SCANDAL AFTER SCANDAL IS PUSHING THE CORPORATE COMMUNITY TO TAKE TOUGHER MEASURES. BUT IT'S NOT JUST A MATTER OF TIGHTER REGULATION, SAYS **PAT SCOTT** OF WOODBRIDGE PARTNERS.

WHERE DID WE GO WRONG?

When my co-author, Don Young, and I decided it might be fun to write a book[1], we thought it would be interesting to look for common factors in big corporate collapses. As research progressed, it became clear that the collapses themselves are a symptom of a larger system at work. Let us start by looking at the following examples. What do they have in common?

- Corporate crises such as the crash of Marconi and the Cable & Wireless difficulties;
- a pensions crisis and closure of defined benefit schemes, threatening to undermine the retirement of many in today's workforce;
- public loss of confidence in the financial services industry, following scandals on pensions, endowments and market-linked bonds;
- a lower 2000 UK spend on research and development (R&D), in terms of share of GDP, than in 1981;
- UK capital investment 30% to 50% per capita less than its competitors;
- loss of public confidence in 'people who run large companies' (according to a recent poll YouGov for the Daily Telegraph March 2003); and
- a depressing list of companies where the accounts have been misleading or just plain wrong.

UNFORTUNATE COINCIDENCES, OR IS THERE A LINK? Let us go back to basics for a moment. Company directors are responsible for developing their organisations to generate business in ways that benefit all stakeholders and the economy in general. This is what, according to research, managers of consistently successful companies do.

From time to time these companies will want to grow in ways that require outside capital, either in the form of equity or bonds. At the same time, individuals will seek to invest funds to enjoy financial security now and a decent standard of living when they can no longer work. Sometimes this will be through the medium of a company pension scheme. The financial markets exist to bring these investors and companies together.

Perfect market theory would suggest that this is a totally efficient mechanism; the best companies will attract the most, and cheapest, capital. However, as George Soros says in his book *The Crisis of Global Capitalism*, rather than behaving like a pendulum always seeking to return to equilibrium, markets have tended to act like a "wrecking ball, knocking over one economy after another". Soros contends that markets are inherently unstable, so imposing market discipline means imposing instability.

Since the Big Bang, we have seen a sea change in the way the City is managed, as described in Philip Augar's book *The Death of Gentlemanly Capitalism*. A good thing, we might say. There is no room for 'amateurism' in today's complex markets. However, as any treasurer knows, market players tend to focus on the instruments traded, rather than the underlying substance. League tables and short time frame reporting demands increase the pressure on investment managers to deliver performance quickly and consistently.

REACHING THE GOAL OF SUCCESS. On the other hand, growing a business takes time. The demands of products, markets, organisation, staffing, and all the other complexities that make up real life have to be managed towards the goal of business success. A turnaround strategy can take several years to show results. A fund manager under pressure to perform each month or quarter does not always have the time to wait. Neither does the chief executive. With an average tenure of four years and two months, and the need to be seen to perform if he or she is to get the next appointment, more rapid results are needed.

Where do these results come from? Transactions. Transactions are exciting, they generate market activity, share price benefits – in the short term at least, research by the David Hume Institute among others has demonstrated that most of the abnormal returns accrue to the target's shareholders – and lots of fees for advisers. The chief executive's reputation as a mover and shaker is enhanced. So, for the market players, transactions are good news all round.

Taken to the extreme, some chief executives undertake serial transactions, making one deal after another. At any one time, at least half of the FTSE 100 companies are undertaking or

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contemplating large transactions. “What is wrong with that?”, you might ask. Mergers and takeovers are good for business. They keep management on their toes. They drive cost efficiency. Companies competing in a global economy have to consolidate.

THERE ARE CONSIDERABLE DOWNSIDES HOWEVER. First, we do not do transactions very well. KPMG’s 1999 research showed that as few as 17% of acquisitions added value, with a further 30% being neutral and a terrifying 53% destroying value. Its 2002 research showed that full integration benefits are often neglected, sometimes because management’s attention has shifted to the next deal, leaving ‘little appetite to rake over unfinished business’. On top of that, according to the *Financial Times*, more than half the 1999/2000 deals were already being undone in 2003.

Second, with management’s attention on transactions, the underlying business is often neglected. As one of our interviewees said “everything just stopped” while his company attempted two mergers in succession. And, with all the money being spent on transactions, R&D and capital investment pay the price. We are not growing strong, long-term businesses, we are generating quick interest and share price movements. Over time this leads to a rundown of the business, which itself becomes a takeover target.

ALL THIS RESULTS FROM TWO SIGNIFICANT DISLOCATIONS. The chief executive, needing to perform for the markets, starts to do things to, rather than with, the organisation. As they are only going to be there for four years, it is probably not worth getting too close to the business. It is easier, and quicker, to get improvements by cost-cutting exercises, bringing in old colleagues and consultants to make them happen, rather than growing the business organically. Any growth that is needed can come from acquisitions.

Then there are the fund managers, investors in equities, whose actions have the most impact on the career of a chief executive. Under pressure to perform, investment decisions are made on expected share price movements, rather than specifics of the underlying business. Investors are no longer providing capital to businesses; they are looking for ‘returns’.

It gets worse. Investment managers are also dislocated from their clients, the real risk takers, on whose behalf they are investing in the first place. If they were not, we might not have seen some of the recent scandals, including misleading analyst reports, investment trust cross-holdings and out of hours trading.

HOW HAVE MATTERS COME TO THIS? We have not uncovered a conspiracy or anything so dramatic. There are undoubtedly individuals, in companies, investment funds and advising banks, who put their own gain before any other consideration. In the main, however, most of the players are genuinely doing their best inside an informal system that has somehow lost touch with what it was created for. We have lost sight of the basics, and the informal system, the machine that should drive the engine of industry and commerce smoothly, is racing out of control. The exponential growth of derivatives (described by Warren Buffett as “financial weapons of mass destruction”) reinforces the separation of market activity from underlying substance.

DOES THIS ALL MATTER? We believe so. We believe that the economy is an integral part of a society, and that the main goal of a society should be to strive to ensure the greatest well being of all its members. The performance of a society as a whole and each of its constituent parts, including its economic component, should therefore be judged by the degree to which it contributes to the overall well being of its members. If these dislocations result in less real investment in industry, in more people being disenchanted with companies and investment managers, and in a widening gap between ‘big bosses’ and their workforces, then we will all suffer.

Even if we accept that things need to change (and a great many people will not), then finding solutions will not be easy. We need to lengthen time scales, re-educate both professionals and lay people in the difference between investment (as practiced by such investors as Warren Buffet) and speculation, which is what most ‘investment’ behaviour more resembles. We need to differentiate between responsible investment and the practices that are more likely to be damaging.

The thrust for all this will not come from a self-regulated industry, nor will it result from single issue committees set up to provide sticking plasters for specific problems. Both the Financial Services Authority (addressing financial education of the population) and Tomorrows Company are doing some interesting work on these areas. However, real change will only happen when the regulatory environment encourages responsible investment behaviour and responsible management. And, for those pure market ideologists who groan “not more regulation”, I can quote no better than Adair Turner, in *Just Capital, the Liberal Economy*, who writes that deregulation has become a dogma rather than a tool with which to achieve desired ends, and that governments need to focus on the difficult things where we cannot rely on the motivation of private profit to achieve desirable ends.

WHAT ABOUT THE HUMBLE TREASURER? WHAT CAN THEY DO? If we act as pension trustees, we might think about how we appoint and target our investment fund managers. Do we just use league tables or do we try to understand their investment philosophy? Do we put pressure on them for short-term performance? Of course, we do not want to encourage slack performance, but perhaps we need to lengthen our time frame and base judgements on a set of wider issues. And, as senior members of management and senior players in the financial markets, perhaps we can add a voice of sanity. In the boardroom, and in the big banks, perhaps our voices can be heard. If you agree, it is over to you.

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[1] Having Their Cake, How the City and Big Bosses are Consuming UK Business *by Pat Scott and Don Young is to be published by Kogan Page on 29 January 2004.*