mild recession that will last one to two years.

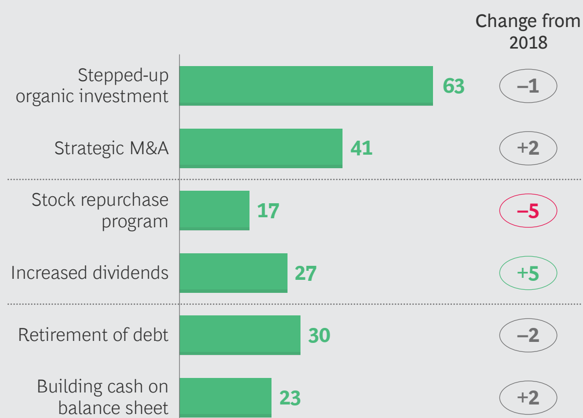
Long-Term Value Creation Remains the Top Priority

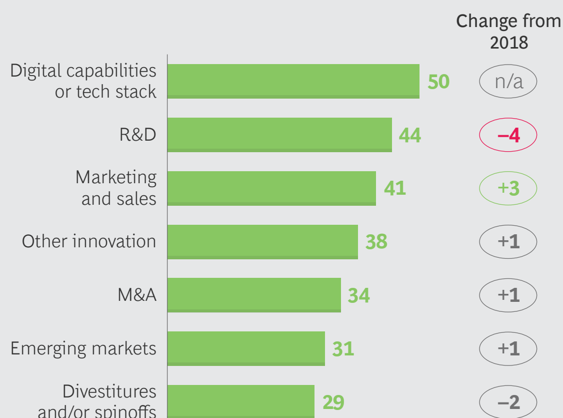
Against this backdrop, investors want companies to invest in opportunities that have the potential to deliver strong and sustainable TSR, even as they prepare to weather economic headwinds in the short to medium term. (See Exhibit 2.)

Survey respondents once again identified organic investment as their top preference for the way a healthy company should deploy capital and free cash flow (beyond meeting existing dividend and debt service commitments)—63% in the 2019 survey versus 64% in the 2018 survey. (Percentages indicate the share of respondents who selected an option first or second.)

M&A was cited as a preferred use of cash by 41% of respondents, a small increase from last year. Respondents indicated slightly stronger support in the 2019 survey for increasing regular dividends and building

Exhibit 2 | Investors Want Companies to Invest to Deliver Long-Term Value Creation





Sources: BCG's 2018 and 2019 investor surveys.
[1]Respondents were asked to consider only healthy companies that generate strong free cash flow (beyond dividend and debt payment commitments). The percentage for each option indicates the share of respondents who selected that option first or second.
[2]Respondents were asked what percentage of companies should be more aggressive in pursuing the following strategies for value creation.

cash on the balance sheet, and nearly one-third continued to favor debt retirement. One investor summed up the broader views of the investor community this way: "While preparing for potential near-term challenges, it is important that management also invest to position the business for success over the next five years and beyond."

Where should companies place their bets to create long-term value? Respondents want to see companies invest thoughtfully in the drivers of durable organic growth. They indicate that 50% of companies should invest more aggressively in digital capabilities and technology. They also believe that a substantial percentage of companies should be more aggressive in pursuing investments in marketing and sales capabilities, R&D, and other innovations.

Respondents saw less need for companies to increase their investments in other strategic levers, including M&A and emerging markets, or to more aggressively pursue divestitures or spinoffs. One way that companies could meet investors' expectations is to approach value creation with the disruptive mindset that many tech companies and startups use. Such companies focus on creating value through innovative and disruptive digital and go-to-market capabilities.

Investors also believe that companies need to improve their governance and management processes to appropriately guide their investments and manage performance. Among governance topics, board effectiveness (43%) and management incentives (40%) were the two most frequently cited as areas with significant or very significant improvement potential.

Among management processes, risk management was the one cited most often (by 43% of respondents) as an area with significant or very significant potential for improvement, followed by value management (36%). In each case, the percentage represents an increase from the previous year's figure.

In contrast, investors appear to see tight cost control and capital management as table stakes, with only one-third of respondents citing capital allocation processes as having significant room for improvement (versus 43% last year).

In sum, to be successful, companies will need excellence in traditional management processes and cost efficiency to enhance resiliency, along with thoughtful investments and choices to enable delivery of strong and sustainable TSR.

Companies Must Cope with Additional Complexities

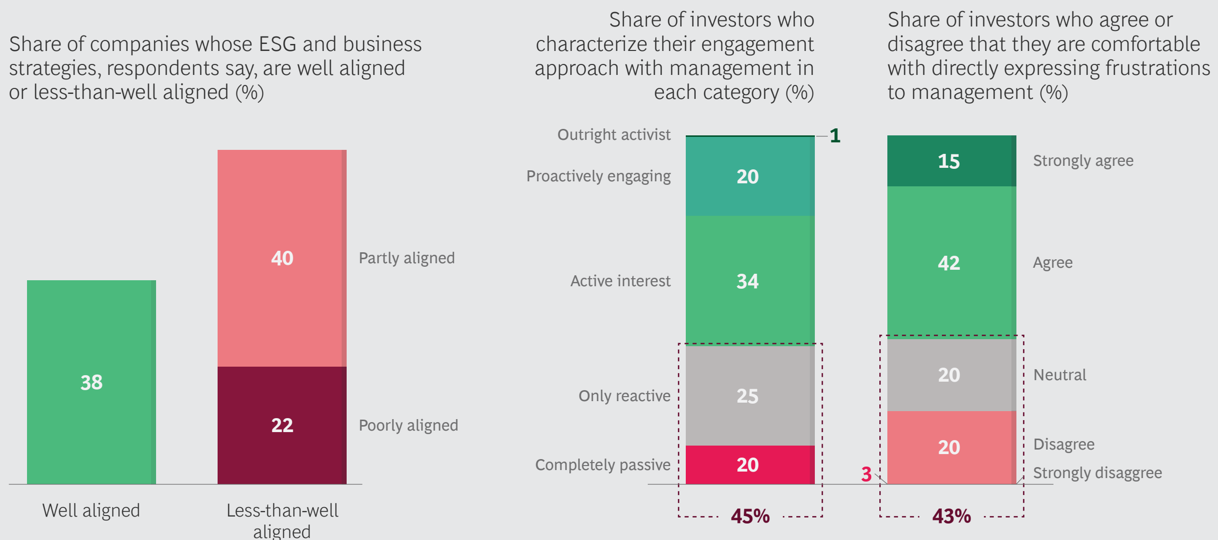
To pursue a compelling long-term value creation agenda in the complex business environment of the 2020s, companies must manage a wide range of new and/or increasingly complex challenges. The survey highlighted two especially important areas.

Alignment of Business and Sustainability Strategies. Investor support hinges on management's having consistent, mutually reinforcing strategic objectives. Our survey found that many companies are falling short in this respect. First, respondents said that 48% of the companies they invest in or follow could improve the alignment of their business, financial, and investor strategies —a percentage consistent with the corresponding figure in the 2018 survey. Second, in the 2019 survey, we also asked investors how well companies align their strategy for addressing environmental, social, and governance (ESG) factors with their business strategy. Respondents said that 62% of companies they invest in or follow could better align their ESG and business strategies. (See Exhibit 3.) This challenge is likely to become more important as more investors incorporate sustainability into their investment thesis and underlying criteria. As a result, companies that fail to address ESG may see reduced interest in their stock, which, in turn, may lead to increasing pressure from investors.

Investor Engagement. Companies need to close the communications gap between management and investors. As shown in Exhibit 3, only 55% of respondents said that they actively engage with the management of the companies they invest in or follow, and only 57% said that they are comfortable with directly expressing their frustrations to management. Although nearly half of investors do not actively engage with management, this does not mean that they are satisfied with its performance. The most vocal investors may represent only the tip of the iceberg when it comes to investor dissatisfaction: the survey found that approximately two in three otherwise silent investors would welcome an activist's intervention and would support the activist, at least privately, if they felt that a company needed to improve its performance.

Capturing broad-based investor support reduces the risk of an activist attack that could cause management to lose control of its strategic and value creation agenda. For example, activists may force management teams to excessively reduce costs to meet

EXHIBIT 3 | Management Must Meet Additional Challenges to Maintain Investor Support



Source: BCG 2019 investor survey.
Note: ESG = environmental, social, and governance.

short-term objectives—even if this weakens the business in the long-term—and/or require them to sell or spin off business units. These survey results underscore how critical it is for companies to better understand their shareholders' expectations and identify ways to engage more effectively with investors to maintain their support.

Build Resilience and Invest to Win in the Long-Term

The survey findings point to three imperatives for all companies as they seek to meet and, ideally, exceed investors' expectations while also balancing short- and long-term objectives.

Prepare a recession plan. The arrival of the long-anticipated downturn is a matter of when, not if. In many sectors, the downturn will be a crossroads, with some companies thriving while others struggle or even disappear. Risk management is only one component of what should be a multifaceted recession plan. To withstand and possibly thrive when facing macroeconomic and sector-specific headwinds, a company must be resilient and agile. It must also closely manage its cost base and capital expenditures to ensure efficiency and flexibility. This preparation should help reduce the impact of the recession when it hits. Moreover, such management can help generate savings to fund investments that will lead to long-term value creation.

To guide its defensive efforts, a company should prepare a recession plan that positions it to gain advantage in recessionary times. The plan should outline the company's approach to navigating various macroeconomic and industry-specific headwind scenarios, including a severe downturn. The company should identify the biggest potential risks it faces today or is likely to face over the next three to five years and create rapid-response options to address those risks and challenges, where necessary. This will enable the company to be more resilient in the face of a wide range of potential adverse developments, which is more important than optimizing a plan for the most likely shape of a downturn.

Continue to invest in growth. In addition to protecting against headwinds, a company should prepare to pursue the competitive opportunities that arise in a downturn. Building resilience and adopting agile ways of working should help a company remain healthy and appropriately aggressive in a downturn. Most companies that outperform the competition during downturns do so by simultaneously seeking growth and playing defense well. This means continuing to invest when others must cut back. Investments in digital capabilities, in the enabling technology stack, and in go-to-market capabilities are key to promoting durable and healthy organic growth over the long term. It also means being well positioned to take advantage of downturn opportunities, such as acquiring companies that are struggling. Playing offense will enable a company to control its long-term destiny and accelerate out of the downturn.

Take a proactive, broad-based approach to winning with investors in the 2020s. Investor engagement and support are critical to avoiding an activist attack and maintaining control of the company's strategic and value creation agenda. A company should have a deep understanding of its investors' expectations and preferences so that it can align its strategy with the right "natural investor type"—for example, those focusing on yield, quality value, growth at a reasonable price (GARP), or aggressive growth. A broad-based approach includes not only traditional considerations—such as investors' preferred type, depth, and frequency of engagement and their most important KPIs—but also newer topics that are rapidly gaining importance, such as sustainability and diversity.

The insights from BCG's 2019 investor survey highlight the balancing act that management teams face today. Effectively addressing the variety of challenges may feel like threading a difficult needle, but companies must seize the opportunities for differentiation before a downturn limits their flexibility. Those that succeed should be well positioned to deliver strong and sustainable TSR in the years ahead.

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