What is the market telling you about your strategy?

Bruckner, Kris; Leithner, Stephan; McLean, Robert; Taylor, Charlie; Welch, Jack. The McKinsey Quarterly; **New York** Iss. 3, (1999): 98-109.

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Headnote

Market expectations are hard for managers to understand and even harder for them to change I But there are ways of doing both that are much more science than black magic

Many managers are confounded by the conflicting messages the market sends them. Strong improvements in the financial performance of a company can be followed by a sharp fall in the price of its shares. Results that moderately exceed consensus forecasts can propel its share price to new heights, leaving managers to wonder how they can possibly achieve the superhuman feats the market expects from them. Either way, they throw up their hands, rail at the market's irrationality, and go on running their businesses as they always have.

Given the market's habit of regularly defying logic, it is not surprising that many managers do not use total return to shareholders (TRS)-dividends plus appreciation in share prices-as their primary decision-making tool. They often look instead to measures of postfinancing returns, notably net present value (NPV) and economic value added (EVA). Such metrics focus on the cash flows of the underlying business and on the ability of initiatives to provide economic returns above and beyond a company's cost of capital.

But running a company is like managing a sports team: owners and fans want a winner. Like it or not, TRS is the way they keep score. NPV and EVA can give you a clearer sense of whether strategies and projects are worthwhile, but these tools don't tell you what you need to know to generate a superior TRS: will the resulting performance exceed the market's expectations?

Of course, most managers frustrated by the share prices of their companies understand that traditional measures, such as price-to-earnings ratios (P/Es), provide some insights into what the market anticipates: a high P/E suggests that...