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It's All about Managing for Value

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Good morning, it's a pleasure to be here and I appreciate the opportunity to share some ideas on managing for value and communicating with shareholders.

I'd like to cover three topics:

- First, I'd like to focus on what I believe is the proper aim of a public corporation and make some observations about how best to serve that aim;

- Second, I'd like to comment on the role of strategy and how I believe that most executives fail to articulate strategy;

- Finally, I'll review some common decision-making mistakes that executives—indeed all decision makers—tend to make.

A Company's Single-Valued Objective Should be Maximizing Long-Term Shareholder Value

Let me be totally upfront and tell you that I'm going to argue that your objective should be to manage for shareholder value. A company creates value when the returns on its incremental investments are above its cost of capital. Saying it differently, this means that the present value of the long-term cash flows an investment generates exceed the cost of the investment.

In fact, I believe that if you are managing to other objectives—and many companies articulate a multitude of financial and non-financial goals—then you are likely doing your key constituents a disservice. Indeed, one can argue that managing for shareholder value is critical for society and for the vitality of the capitalist system.

But before I explain why I believe this to be true, let me take a moment to acknowledge that the idea of shareholder value has come under attack from some pretty prominent sources. On one level, it's easy to see why that's the case. People are understandably upset by market volatility, government bailouts, and exorbitant executive pay. Somehow, the principle of shareholder value is viewed as one of the contributors to these problems. That blame is false, in my view.

For example, Roger Martin, dean of the Rotman School of Management at the University of Toronto, has said that "it's time to scrap shareholder value theory" and that shareholder value "is a tragically flawed premise." I find a great deal of Professor Martin's work interesting and useful, but would say that his view of shareholder value is tragically flawed.

The attacks have come not just from academia, but from practitioners as well. Jack Welch, the former chairman and chief executive officer of General Electric, has said that shareholder value is the "dumbest idea in the world." I can name a lot of ideas that I'd rank as a lot dumber, but—OK—let's take a closer look at this criticism.

Let's start at the beginning. The fact of the matter is that running a business requires *evaluating, and deciding about, trade-offs*. As an executive, your resources—primarily people and money—are practically limited. Your job is to figure out how to put the resources at your disposal to their best and highest use over the long term. You can't do this without facing difficult trade-offs. *And to properly judge tradeoffs, you have to have a single objective.*

To make this a little more concrete, let me borrow an example from Michael Jensen, a retired professor from the Harvard Business School best known for his work on agency theory. Let's say a company wants to increase its short-term profits *and* gain market share.

Naturally, some gains in market share are likely to come with an increase in profits, up to a point. But beyond that point, gains in market share will come at the expense of this year's profits. You can maximize profits, maximize market share, or do something in between. But there is no way to evaluate those trade-offs. At what point is gaining share counterproductive? What level of profits is necessary? When there are multiple goals, there is confusion.

For example, this morning we heard a CEO discuss his company's transformation. He cited the four priorities that he put in place shortly after becoming CEO about three years ago, none of which were tied explicitly to creating value. The number one priority was to improve the quality of the products. And, in fact, he reported that the company went from poor quality rankings to leading the industry. The questions you need to ask are: How much quality is right? Can you have too much quality? What is the explicit link between quality and value?

The fact is that the stock has dramatically underperformed the S&P 500 since that CEO took over. The company's results may ultimately be fine, but skepticism about that management's capital allocation decisions seems warranted until there is clear thinking about the links between corporate priorities and value.

Creating shareholder value provides an objective, economic goal for executives. How you get to that goal is, of course, a substantial challenge. You have myriad decisions about prices, quality, wages, incentives, employee levels, investments, asset sales, etc. But with a single-valued objective, at least you have a way to assess trade-offs.

Now, you might ask, is shareholder value the only way to go? Roger Martin, for instance, has argued for what he calls "customer capitalism"—making customer value a top priority. This, too, is flawed thinking, in my view.

Dealing with customers, like any other stakeholder (including suppliers, employees, and the government), requires evaluating trade-offs. Successful management requires balancing the interests of the company and the stakeholders. I know of no company that has generated long-term value by systematically exploiting, or giving undue advantage to, a stakeholder. If you have an example in mind, please share it with me.

Here's a simple way to think about it. If you want to make customers really happy, and deliver lots of value to them, then simply lower your prices way below the market rate or provide them much more value than your competitors. Your customers will be thrilled, and you'll be on the path to poor performance because you are selling a good or service for less than what it costs to produce that good or service. Now there may be cases where subsidizing a customer in the short-term leads to sufficient customer value in the long term. But to create economic value, the returns you earn on the capital you employ ultimately have to cover all of your costs, including the cost of capital.

Why is the concept of shareholder value so vital? Because it provides a societal good by making sure that the firm gets the greatest output for a given input. So there's no need for so-called "customer capitalism." If you're thinking about the problem correctly, you're already properly assessing trade-offs. Of course happy customers are important. Of course motivated employees are good. Of course constructive relationships with suppliers are desirable. The challenge is how to balance all of those trade-offs.

I would also characterize Jack Welch's comment as an error, but he was reflecting a sentiment that is more prevalent than Martin's, and one that may be traced to a failure of communication.

Properly conceived and executed, the shareholder value approach starts with judicious capital allocation, which leads to an increase in value, which ultimately shows up in the stock price. The point is that greater value ultimately leads to a higher stock price. This connection need not be immediate.

In recent years, however, it appears that Welch and many other executives have understood shareholder value as making corporate decisions that *boost the stock price*. The idea of value seems to have been bypassed. So if you believe that shareholder value is all about boosting today's stock price versus building enduring value, then Welch's description is right: it's a dumb idea.

Let me give you one example of a decision that seems to focus on price versus value: earnings guidance. Brian Bushee, a professor of accounting at Wharton, took the novel step of classifying investors. He came up with three categories:

- *Quasi-indexers*: These are funds that hold small stakes in lots of companies and are long-term holders. These funds are basically closet indexers.
- *Transients*: These funds hold small stakes for a short time. These are the traders.
- *Dedicated*: These funds hold large stakes for the long haul. These funds try to emulate Warren Buffett's espoused style.

Bushee estimates that quasi-indexers make up about 60 percent of funds, that about one-third are transients, and that less than 10 percent are dedicated.

Here's the point: transient investors are attracted to companies that provide a lot of "information events"—for example, conference calls and management forecasts. They run up those stocks during strings of positive earnings growth, but dump them at the first sign of trouble. As Warren Buffett says, "you get the shareholders you deserve."

How do you cultivate a quality base of shareholders? Bushee offers a number of steps. "Perhaps the most important step that managers could take," he notes, "would be to discourage transient ownership by refusing to manage (that is, smooth) reported earnings." In lieu of news events, companies can disclose information about the company's long-term strategy and the leading indicators that support that strategy.

Let me linger on this topic of earnings guidance for a moment, because it is so intertwined with the false understanding of creating shareholder value.

A few years ago, John Graham and Campbell Harvey, professors of finance at Duke University, did a survey of about 400 chief financial officers (CFOs) on the issue of financial reporting. They found that delivering earnings per share (EPS) was perceived to be far and away the most important issue in reporting. Why?

- Investors need a simple metric that summarizes performance
- EPS gets the broadest media distribution and coverage
- Focus on EPS makes the analyst's job easier

- Analysts evaluate a firm's progress based on making EPS

Here's where things become problematic: When surveyed, almost 8 in 10 CFOs admitted that they would be willing to forgo value creating projects in order to deliver EPS. This is a problem. *CFOs are managing to the wrong aim because they believe that delivering earnings is the key to boosting the stock price.* This is at the heart of the false belief about what creating shareholder value is all about.

Now, maybe your comeback is that earnings do matter. And, of course, on some level they do. But the primary focus on earnings growth is misplaced, because it is possible for a company to increase earnings while destroying shareholder value. In fact, over time companies have been able to fund roughly 80 percent of their investments with internally-generated cash. There is no explicit capital market check on that spending. Companies can, and do, invest the cash the business generates into investments that boost EPS but destroy value.

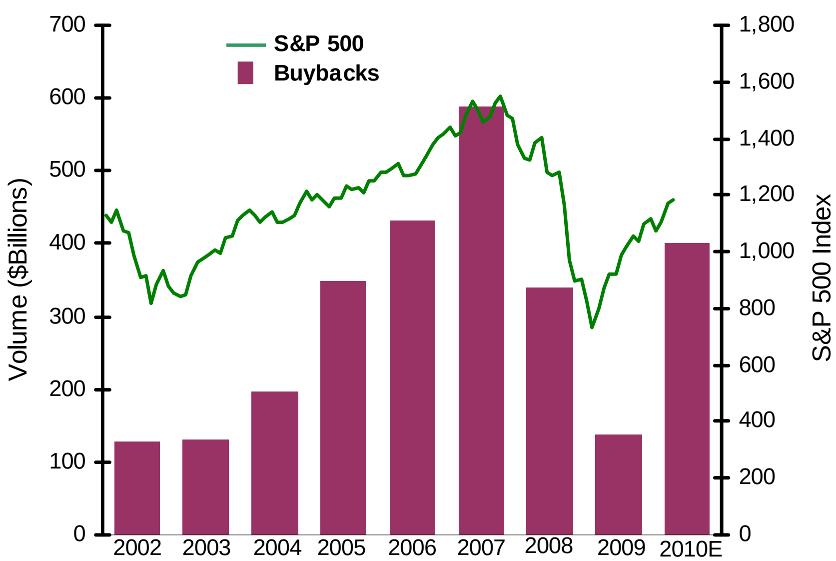
This growth-first mentality has to be checked. In contrast, companies should first consider whether an investment earns a sufficient return and only then consider growth. When investments create value, growth is great. When investments are value neutral, growth makes no difference. And when investments destroy value, growth is bad.

Let me share two other observations that demonstrate that companies have difficulty managing for value. The first is the pattern of share repurchases. In our book, *Expectations Investing*, Al Rappaport and I offered what we called "the golden rule of share buybacks:"

A company should repurchase its shares when its stock is trading below its expected value and when no better investment opportunities are available.

The rule is an offshoot of the old adage, "buy low, sell high." But, as we see from Exhibit 1, executives tend to do the exact opposite: the pace of buybacks closely matches the results for the market. Not surprisingly, following a strong 2009, buybacks are slated to rise smartly in 2010, with announcements on pace to reach about $400 billion.

Exhibit 1: S&P 500 Share Repurchases and the S&P 500 Price Index (2002-2010E)

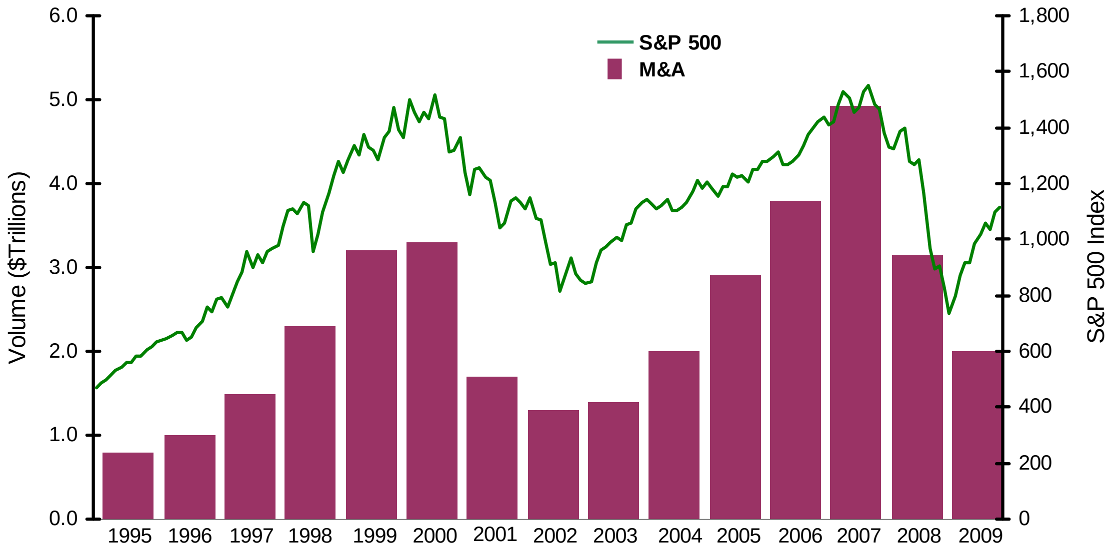


Source: Standard & Poors, LMCM estimates.

As a side note, I continue to find it remarkable that executives are inherently more comfortable making acquisitions than they are repurchasing stock. Both transactions require assessing the present value of future cash flows. But in the case of acquisitions, there are two additional hurdles. First, an acquirer almost always has to pay a premium for control, raising the price (and hence the cash flows necessary to justify the deal). Second, estimating the cash flows of another company—even one in the same industry—is inherently harder than estimating cash flows of your own company. So buybacks can offer the prospects of paying less for a more certain payback. This way of thinking about the problem is rare in corporate suites.

"Buy high" also seems to explain the behavior in the world of mergers and acquisitions (M&A). Exhibit 2 shows M&A volume and the S&P 500 Price Index over the past 15 years. Deal activity is heavily pro-cyclical: deals go up when the market goes up.

Exhibit 2: M&A Volume and the S&P 500 Price Index (1995-2009)



Source: Bloomberg, Reuters, LMCM estimates.

M&A is particularly interesting because there is a reasonable framework for assessing the prospects of whether an acquiring company's stock will rise or fall upon deal announcement. This framework is very simple and makes common sense: the value change for the acquirer equals the present value of the synergies minus the premium pledged.

Value change for acquirer = present value of synergies – premium pledged

What's remarkable is that *companies often provide all the information investors need to correctly reduce the value of their stocks.* Deal announcements now often come with an estimate of synergies, and it is easy to determine the premium based on the deal terms. It comes as no surprise that the markets look past rosy comments about earnings accretion and home in on the deal's economic consequences. It's also no surprise that a solid majority of deals fail to create value for the acquiring companies.

What is Strategy?

We now turn to how best to think about what guides capital allocation. To do this, let me start with a high level observation of how we teach strategy and valuation at business schools.

In strategy classes, we discuss topics including profit pools, value chains, five-forces, generic sources of competitive advantage, and game theory—all great and important ideas. But there's little discussion of how those frameworks explicitly tie to value creation. See for yourself: pick up a popular book on corporate strategy and look for how it links to creating shareholder value. The chances are good that you'll be disappointed. This is too bad, because *the litmus test for a successful strategy is whether it creates shareholder value.*

In finance courses, we teach the importance of net present value, discounted cash flow models, the capital asset pricing model, Black-Scholes—also all useful ideas. But, in fact, you can't inform your valuation model intelligently without an understanding of the competitive situation. The competitive position of a company or industry heavily influences what the cash flow pattern will look like.

Competitive strategy analysis and valuation must be joined at the hip, but they rarely are.

I have a phrase that I am fond of repeating: *All roads of managerial evaluation lead to capital allocation.* How well do you allocate resources—including financial, organizational, human resources? Companies can talk all they want about their strategy, their incentive structure, and their financing policy. But at the end of the day all that matters is how well they have allocated capital. Full stop.

Now, I want to be clear that strategy is important. But most of what companies try to pass off as strategy in corporate presentations is not strategy at all. Often you hear about goals, or priorities, or initiatives. The example a moment ago about improving quality is a great example. None of that is strategy.

Michael Porter, a professor at Harvard Business School, made a very important distinction between *operational effectiveness* and *strategic positioning*.

Operational effectiveness means doing what everyone else is doing, but hopefully as well or better. There's no doubt that operational effectiveness can be a source of edge, but in a highly competitive world, beating competitors solely on operational effectiveness is really tough. As Porter suggests, constant improvement in operational effectiveness is a necessary, but not sufficient, step toward superior performance.

Strategic positioning is about making trade-offs, and doing things that are different from rivals. Porter defines strategy as "the creation of a unique and valuable position, involving a different set of activities." Strategy is about differences. It means combining your activities so that they create value and are hard to imitate. For incumbents in an industry, the ultimate goal is to have a sustainable barrier to entry that allows for consistent returns above the cost of capital.

Note that trade-offs are central to the discussion of both shareholder value and strategy. As Porter says, "a trade-off means that more of one thing necessitates less of another." These difficult trade-offs throughout the organization need to serve the singular objective of maximizing long-term shareholder value.

Before leaving the topic of strategy, there is a final thought worth sharing. This thought can also serve as an introduction to the next section. In discussing their desire to improve their operational effectiveness, many companies seem to focus on absolute instead of relative improvement. Phil Rosenzweig, a professor at IMD, calls this "the delusion of absolute performance." His point is that "in a competitive market economy, the performance of one company is always affected by the performance of other companies." So even if your company is getting better along an important facet of operational effectiveness, what matters from a competitive point of view is whether your company is getting better *relative to the competition*.

Mental Models for Managers

My recent book, *Think Twice*, describes a number of situations where your mind will want to think about the problem one way when there is a better way to think about it. All of us do this, it's the natural way we all think and get through our days. But by understanding these situations and learning how we are likely to go wrong, we can take some steps to improve our decisions. I want to mention three of these situations in particular.

The first is the mistake of relying on the inside versus the outside point of view. This is prevalent in many organizations. The inside view says that when you're trying to predict something or to solve a problem, you'll gather lots of information about the issue, combine it with your own inputs, and you'll project into the future. The inside view is a common way to think about lots of things, from when a student will hand in a term paper, to how long it will take and how much it will cost to remodel your kitchen, to launching a new product. It's the natural way to think.

The outside view suggests considering your problem as an instance of a larger reference class. In other words, you want to ask the question, "when other people have been in this situation, what happened?" You are shifting from your own view to rely more on base rates. This shift is unnatural in part because it requires you to shelf all of the information you worked hard to gather and in part because it rubs against an innate optimism we tend to have about ourselves.

Let me give you an example from the corporate world, and it's one I mentioned just a moment ago: M&A. If you care to study the data, you'll see—with a fair degree of consistency—that about 60-65 percent of all M&A deals fail to create value for the acquiring company. Yet, executives frequently feel that the deal *they* are doing will add value. The lesson here is not to avoid M&A; the lesson is to learn, using the data from the outside view, what contributes to increasing the probability that the deal you do *will* add value. The most direct insight, as I mentioned before, is to make sure that the value of the anticipated synergies exceeds the premium.

The second mistake is what I call attribute versus circumstance thinking. Our natural way to view things is to find success stories, look for some attributes that we can attach to that success, and assume that those attributes will lead to success in another setting. In reality, we know that success or failure often reflects the circumstances of the situation. The answer to most questions a professional faces is, "it depends." But that truth doesn't stop executives from cramming what worked in one setting into another setting and from being surprised at the subsequent failure.

To make this idea more tangible, let me give you a recent example from the world of business. For the last couple of decades, companies, consultants, and academics have extolled the virtues of outsourcing—the practice of contracting a previously in-house service to an outside company. Companies that outsource have been known to lower their costs and capital intensity, allowing them to focus on more value-added aspects of the business. That's all good.

But what is not always explicit is the conditions under which outsourcing makes sense. Outsourcing isn't always good; it depends on the competitive circumstances. In this case, when an industry is young or highly complex, vertical integration is necessary *to make the product work*. Think of IBM's personal computer business 30 years ago. They made the chips, the drives, and the software all to ensure the product actually worked. Over time, those components became modules and the industry flipped to a horizontal orientation, with specialists making each component. Outsourcing works very well when you have a product or service that you can break into modules. Incidentally, modularization is not a trivial process.

So with that in mind, let me tell you the story of the Boeing 787, called the *Dreamliner*. Planes are obviously very complicated machines, and a lot of parts have to be designed properly for the plane to fly safely and efficiently. For years, Boeing had a strategy called "build-to-print," where it would design the aircraft in house, and then outsource the manufacturing of components to the exact specifications that Boeing had worked out. This worked well.

For the 787, Boeing decided to rely on outsourcing to a greater degree, for the logical reasons: to reduce it's own costs and shorten the assembly time. In this case, Boeing outsourced the *design* to suppliers. The idea was to have the suppliers ship approximately 1,200 parts back to Boeing and have the mechanics there assemble the aircraft in a fraction of the time it took to assemble a typical plane that size. The first plane came back in 30,000 pieces, requiring Boeing to spend substantial time and money to pull the design work back in house.

So is outsourcing good? The answer is, "it depends." For your own organization, you have to think carefully about whether the people or processes that worked well in one setting are likely to work well in another. The answer in most cases is no.

The final mistake is one that is common with executives: thinking about a problem at the wrong level. Let me try to explain this mistake with the seemingly unusual example of an ant colony. If you're an aspiring myrmecologist, you can choose to study ants at a couple of different levels. For example, you might choose to study ant colonies. If so, you'd see that the colony has a life cycle, forages wisely, builds amazing dwellings, and fights off its neighbors—the colony is almost an organism in and of itself. Or you might study the individual ants to see how they follow chemical trails and interact with one another. The general observation is that colonies are smart while individual ants are bumbling and fairly inept.

What do ant colonies have to do with CFOs? Well, the ant colony metaphor is not a far-fetched way to think of markets. The market itself tends to be very smart under normal conditions, even though the investors that make up the market are generally much less informed. So if you want to understand the expectations that your stock reflects, which should you consult, the market or the individual analyst?

I'm hopeful that the answer is obvious: the market reflects vastly more information than the individuals. Yet we persist in listening to individuals in order to explain the markets. Executives point to analyst reports or discussions in the media to try to understand what's going on with their stock. The media find an esteemed strategist to explain yesterday's market move. Don't ask the ants, ask the colony. The market is the best source for understanding expectations.

Your reaction might be: how can anyone rely on the market after what we went through in 2008 and 2009? And I totally understand that sentiment. The market is only smart when certain conditions are in place. Some of those conditions were violated, especially in 2008. But the point is not that individuals were somehow smarter than the market—they weren't. Neither the market nor individuals did a sensible job of reflecting expectations. That happens periodically in markets. It is the exception, not the rule, but it happens.

So the message from this mistake is that to understand markets, you have to consult markets. Individuals may satiate your desire to link cause and effect, but they will do so very unreliably. This lesson applies not only to analysts who follow your stock, but also to investment bankers or consultants.

Let me wrap up with three major points I have tried to stress:

- Management's responsibility is to manage for shareholder value. Capital allocation is management's prime task. This approach requires difficult trade-offs, but the objective is clear. Today, many corporate decisions fail to serve this objective.

- In defining and communicating strategy, focus on what is *unique*. Most strategic proclamations relate to operational effectiveness, but must deal with trade-offs.

- Learn about the cognitive mistakes you are likely to make, and take steps to mitigate them.

Thank you.

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