The Capitalist’s Dilemma
Presentation to the Ethical Capitalism Group

Derek van Bever
The United Nations
October 10, 2017

“Two ways,” Mike said. “Gradually, and then suddenly.”

- Ernest Hemingway,
  *The Sun Also Rises*
Objectives for This Presentation

1. To explain what we mean when we say that we are all caught in what we are calling “the Capitalist’s Dilemma”: What is right for us in the long term (investing in market-creating innovation) is wrong for us in the short term

2. To explain why we are so concerned about this now, and how we are engaging our alumni to help us understand the problem as well as its potential remedies

3. To explain why we are focused on changing the investment behavior of public company management teams, and why we think that is a worthwhile area of focus

4. To encourage you to exercise your influence to emancipate management of these companies—to free them to put enterprise capital to work in long-term innovation

5. To teach you to spot powerful market-creating investment opportunities

6. To learn more from all of you about how we might help you as we complete researching and writing our book on this very important challenge
Roadmap for Our Time Together

- Backstory to the Capitalist’s Dilemma Initiative
- Who (or What) *Really* Drives Growth in the Economy?
- The Signature Impact of Market-Creating Innovation
- Restoring the Broken Cycle of Corporate Growth Investment
  - Spotting MCI Investment Opportunities
  - Aligning Interests Along the Investment Channel
  - Emancipating Public Company Management
  - Evolving Our Performance Metrics
- Discussion: What’s Your Perspective on The Capitalist’s Dilemma?
The HBS Forum for Growth and Innovation

A Community of 9,000 Of Our Alumni Intent on Changing the World

A Work in Progress

- BSSE is helping to lead the school in building lifelong relationships with alumni of our course through a variety of online and in-person channels

- We have two principal goals: to connect alumni with each other to share learning on applying the lessons of the course in “the real world”; and to mobilize alumni to take on big societal challenges

- We are currently studying what many are calling “the no-growth future”; aka, What will your kids do if the economy isn’t producing enough jobs?

- We call this initiative “The Capitalist’s Dilemma,” and we welcome your participation!
A New Approach to Academic Research

The Capitalist’s Dilemma

How Ideas Flow

Each dot here represents a post to the online forum where the authors invited HBS students and alumni to contribute ideas for “The Capitalist’s Dilemma.” The dots also show the number of comments on the post. The lines between dots show when one post influenced the writing of another, as indicated by the authors in the forum.

Selecting a dot will show you which posts directly influenced it, and which posts were directly influenced by it later on. Orange dots show posts that forum members considered key.

The final article’s seven core ideas are shown across the top of the map. Select any one of these to see the full lineage of that idea in the forum and what the shape of that lineage means.

Source: https://hbr.org/2014/06/the-capitalists-dilemma
Seeds of Our Concern

A puzzlingly slow recovery—in growth and in jobs—caught our eye in 2012

Grinding to a Halt?

Source: U.S. Council on Competitiveness
A Problem Across the Large Corporate Economy

Almost all large companies stall

Growth of Fortune 100 and Global 100 Companies: 1950–2006

- Companies Suffering Stall Points = 87%
  - 11% Continuous Growth n = 67
  - 13% and the remaining 13% have grown continuously over time
  - 76% Stalls n = 379

- Growth Restarts n = 57
  - another 11% of companies stall and then return to significant growth

Seventy-six percent of all companies stall and never restart
How Long Has This Been Going On?

THE DELINKING OF TOP- AND BOTTOM-LINE GROWTH

Median Year-Over-Year Growth Rates, Across Five-Year Periods
Very Large Firms (Fortune 100 Sized), 1955-2005

I. Era of Congruent Growth Rates
II. Era of Corporate Restructuring
III. Era of Delinked Bottom-Line Growth

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HARVARD BUSINESS SCHOOL
How Long Can This *Keep* Going On?

**THE DELINKING OF TOP- AND BOTTOM-LINE GROWTH**

**Median Year-Over-Year Growth**

Very Large Firms

Revenue and Net Income Growth

- Net Income
- Revenue
- Difference

Fortune 100-sized Companies
Source: Compustat
Where to Look?

Who (or What) Causes Growth?

Macroeconomics
*The performance, structure, behavior, and decision-making of an economy as a whole*

Microeconomics
*The study of single factors and the effects of individual decisions*

A Manager’s View of Economic Growth
For Better or For Worse

Public Companies **Are** the Economy


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<tr>
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</thead>
<tbody>
<tr>
<td>Number of listed companies</td>
<td>4,796</td>
<td>7,322</td>
<td>3,671</td>
</tr>
<tr>
<td>Market capitalization (billions 2016 USD)</td>
<td>$2,975</td>
<td>$12,322</td>
<td>$25,303</td>
</tr>
<tr>
<td>Gross domestic product (billions 2016 USD)</td>
<td>$6,325</td>
<td>$11,769</td>
<td>$18,565</td>
</tr>
<tr>
<td>Market capitalization as a % of GDP</td>
<td>47.0%</td>
<td>104.7%</td>
<td>136.3%</td>
</tr>
<tr>
<td>Individual direct ownership</td>
<td>50.0%</td>
<td>27.2%</td>
<td>21.5%</td>
</tr>
<tr>
<td>Number of ETFs (U.S. domestic equity)</td>
<td>0</td>
<td>2</td>
<td>658</td>
</tr>
<tr>
<td>NYSE annual share volume (in millions)</td>
<td>5,360</td>
<td>104,636</td>
<td>316,495</td>
</tr>
<tr>
<td>Equity options traded (contracts in millions)</td>
<td>32</td>
<td>199</td>
<td>3,626</td>
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<tbody>
<tr>
<td>Average market capitalization (millions 2016 USD)</td>
<td>$620</td>
<td>$1,683</td>
<td>$6,893</td>
</tr>
<tr>
<td>Corporate profit as a % of GDP</td>
<td>6.9%</td>
<td>6.2%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Average age in years of a listed company</td>
<td>10.9</td>
<td>12.2</td>
<td>18.4</td>
</tr>
<tr>
<td>Herfindahl-Hirschman Index (HHI)</td>
<td>1,392</td>
<td>812</td>
<td>1,180</td>
</tr>
<tr>
<td>New establishments</td>
<td>697,749</td>
<td>711,716</td>
<td>669,917</td>
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<tr>
<td>Mutual funds</td>
<td>$40</td>
<td>$1,725</td>
<td>$8,725</td>
</tr>
<tr>
<td>Index funds</td>
<td>&lt;$1</td>
<td>$85</td>
<td>$1,990</td>
</tr>
<tr>
<td>Hedge funds (long/short equity)</td>
<td>&lt;$1</td>
<td>$130</td>
<td>$850</td>
</tr>
<tr>
<td>Venture capital</td>
<td>$4</td>
<td>$48</td>
<td>$827</td>
</tr>
<tr>
<td>Buyout funds</td>
<td>&lt;$1</td>
<td>$80</td>
<td></td>
</tr>
</tbody>
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Source: Michael J. Mauboussin et al., “The Incredible Shrinking Universe of Stocks, Credit Suisse, March 22, 2017
A Taxonomy of Innovation

Managers Invest in Three Types of Innovation

Performance-Improving Innovation
Replace old products with new and better models

Efficiency Innovation
Help companies make and sell mature, established products or services to the same customers at lower prices

Market-Creating Innovation
Transform complicated or costly products so radically that they create a new class of consumers, or a new market
Targeting Nonconsumption

From the Rich and Skilled … to Everyone!
The Cycle of Reinvestment Operates in Healthy Companies and in Healthy Economies

Performance - Improving Innovation

Focus of improvement:
- Improve margins through increased revenue or profit
- Gain market share
- Creates little net growth

Efficiency Innovation

Focus of improvement:
- Eliminates jobs
- Increases free cash flow

Market - Creating Innovation

Focus of improvement:
- Makes products affordable and accessible:
  - Creates growth
  - Creates jobs
  - Consumes capital
“Most rural adults had just one or two sets of everyday clothing—shirts and pants for men and simple dresses for women. Depending on income, the adults might have a better set of clothing for church or social occasions. In both the city and the countryside, women and their daughters spent much of their time making clothing for themselves. The younger children were clothed with hand-me-downs. Modern standards of cleanliness did not apply. Working clothes were washed at most once per week and were filthy after days of hard labor in dirty surroundings.”

Sources: Jack Buckman, Unraveling the Threads: The Life, Death and Resurrection of the Singer Company, p. 48; Robert J. Gordon, The Rise and Fall of American Growth: The U.S. Standard of Living Since the Civil War, p. 43
With fingers weary and worn,
With eyelids heavy and red,
A woman sat in unwomanly rags,
Plying her needle and thread –
Stitch! Stitch! Stitch!

In poverty, hunger, and dirt,
And still with a voice of dolorous pitch,
Would that its tone could reach the rich
She sang this “Song of the Shirt!”

- Thomas Hood (1843)
The Original “Odd Couple”

Isaac Singer  
Edward Clark
How Hard Could It Be?

Harder Than It Looks!

Essential Components of a Functioning Sewing Machine

Developed in the 1790s

1. A straight needle with an eye-point
2. A horizontal table
3. An overhanging arm

Developed in the Early 1800s

4. Continuous thread
5. A shuttle for the secondary thread
6. The lock-stitch

Invented or Licensed by Singer

7. A pressure foot
8. Continuous synchronous feed
9. Thread or tension controls
10. The ability to sew in straight or curving lines
A Bias Toward Continuous Improvement

Source: http://www.sewalot.com/sewing_machine_pictures.htm
The Real Genius of Singer?
Unparalleled at Business Model Innovation

Singer “Firsts”

- Advertising to women
- In-home demonstration
- Canvasser-collector model
- Installment selling
- Trade-in/trade-up
- After-sales service
- Warranty protection
- Affinity marketing
- Interchangeable parts
- Assembly line production
- Vertical integration
- Precision manufacturing
- Functional organization chart
- Scientific management
- Branch office/franchise structure
Impact Across the Economy
You Say You Want a Revolution?

**Stimulate Sale of Consumer Products**
- Canvas
- Sheets
- Drapes
- Curtains
- Rugs
- Blankets
- Towels
- Umbrellas
- Hats
- Tents
- Uniforms

**Boost Related Industries**
- Textile Manufacturing
- Thread Spinning and Spooling Industries
- Sewing Patterns
- Drafting Systems
- Cabinetry
- Ready-to-Wear Garment Industry

**Create New Distribution Channels**
- Mail-order catalogs
- Department stores
- Dry goods stores
The First Corporation with Global Reach

“America’s Chief Contribution to Civilization”

A Peerless Accomplishment

- 86,000 employees
- 5,000 branch offices
- 190 countries
- Manuals in 54 languages
- Backward integration into iron ore mining, foundry operation, forestry assets; forward integration into warehouses, freight trains and ships
- 50% global market share
A Practically Infinite Target Market

<table>
<thead>
<tr>
<th>Year</th>
<th>Singer Company Unit Sales (thousands)</th>
<th>Singer Company Profit (thousands of USD)</th>
</tr>
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<tbody>
<tr>
<td>1860</td>
<td>11</td>
<td>400</td>
</tr>
<tr>
<td>1880</td>
<td>538</td>
<td>4,400</td>
</tr>
<tr>
<td>1900</td>
<td>1,000</td>
<td>8,300</td>
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</tbody>
</table>

Source: [http://www.sewalot.com/sewing_machine_pictures.htm](http://www.sewalot.com/sewing_machine_pictures.htm)
Why do I tell you this story?

Markers of Market-Creating Innovation

*The combination of an enabling technology, supported by a new business model, and embedded in a new value network*

- Targets **nonconsumption**: Makes something previously available only to the rich and skilled affordable and accessible to a new, larger segment of the population
- Incorporates **enabling technology** that allows low-cost performance and provides trajectory for upward improvement across time
- Focused on a **Job-to-Be-Done** that is:
  - Unfulfilled: Potential customers engaged in workarounds or “hacks”
  - Significant: Large delta between current and proposed solution
  - Broadly Shared: Large population of potential customers share this problem
  - Recurring: Offers the ability to form a new habit of consumption
- Enables early customer **empowerment** (monetization), to accelerate adoption
- Requires **design of new business model** to deliver value proposition profitably
- Requires **construction of new value network** to pull customers and suppliers into the new model
- (Almost) impossible to value using traditional metrics—**high-conviction**, not high-certainty, projects

*Operating in terra incognita—a new, rather than established, market*
Impact of Market-Creating Innovation on Job Creation

**Direct Employment**
- Hired directly by company, on firm payroll
- Easiest to track precisely
- Typically the smallest of effects

**Value Network Employment**
- Employment supporting purchased inputs and distribution
- Large effect; generally new-to-world capability creation
- Innovator “pulls” other players into value network

**Empowering Employment**
- Jobs created due to adoption of product or service by entrepreneurs
- Almost always an “upsurge surprise” of MCI; relates to the unexpected ways in which customers put products to use

**Indirect Employment**
- “Spillover jobs” created in the social and economic environment in which the business and its ecosystem exist: grocery stores; retailers; restaurants; etc.
- Most difficult to estimate of all of the effects; generally calculated using multipliers
The Hidden Power of MCI Job Creation

Two million U.S. jobs. And counting.

The numbers tell the story. Apple is among the biggest job creators in the United States, employing both its own workers and partners. In 2023, for example, Apple spent over $50 billion with more than 5,000 U.S. suppliers and manufacturers. Since we launched the App Store in 2008, U.S. developers have earned over $50 billion through in-app purchases alone. And we’re just getting started.

Ryan | Cincinnati Test Systems | Harrison, OH

CTS helped develop innovative techniques that test for water resistance in iPhone 7.

2,000,000

Jobs across all 50 states

80,000
Apple employees

450,000
Jobs through our U.S.-based suppliers

1,530,000
U.S. jobs attributable to the App Store ecosystem
Market-Creating Innovations

The Economic Engines That Drive Us Forward

- Kodak Simplicity (1888)
- Ford Model T (1908)
- Wireless Telegraph (1928)
- Fiber Optics (1970)
A Taxonomy of Innovation

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- Creates little net growth

Market- Creating Innovation

Makes products affordable and accessible:
- Creates growth
- Creates jobs
- Consumes capital

Efficiency Innovation

Reduces cost of generating sales of existing products:
- Eliminates jobs
- Increases free cash flow
Kudos to Professor Lazonick

Ain’t Living Long Like This!

S&P 500 Earnings Reinvestment Trend (5-year cumulative)

<table>
<thead>
<tr>
<th>Year</th>
<th>Reinvestment</th>
<th>Dividends</th>
<th>Stock Repurchases</th>
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<tbody>
<tr>
<td>67-71</td>
<td>45%</td>
<td>54%</td>
<td>1%</td>
</tr>
<tr>
<td>72-76</td>
<td>55%</td>
<td>43%</td>
<td>2%</td>
</tr>
<tr>
<td>77-81</td>
<td>55%</td>
<td>41%</td>
<td>4%</td>
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<tr>
<td>82-86</td>
<td>22%</td>
<td>22%</td>
<td>28%</td>
</tr>
<tr>
<td>87-91</td>
<td>13%</td>
<td>56%</td>
<td>25%</td>
</tr>
<tr>
<td>92-96</td>
<td>17%</td>
<td>59%</td>
<td>25%</td>
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<tr>
<td>97-01</td>
<td>16%</td>
<td>58%</td>
<td>39%</td>
</tr>
<tr>
<td>02-06</td>
<td>2%</td>
<td>45%</td>
<td>51%</td>
</tr>
<tr>
<td>07-11</td>
<td>42%</td>
<td>48%</td>
<td>60%</td>
</tr>
<tr>
<td>12-16</td>
<td>45%</td>
<td>57%</td>
<td>57%</td>
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- As soon as the SEC instituted Rule 10b-18 of the Securities Exchange Act (1982), allowing companies to repurchase their shares on the open market with virtually no regulatory limits, repurchases take a significant share of net income.
- By the mid-2000s, reinvestment has virtually disappeared, and companies spent more than 100% on dividends and buybacks, meaning they were dipping into reserves or borrowing.
Where Are All the Good Ideas, Anyway?

If they don’t know, investors know even less!

Senior managers don’t know all of the good ideas in their companies

Senior Management

Middle Management

Front Line
Is this idea truly market-creating, targeting nonconsumption through use of an enabling technology that will provide enduring cost advantage?

Has the company identified a significant, unfulfilled job to be done shared by a large potential market?

Is the product architecture interdependent, integrated over elements of the job that will continue to be “not good enough”?

Is the company pursuing an emergent strategy—or are they overly invested in their current approach?

Does management possess the correct schools of experience for this opportunity; have they seen the problems they’re likely to encounter?
Noise on the Line?

Do the interests of primary asset owners align with the incentives of agents and intermediaries all along the investment channel?
Emancipating Management to Invest in MCI

<table>
<thead>
<tr>
<th><strong>You Get What You Measure</strong></th>
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<tbody>
<tr>
<td>“Everyone will say you should invest for the long term, but they measure you using short-term metrics. Even if you take away the quarter-by-quarter pressure, you still can’t invest in market-creating innovation because it takes multiples of years to pay off.”</td>
</tr>
<tr>
<td>- CFO, Healthcare company (Asia)</td>
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<thead>
<tr>
<th><strong>Learned Helplessness</strong></th>
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<tr>
<td>“We’re letting people run our corporations now who buy into a mythology that I don’t think is true. Are we so timid that we believe that Carl Icahn knows more about [our business] than we do? We pay deference to the Icahns of the world, but what does he know about running my business?”</td>
</tr>
<tr>
<td>- CEO, Fortune 500 company</td>
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<table>
<thead>
<tr>
<th><strong>87%</strong></th>
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<tr>
<td>of executives and directors feel most performance pressure over 2 years or less</td>
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<table>
<thead>
<tr>
<th><strong>99%</strong></th>
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<tr>
<td>of 2015 earnings for S&amp;P 500 companies spent on dividends and buybacks</td>
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<table>
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<tr>
<th><strong>55%</strong></th>
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<tr>
<td>of CFOs would delay NPV-positive projects to hit quarterly earnings targets</td>
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<table>
<thead>
<tr>
<th><strong>86%</strong></th>
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<tbody>
<tr>
<td>of executives agree longer time horizons for business decisions would improve performance</td>
</tr>
</tbody>
</table>

Source: FCLT Global; McKinsey analysis.
Innovation Killers

1) DCF analysis assumes the base case (the so-called “do-nothing option”) will persist into the future
2) DCF analysis drastically over-weights near-term cash flows
3) NPV analysis favors projects with projectable cash flows and determined time horizons
4) IRR favors projects that return investment dollars quickly
5) All ratio analysis is indifferent between improving the business (the numerator) or the metric (the denominator)
Our Questions to You

1. Do you believe our assertion that the companies you invest in have more good ideas to pursue than they are currently funding? If so, why do you think that is?

2. Is it your role to encourage management to invest in long-term (“market-creating”) initiatives, or should they simply return the capital to you to reinvest elsewhere?

3. How (and when) do you attempt to exercise influence over management decision-making? Are you successful, and if so, what works?

4. What are your biggest frustrations in attempting to find good, long-term investments?

5. What would you like to know more about in this area?