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THE OUTSIDERS : RADICALLY RATIONAL BLUEPART FOR SUCCESS

Dr. Prasanna Chandra

Jack Welch has often been cited in the business press as the most outstanding CEO of the last 50 years. The business press, however, does not attempt to identify in a rigorous manner the top performer. It focuses on the Fortune 100 companies (the largest and best known companies) which figure prominently on the covers of top business magazines and relies on metrics like revenues, profits, and market capitalisation. This is understandable because these metrics loom large in public imagination.

The ultimate barometer of a CEO's greatness is, however, the increase in a company's *per share* value, not the growth in its sales or profits or employees. As William Thorndike in his book *The Outsiders* published by Harvard Business Review Press in 2012 put it: "You really only need to know three things to evaluate a CEO's greatness: the compound annual return to shareholders during his or her tenure and the return over the same period for peer companies and for the broader market (usually measured by the S & P 500) ."

GE's stock outperformed S & P by 3.3 times over Jack Welch's twenty year tenure as GE's CEO and Jack Welch was an undeniably great CEO. However, Jack Welch does not belong to the league of people like Henry Singleton and others covered in the book.

Henry Singleton and Capital Allocation

Who is Henry Singleton and what has been his achievement? A world – class mathematician, Singleton programmed MIT's first computer while earning a doctorate in electrical engineering. In the 1940's he developed a "degaussing" technology that allowed Allied ships to avoid radar detection; in the 1950s, he invented an inertial guidance system which is used even now in aircrafts, and in the early 1960s he founded a conglomerate, Teledyne. He ran Teledyne from 1963 to 1990, when he retired as chairman during a severe bear market. An investment of a dollar in Teledyne in 1963 was worth $180 by 1990. The same dollar invested in the S & P 500 would have been worth only $15. Astonishingly, Singleton outperformed the index by over twelve times. Warren Buffett wrote in 1980, "Henry Singleton has the best operating and capital deployment record in American business… if one took the top 100 business school graduates and made a composite of their triumphs, their record will not be as good as Singleton's."

The success of Teledyne was not because it owned any unique, rapidly growing business. Rather, it was mainly in Singleton's skill in capital allocation. CEOs essentially need to do two

things to succeed: (1) They must manage their operations efficiently. (2)They must deploy rationally the cash generated from operations. Most CEOs (and management books) focus on management of operations, which undoubtedly is important. By contrast, Singleton paid most of his attention to capital allocation.

There are three ways of raising capital (tapping internal cash flow ,issuing debt, or raising equity) and five ways of deploying capital (investing in existing businesses, acquiring other businesses, paying dividends, reducing debt, or repurchasing stock). Regard these options collectively as a tool kit. In the long run, shareholder returns will be determined largely by the decisions a CEO makes in choosing or avoiding the options in this tool kit. Unfortunately, very few CEOs come well prepared for this critical task of capital allocation.

As a master capital allocator, Singleton used the various options in the tool kit very rationally. He deployed capital on selective acquisitions and a series of large repurchases. He did not pay dividend until the late 1980s, refrained from issuing shares, and frequently used debt. In contrast, most of the other conglomerates followed a diametrically opposite capital allocation strategy: they actively issued shares to buy companies, paid dividends, avoided share repurchases, and generally used less debt. It is not surprising that while Singleton generated stellar results, most other conglomerates produced lackluster outcomes. Differences in the set of tools deployed produced vastly different results.

If capital allocation is defined more broadly as resource allocation to include the deployment of human resources as well, we find that here too Singleton pursued a very different approach. As Thorndike said, "Specifically, he believed in an extreme form of organizational decentralization with a wafer- thin corporate staff at headquarters and operational responsibility and authority concentrated in the general managers of the business unit." This differed significantly from the approach of his peers, who had elaborate headquarters staffs and fairly centralized way of doing things.

According to Thorndike, the most extraordinary CEOs of the last fifty years followed an approach to resource allocation that was uncannily similar to Singleton's.

Investment Superstars

To commemorate the fiftieth anniversary of *Security Analysis*, Columbia Business School hosted a conference in 1984. The book which became the bible of security analysts was conceived in Benjamin Graham's course on security analysis that he taught at Columbia in the late 1920s. To debate the impact of this classic work, the organisers invited two speakers, Warren Buffett, a Graham student and an outstanding value investor, and Michael Jensen, a leader of the Efficient Markets Hypothesis, who had asserted few years earlier that there was "no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Markets Hypothesis."

Jensen explained that extensive academic research had shown that analysis of publicly available data was almost worthless, at least as a means of outperforming the market. The great success of some practitioners of Graham's principles, he argued, could be dismissed as luck. Jensen said, "If I survey a field of untalented analysts, all of whom are doing nothing but flipping coins, I expect to see some who have tossed two heads in a row and even some who have tossed ten heads in a row."

Popularised by William Sharpe, the coin-flipping analogy has become a staple of MBA education. According to this analogy, if a million people flip a balanced coin, about 500000 will get a head and the balance a tail. Those who get a head continue the game and those who get a tail quit the game. In the second round about 250000 get a head. In the third round about 125000 get a head. By the end of the tenth round nearly 975 people get a head. A straight run of 10 heads may persuade these people to believe that they have great skill in tossing coins. In reality, their success is due to chance not skill. Finance academics believe that the stock market works pretty much the same way: the chance factor will ensure that some investors will have a long streak of successes.

In response to the argument of academics that coin-flipping orangutans would achieve the same result as a bunch of successful investors, Buffett gave a fitting reply: "If you found that 40 per cent came from a particular zoo in Omaha, you could be pretty sure you were on to something. So you would probably go out and ask the zoo-keeper about what he's feeding them, whether they have special exercises, what books they read, and who knows what else."

Expressing admiration for Buffett, Michael Jensen said, "One of the things I came away from that was Warren Buffett was one of the smartest people I've ever met, and wise. He could play on my turf without making mistakes. It's not by accident that he's worth billions."

Managerial Superstars and Their Principles

As in the world of investing there are a few star managerial coin – flippers like Henry Singleton . In his insightful book *The Outsiders*, William N. Thorndike, Jr. talks about eight unconventional CEOs and their radically rational blueprint for success. On average, they outperformed the S & P 500 by more than twenty times and their peers by more than seven times.

Thorndike, Jr. examined the performance of Teledyne under the stewardship of Henry Singleton. Singleton was clearly an unusually effective performer or as Atul Gawande of *The New Yorker* would call a *positive deviant*. Thorndike, with the help of a talented group of Harvard MBA students looked for other cases where one company handily outperformed its peers and the market. Based on an extensive search of the databases at Harvard Business School's Baker Library, they came across seven other examples that satisfied these two tests.

The managerial superstars identified by Thorndike are:

- Tom Murphy of Capital Cities Broadcasting.
- Henry Singleton of Teledyne
- Bill Anders of General Dynamics
- John Malone of TCI
- Katharine Graham of Washington Post
- Bill Stiritz of Ralston Purina
- Dick Smith of General Cinema
- Warren Buffett of Berkshire Hathaway.

Like Singleton, they developed a unique, iconoclastic approach to their businesses and drew a lot of questioning comments from business press and their peers. As Thorndike commented, "Even more interestingly, although they developed these principles independently, it turned out they were iconoclastic in *virtually identical ways*. In other words, there seemed to be a pattern to their iconoclasm, a potential blueprint to success, one that correlated highly with extraordinary returns."

They shared a common set of principles which represents a *worldview* that entitled them citizenship of a tiny intellectual village that Thorndike calls Singleton Ville (Warren Buffett calls the tiny intellectual village inhabited by the disciples of Benjamin Graham as Graham – and – Dodds Ville). These principles are:

1. The most important job of a CEO is *capital allocation*.
2. Increase in *per share value* and not overall growth or size is what really matters in the long run.
3. Long term value is determined by *cash flow* not reported earnings.
4. *Decentralisation* and empowerment release entrepreneurial energy, reduce costs, and lower "rancor."
5. *Independent thinking* is important for long- term success. Interactions with the outside world (Wall Street, the press, and so on) can be a source of distraction and waste of time.
6. At times, the best way of deploy capital is to *repurchase* your company's stock.
7. Patience and occasional boldness are required when it comes to *acquisitions.*

Describing these eight CEOs, Thorndike said, "They were practical and agnostic in temperament, and they systematically tuned out the noise of conventional wisdom by fostering a certain simplicity of focus, a certain *asperity* in their cultures and their communications."

The Outsider's Checklist

Thanks to Atul Gawande's classic work, *The Checklist Manifesto*, it is now widely appreciated that checklists are effective decision- making tools in fields are diverse as medicine, aviation, and construction. Checklists help in promoting rationality and eliminating the distractions that often cloud complex decisions.

Gawande suggests that checklists are best kept to ten items or fewer. Based on the experiences of the outsider CEOs, Thorndike has developed the following checklist to help companies in making effective resource allocation decisions (and hopefully avoiding value-destroying decisions).

1. The capital allocation process must be led by the CEO.
2. Begin by establishing the hurdle rate which is the minimum acceptable return for investment projects. This is one of the most important decisions any CEO makes.
   The hurdle rate is determined with reference to the investment opportunities available to the company and must exceed the weighted cost of capital.
3. Estimate returns for all internal and external investment alternatives using conservative assumptions. Rank all alternatives by return and risk.
4. Calculate the return for share buybacks. Returns from acquisitions must meaningfully exceed this benchmark.
5. Calculate returns in post- tax terms.
6. Establish acceptable, conservative cash and debt levels for the company.
7. Adopt a decentralized organisational model.
8. Plough back profits only when you can generate returns in excess of the hurdle rate.
9. Pay dividends only if you do not have high – return investment objectives.
10. When share prices are extremely high, consider selling stock or business. Close under-performing business units if they are no longer capable of producing acceptable returns.

1.Equity Risk Premium

The conventional wisdom was that the equity risk premium was constant over time and the best way to estimate it was to look at the historical average returns.

The tech boom and bust cycle of 1999-2002 challenged this view. During the bull market of 1990s, estimates of the long- run equity premium based on historical average returns kept inching upward, even when yields were falling. Yet, any valuation measure based on a lower beginning yield should imply lower future returns (even when mean- reverting valuation is not assumed). The bust of the early 2000s suggested that forward- looking valuation measures provide an empirically and logically better signal than historical average returns. Empirical evidence showed that low dividend yields tend to be followed by sub-par market returns rather than above average growth.

In his presidential address to the American Finance Association in January 2011, John Cochrane argued that there has been a full reversal of academic thinking on this question:

> "The equity premium is no longer though to be constant over time. All- time variation in market valuation ratios was thought to reflect changing growth expectations (with an unchanging *ex ante* required risk premium), while now all such variation is thought to reflect changing required returns."

What can explain the variation in expected returns over time? Cross- sectional variations (average return differences between assets) as well as temporal variations in expected returns can be explained by either rational or irrational theories.

- Rational explanations rely on factors like time- varying volatility, time- varying risk aversion, and time- varying risk of rare disasters.
- Irrational explanations rely on factors like time- varying investor sentiment, cycles of greed and fear, as well as social interaction.

While it is well-nigh impossible to disentangle these explanations for predictable returns, survey- based evidence clearly favours irrational explanations

2. Some Anomalies

According to the uncovered interest rate parity condition, it is not possible to borrow in one currency and invest in another and generate positive returns in the long run.

Studies in empirical finance, however, show that some simple currency speculation strategies have performed well during the post- Bretton Woods period.

- *Carry Trade* a carry trade is a trade that involves borrowing in low interest currencies and investing in high interest rate ones. Some researchers interpret the returns to carry trade as compensation for taking risk.
- *Momentum* The momentum strategy involves borrowing in currencies with low recent returns and investing in currencies with high recent returns.
- *Currency Value Strategy* Currency value strategy consists of borrowing in overvalued currencies and investing in undervalued currencies on the basis of an assessment of real exchange rates.

3. Compensation and Incentives: Theory vs Practice

A number of features of organization incentive system in practice are not easily explained by traditional economic theory. These include egalitarian pay systems in which there is a weak link between performance and compensation, the considerable use of promotion- based incentive systems the general hesitation on the part of employers to fire, penalize, or give poor performance evaluation to employees, the absence of upfront fees for jobs and ineffective bonding contracts. The explanations offered by behaviorists and practitioners for such practices are distinctly uneconomic: notions like equity, social responsibility, trust, morale, and culture.

4. Assumptions Underlying APT

Developed by Stephen Ross in the mid- 1970s, the arbitrage pricing theory (APT) is based on three major are perfectly.

1. The capital markets are perfectly competitive.
2. Investors have a preference for more wealth to less wealth with certainty.
3. Asset returns are generated by a stochastic process that can be expressed as a linear function of a set of K risk factors (or indices)

Equally important, APT does not make the following major assumptions which underline the CAPM.

1. The utility function of investors is quadratic.
2. Security returns are normally distributed.
3. The market portfolio comprising of all risky assets is mean- variance efficient.

If APT model, which is richer and simpler, can explain differential security prices, it will be regarded as superior to the CAPM.

1. HUMOUR

- Jack got up late every day and reported late for work. Enraged, his boss threatened to fire him and asked him to consult a doctor. So Jack went to see his doctor who gave him a pill to be taken at night. Bill slept well and got up early in the morning. He had a leisurely breakfast and reported to work well in time. He told the boss, “The doctor’s pill really worked.” The boss chastised him, “But where were you yesterday.”

- Friendship between Women: One night a woman did not come home. Next morning when she came home she told her husband, “Due to bad weather, I stayed with a friend.” The husband contacted his wife’s 10 best friends. None of them knew about it.

  Friendship between Men : One night a man did not come home. Next morning he came home and told his wife, “Due to bad weather, I stayed with a friend.” The wife contacted her husband’s 10 best friends. Eight of them said that he was with them the previous night. The other two said that he was still with them.

2. WISE SAWS

- A painter is a man who paints what sells. An artist, however, is a man who sells what he paints. : Pablo Picasso

- Visitors should behave in such a way that the host and hostess feel at home.