

Brief Comments on “Taking Business Seriously”

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This issue of the *International Journal of Business*, “Taking Business Seriously” presents an overview of issues relating to why businesses underperform, and suggests various ways to improve corporate performance along with optimism that “proper scientific evaluation” might overcome biases in current strategic management thinking. The following review of these issues and concepts come from a financial vantage point. From a finance perspective there is only one primary objective of an enterprise – namely, maximize the long-term wealth of the owners! In order to take business seriously we need to go back to the basics. The key is to recognize that the objective of all firms is to maximize long-term wealth of owners. This objective recognizes and incorporates all stakeholders, from employees, suppliers, and customers to social and environmental responsibilities, and last, but certainly not least, the owners of the firm (holders of common stock). Of course the objective is confounded by agency questions and costs, concern over whose wealth the Board of Directors [BOD] and management is maximizing, and are all stakeholders being treated fairly. From this vantage point, the articles contained herein are briefly reviewed and a summary presented.

Richard Franke in the introduction lists various domains, problems and opportunities relating to problems in strategic management and empirical tests thereof. He concludes that with improved empirical techniques it is possible to explain most of the variability in corporate performance, and if implemented properly strategic management could contribute positively to corporate performance.

John Grant cites and presents a list of various strategic management frameworks, anecdotal evidence, and research challenges. He further notes that strategic management faces a moving target, and, if strategists from different sectors collaborate, improved research and understanding are possible.

Bernard Bass presents a laundry list of anecdotal evidence regarding top management successes and failures. He recognizes the strategic importance the CEO and other senior executives play in a dynamic environment where many stakeholders need to be satisfied. While he notes agency theory, he does not include the assumption that owners (shareholders) control the BOD, nor the difference between profits and wealth maximization. In his article he says “... the CEO ... learns who are the most important stakeholders.” There should be nothing to learn. The BOD and the CEO should know that the most important stakeholders are the owners of the firm. The fact that something needs to be learned shows a weakness in current strategic management thinking. A possible way to reduce agency problems is to have the compensation of top managers configured as a base salary with bonuses based on financial performance. For example the maximum base salary of any manager should be \$2,000 per hour [given a normal work year of 2000 hours this translates to a \$4,000,000 annual salary, certainly

a livable wage for the vast majority of people]. The bonus would then be constructed to reward both short-term profitability and long term-wealth creation, with the emphasis on longer term aspects. Obviously ethical behavior should be expected along with fair treatment of all stakeholders.

Franke and Miller provide a critical review of investment-economic performance and find that more capital investment does not seem to contribute to higher national economic growth or higher corporate profitability. From a finance perspective this result is not surprising in light of efficient markets, and the recognition that “excess profits” are not low hanging fruit. Bigger is not better; instead more effective utilization of current resources, from capital to human resources, leads to better economic performance--which is exactly what Franke and Miller found to be the case. Efficient markets indicate that excess profits equal zero, especially over a larger group and in the long-term, because arbitrage and competition reduce/eliminate any excess profits. Therefore management needs to work smarter with what the corporation already has in order to achieve superior performance. As the authors conclude, a truly capitalistic focus might be more useful. For example, maximize the long-term wealth of the owners.

Gerald Barrett points out that many strategic management doctrines are “folk theories” and are scientifically unsupported. These folk theories with the help of the media have become dogma for corporations. Barrett correctly states that the use of classroom experiments or small samples without any replication, to influence or have relevance for business or the courtroom is junk science. He details that groupthink leads to poor decisions; confounded by the mistaken belief that strategic management innovations and doctrines are based on legitimate scientific research. He further indicates massive distortion in research results in order to match the writer’s opinion, or to be politically correct.

Armstrong and Green discuss competitor-oriented objectives and indicate that these objectives are harmful to firms. Their review of literature finds that this type of objective violates economic theory and leads to reduced profitability. They also state that academics support this objective. While this may be true for management and marketing academics, it is generally not true for finance academics. Basic corporate finance still teaches that the objective of the firm is to maximize shareholders wealth. In their conclusion, they correctly point out the enormous influence of Michael Porter and the tremendous harm to business students and corporations.

The last article, by Franke, Mento, Prumo, and Edlund, presents a systematic and empirical appraisal of General Electric over a half-century. While the analysis is sound, the authors almost appear to fall into the trap of distorted conclusions discussed by Barrett. They, almost begrudgingly, indicate that Jack Welch provided “an aura of managerial strength, with the ability to hold GE on a survival course to increase market value.” Being the chief steward of a firm that increased shareholder value from \$12 billion to \$500 billion over a twenty year period should be recognized as an outstanding performance in the creation of shareholder wealth. This does not imply that Welch was “the reason” for the results, nor should he become a management god to idolize. Instead many factors, including external ones, drove the results, which is what the authors found in their scientific analysis.

The following simplified example helps identify some of the challenges facing strategic management. In order to increase profits, and in turn the wealth of the owners,

a typical business faces three possible strategies: (1) increase sales, (2) decrease costs, or (3) increase price. The vast majority of managers following the current strategic thinking/doctrine of Porter and his disciples choose to increase sales since they believe market share and competitor orientation is primary. In fact, a likely avenue to increase sales would be to increase capital equipment and/or acquire another firm. Discounting to increase market share is another primary way to increase unit sales – GM and Ford are prime examples of market share competitive strategy and their financial condition is not unexpected. Another large group would cut costs, along the lines of Jack Welch at GE, from raw materials and production to the number of employees and employee benefits. Very few managers select option three, which is the one option most likely to increase the wealth of the owners. The increase in sales price would flow directly to earnings before taxes and then to the bottom line. Increasing sales price is the preferred strategic strategy and should benefit all stakeholders as profitability and wealth are increased. Graham Forster in his book, *The Power of Positive Profit*¹, shows that for a one percent increase in the sales price a typical firm would have to lose over ten percent of its sales to decrease the overall profitability of the firm or the wealth of the owners. It is difficult to imagine a ten percent decrease in a well promoted quality product or service given a one percent increase in price. Forster concludes that a balance of all three is recommended to sustain profit over the long-term, and that increasing price is the most powerful of the three strategies. A goal of being number one in the market by discounting is a strategy which often leads to bankruptcy.

In summary, it is necessary to have a system of checks and balances so management focuses on wealth maximization, while ensuring they do not lose their moral compass, and that all stakeholders in the firm are respected. The concept of competitiveness as a driving strategic management goal is analogous to the dot.com bubble belief that the number of hits or clicks on a web site was more indicative of firm/stock value than cash flow. Bubbles in the financial markets are corrected with a vengeance, and many times it takes years to recover from them. The same will most likely be true for business to recover from issues and “falsehoods” identified herein. Hopefully this issue of the *International Journal of Business* will lead strategic management back to a more rational finance/economic focus on profitability and wealth maximization. However, one should also recognize that sacred cows and false gods are difficult to attack.

¹ Graham Forster, 2006, *Power of Positive Profit*. John Wiley & Sons.