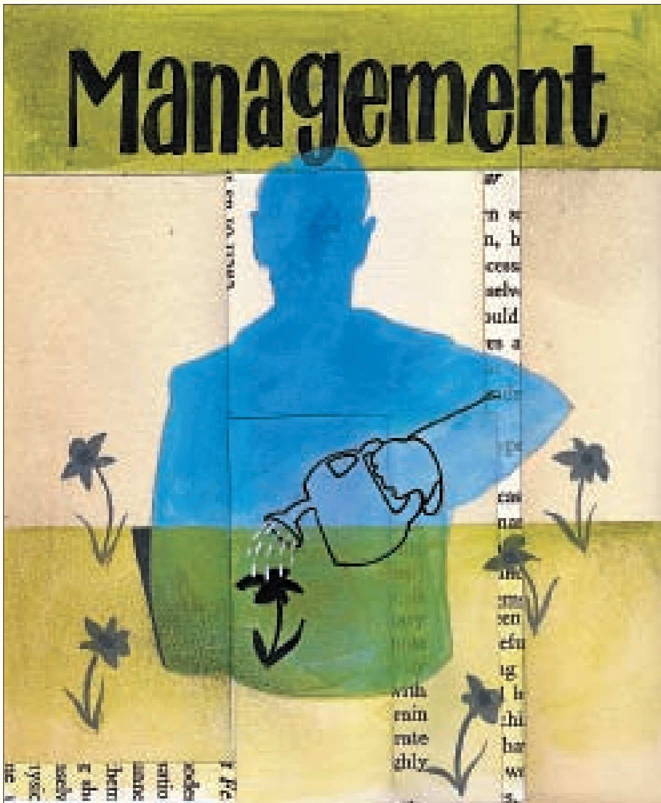


THE Good, THE Bad, AND Jack Welch

by David K. Hurst

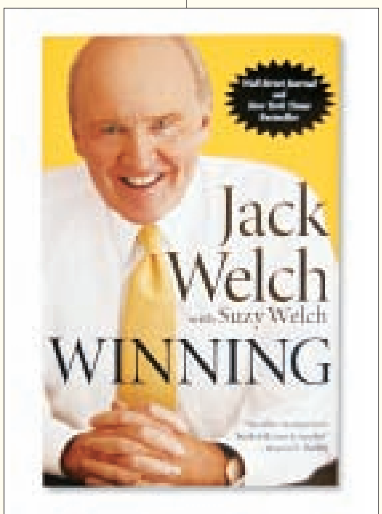
The late historian and former Librarian of Congress Daniel Boorstin once observed that planning for the future without a sense of the past is like trying to plant cut flowers. Dr. Boorstin's remark is especially applicable to the field of management, where the florists always seem to outnumber the gardeners. Many business academics regularly represent competencies (managerial abilities arrived at through on-the-ground experience and learning, which apply only to the particular context at hand) as strategies (context-free courses of action that can be implemented anywhere). Some consultants fall into the same trap, finding firms that are apparently doing well, identifying their "key success factors" and then promoting these to other firms so that they too can be like Dell, GE, Wal-Mart, or whoever else's corporate garden is currently in bloom. And managers themselves frequently arrange their financial reporting to exhibit "flowers of success" that later turn out to be rootless and unsustainable. In the worst cases, such as Enron, the blossoms turn out to be entirely artificial.

Similar charges could be leveled at those most ardent of flower arrangers: writers of books on management. Too often, their books depict managers as lone actors in generic landscapes, whose methods and techniques can be freely transferred from one corporate situation to another. Yet if we are to learn from the experience of others, surely we have to understand their thoughts and actions in the particular situations in which they found themselves. When it comes to human action of any kind, context matters.

Each of the five books reviewed in this essay underscores the importance of context in business, though in different ways and from very different perspectives. The first two, *Winning* (HarperBusiness, 2005), by Jack Welch with Suzy Welch, and *Will Your Next Mistake Be Fatal? Avoiding the Chain of Mistakes That Can Destroy Your Organization* (Wharton School Publishing, 2005), by Robert E. Mittelstaedt Jr., are written specifically for managers. The other three are aimed at more general audiences, but provide important lessons for business leaders by reviewing both the recent and distant history of financial scandals: *Conspiracy of Fools: A True Story* (Broadway Books, 2005), by Kurt Eichenwald; *Blood on the Street: The Sensational Inside Story of How Wall Street Analysts Duped a Generation of Investors* (Free Press, 2005), by Charles Gasparino; and *Ponzi's Scheme: The True Story of a Financial Legend* (Random House, 2005), by Mitchell Zuckoff.

You would expect that *Winning,* by Jack Welch, the retired celebrity chief executive officer of General Electric, and his wife, Suzy Welch, former editor (under the name Suzy Wetlaufer) of the *Harvard Business Review,* would surely illustrate the importance of context to management action. GE, after all, was one of the great laboratories of managerial thinking in the 20th century, and the authors set out to provide managers with guidelines to follow, rules to consider, assumptions to adopt, and mistakes to avoid.

Although *Winning* is well organized, clearly written, and worthwhile, it is disappointing in one major respect: its *lack* of concern for context. Mr. Welch freely acknowledges the importance of organizational culture (context writ large) by recounting, for example, the problems that GE faced when it acquired Kidder, Peabody (that firm's top three values, he says, were "my bonus, my bonus, my bonus"), but he seems reluctant to accept the importance of a business environment or culture to the key policies and processes of organizations. This reluctance is best seen in the discussion of the "20/70/10" people differentiation formula (in which the top performers are promoted, the majority in the middle are nurtured, and the bottom 10 percent are fired) for which both Mr. Welch and GE became famous. One problem with the formula is the validity of the numbers themselves: Even Bob Nardelli, Mr. Welch's former colleague and now CEO of Home Depot, has said, "There's nothing magic about 10 percent." (See "Winning Hearts and Minds at Home Depot," by Victoria Griffith, *s+b,* Spring 2005.) Then there is the statistical nonsense of applying the formula to small departments. More importantly, the authors do not appear to consider that the measurement and reward of individual performance works in some contexts but does not work in others. The examples in the book, drawn from the playground and professional baseball, just don't cut it as useful analogies to the business world. And surely the failure of the differentiation process in many organizations cannot be explained away by leadership teams "lacking in brains or integrity or both," as the authors maintain. Isn't it more likely that the 20/70/10 process works acceptably in GE largely because of the unusual context created by GE's culture?



Two key components of GE's culture discussed in *Winning* come to mind. The first is its budgeting process, wherein the functions of financial forecasting and performance management are clearly separated. Performance bonuses are not based on budgets; rather, they are calculated retrospectively against the performance of the same individuals in prior years and against the performance of competitors. Very few companies make this commonsense separation between the need for financial forecasting and the demands of performance management. Most practice more dysfunctional budgeting and performance-management processes, which all too often encourage otherwise smart people to do dumb things — or worse, to compromise their integrity.

The second crucial component of GE's culture is the genuine elevation of the human resources (HR) function to the equivalent of finance and marketing or an even higher function (this was one of Mr. Nardelli's first moves at Home Depot). Could any action be better calculated than this to underline the importance of "people development" in an organization, heighten the critical role of differentiation, and give the process the right "spin"? In many, if not most, corporations, HR is at the bottom of the functional totem pole, where it mocks all those pious statements about people being our "most important asset."

Winning has much to commend it, especially for young managers setting out on their careers. There are excellent sections on the role of leaders, straightforward strategy, and the handling of crises and mergers. If only there had been more emphasis on history and context, the reader might have learned a great deal more from this highly successful manager's experience. There is, for example, anecdotal evidence that even GE's star "alumni" often struggle on their first managerial assignments after they leave GE. If that is true, there are many possible explanations, but one leading candidate has to be that these alumni fail to appreciate how different the contexts of most firms are from that of GE.

Disastrous Situations

It is generally acknowledged that tough assignments and hardships are among the best developers of leadership skills, and that managers usually learn much more from mistakes and even failures than they do from successes. In *Will Your Next Mistake Be Fatal?* Robert E. Mittelstaedt Jr., dean of the W.P. Carey School of Business at Arizona State University (and former entrepreneur and submariner in the U.S. Navy), examines some of the more notorious business and physical calamities of recent times.

Professor Mittelstaedt suggests that there is a common sequence of failure:

1. An initial problem, often minor, that goes uncorrected

2. A subsequent problem that compounds the effect
3. An inept corrective effort
4. Disbelief at the accelerating situation
5. An attempt to remedy the situation while hiding the facts
6. Sudden recognition that the situation is out of control
7. The disaster scenario — with loss of life and/or financial resources

All these elements are intimately connected with the power of context to sway the perceptions and behaviors of the actors in a given situation. The Ford Explorer/Firestone tire debacle of 2000 is a perfect example of a complex situation with numerous actors in multiple contexts that produced a disastrous result. The first clues that there might be a problem with the tires on the Explorer sport utility vehicle came, as they often do in complex situations, from the periphery of the system — tire failures occurring in extremely hot countries like Saudi Arabia and Venezuela as early as 1997. Both Ford and Firestone discounted the significance of these results for the U.S. market, but by 1998 an analyst for the State Farm insurance company had already identified a pattern. It was not until 2000 that the media picked up on the problems and the issue mushroomed in the public's awareness. A complex set of causes, including numerous cost-driven design and specification issues at Ford and labor strife at one of Firestone's older manufacturing plants, had interacted to tip the system over the edge and create a disaster that damaged both companies severely.

Professor Mittelstaedt draws 38 insights from the incidents he studies, conveniently summarized at the end of the book. Some of these, such as "establish and enforce standard operating procedures" and "culture is powerful — what creates success may kill you," fall into the true-but-not-very-helpful category, and it is difficult to see how a manager could integrate them into his or her daily activities. Many of his points, however, are valuable, such as the suggestion that every organization conduct an "economic business visioning" (EBV) exercise. This demands an in-depth understanding of the present and historical context in which the firm finds itself. In EBV, the management team surfaces its often implicit assumptions about the business and examines which are valid and which are not. The exercise also gives managers a sense of what is possible and what might be very difficult in their industry and organizational contexts.

School of Scandal

The downfall of Enron is an enormous object lesson in the importance of context, but if we are to learn anything from its fate, we need to remember and understand what went wrong. Fortunately, we have financial journalist Kurt Eichenwald to help us. In *Conspiracy of Fools,* he reminds us that Enron *did* exist not so long ago, and shows us very clearly how its managers fooled so many people so comprehensively that they even fooled themselves.

***Conspiracy of Fools* reveals the incompetence of Enron's managers and their disdain for systems, disciplines, and accountability.**

Mr. Eichenwald, a writer for the *New York Times,* does a masterful job of weaving together the multiple characters and complicated deals that were Enron — and *Conspiracy of Fools* is my choice as the year's best management book. The rich and complex picture that emerges reveals that the company's collapse was rooted in America's muddy standards of accounting and reporting, and in the environment of corner-cutting that had been rampant for nearly a decade. Abetted by fee-hungry bankers, lawyers, and accountants; lax government regulation; and booming stock markets, a small group of smart but arrogant executives in effect created a Ponzi scheme so complex that neither they nor their advisors understood its true dynamic.

Mark-to-market accounting, when applied to long-term contracts, allowed Enron to report profits earned over the lives of such contracts immediately, but left the company exposed to market risk for the contracts' durations. The firm's efforts to mitigate these risks led to attempts to create complex hedges using special-purpose entities that did not appear on Enron's balance sheet.

Conspiracy of Fools shows that many of Enron's vaunted new ventures were simply bad businesses, whose poor results had been disguised for a while by bogus accounting. The sheer incompetence of many of the company's managers and their universal disdain for the nitty-gritty systems, disciplines, and accountability that underpin every successful organization are breathtaking. "Ultimately it was Enron's tragedy," writes Mr. Eichenwald, "to be filled with people smart enough to know how to maneuver around the rules, but not wise enough to understand why the rules had been written in the first place."

Charles Gasparino, a senior writer at *Newsweek,* in *Blood on the Street,* illuminates the larger context in which the Enron debacle took place — and in which managers at countless other companies made unwise and costly decisions during the boom of the late 1990s. His book is a catalog of the pride, envy, anger, sloth, avarice, gluttony, and lust that lie behind Wall Street's professional facade. He focuses on the actions of the major players: analysts Jack Grubman of Salomon Smith Barney, Henry Blodget (Merrill Lynch), and Mary Meeker (Morgan Stanley); Securities and Exchange Commission Chairman Arthur Levitt; Richard Grasso, chairman of the New York Stock Exchange; Citibank Chairman Sandy Weill; and New York Attorney General Eliot Spitzer.

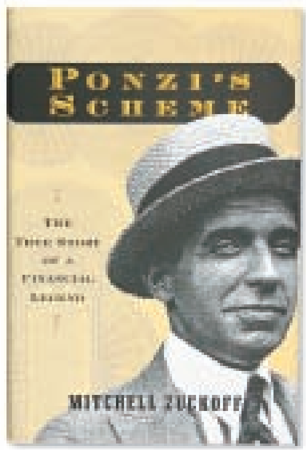
One has to have some sympathy for Wall Street's analysts and traders during the dot-com boom. For several years in the "New Economy," the financial laws of gravity were seemingly suspended — stocks went up and never came down. Within this context, it seemed folly to be wise: The reputation of investing legend Warren Buffet, with his quaint buy-and-hold strategy, suffered; the memories of the few people with personal experiences of the great booms and busts of the past were devalued. A diversified portfolio was for those who didn't "get it." Investment analysts did their best to rationalize the irrational and live with their consciences, but by the time the crash came, the stars were too committed to a never-ending boom to recant. Mary Meeker, the only one of them to retain her job, had always urged investor caution and, according to Mr. Gasparino, kept Morgan Stanley out of hundreds of marginal initial public offerings. Jack Grubman and Henry Blodget, on the other hand, became full-blown cheerleaders for deals, and indulged in a form of Orwellian doublethink, praising shaky startups on television and in the financial press, while denigrating them in private e-mails to their colleagues. They paid for their hypocrisy when the media that had built them up tore them down.

Perhaps the most interesting feature of the dot-com debacle that Mr. Gasparino examines is that it happened in plain view and at the pace of a slow-motion train wreck. The dearth of "sell" ratings on stocks and the stories of the "spinning" of IPO shares showed that the so-called Chinese Wall separating investment banking and stock brokerage had been crumbling for years, yet the regulators did very little to bolster it. *Blood on the Street* is scathing about the inadequacy of the role performed by Mr. Levitt, who headed the SEC from 1993 to 2001. No doubt Mr. Levitt was hamstrung by the pro-business Congress that was elected in 2000. But his failure to act prior to that probably owes more to the challenge of complex problems and the equivocal ways in which they unfold. As a complex problem emerges, there are many straws in the wind, but their import is usually unclear. Without outstanding leadership at several levels — regulatory, legislative, executive — it is usually only in hindsight, after the crisis, that it is possible to build an unassailable case for action.

History, of course, provides the highest level of context. In *Ponzi's Scheme,* Mitchell Zuckoff, a professor of journalism at Boston University, recounts the little-known tale of the king of all get-rich-quick schemers. It is an engagingly written book that both adds perspective to the recent past and, unfortunately, probably foretells the future as well. Before the Great Crash of 1929 and the formation of the Securities and Exchange Commission to regulate securities markets, the most famous "SEC" was Charles Ponzi's Securities Exchange Company. Like Enron, Ponzi's company had an arcane but superficially plausible business model: foreign exchange arbitrage in international reply coupons (negotiable instruments sold at the time by post offices in many countries, which allowed letter writers to send coupons to pay for the stamps on reply letters). After World War I, the official exchange rates for these coupons no longer reflected market rates, and profits could be made, at least in theory, by buying them with a cheap currency and redeeming them in a stronger one.

On paper, the scheme could be made to work, and there was nothing illegal about it. This later slowed down the investigators looking into the case, who often came from competing jurisdictions and faced other problems. As a result, the scheme grew from nothing to a full-blown financial crisis in less than eight months. The charming, affable Ponzi tried to make the arbitrage business work in practice (it never did), and he gave his early investors a 50 percent return on their investment in 45 days by paying them with money from new investors. This turned out to be easy: As testimonials from early investors became public, he was flooded with funds, pulling in more than $1 million a week as the Boston public became gripped by money madness.

Charles Ponzi remained irrepressibly optimistic as he twisted and turned to find legitimate, profitable businesses that would allow him to restore his fortunes and repay his creditors. When his business model was criticized by Clarence Barron, owner of Dow Jones & Company and doyen of the era's financial journalists, Ponzi replied that Mr. Barron just didn't have sufficient knowledge of foreign exchange to understand it. When a last-ditch attempt to sell his company to another group of shady investors failed, Charles Ponzi was doomed. Twenty thousand investors received 37.5 cents on the dollar in the largest and most complex bankruptcy that Massachusetts had ever seen. Ponzi himself served four years in a state prison and seven years in a federal penitentiary before being deported to Italy. He died penniless in Rio de Janeiro in 1949.



Ponzi's thoughts on ethics in business from his 1937 biography echo down the years: "The [American business] environment had made me rather callous on the subject of ethics.… Then, as now, nobody gave a rap for ethics. The almighty dollar was the only goal. And its possession placed a person beyond criticism for any breach of ethics incidental to the acquisition of it."

The Fundamental Error

In business, executives usually take personal credit for success and blame any mistakes or failures on circumstances beyond their control. Cases of outright fraud such as those at Enron, WorldCom, and Adelphia, and the recurrent abuses of the public trust on Wall Street, are usually ascribed to the actions of a few bad apples rather than problems with either the barrels that store them or the trees that grew them. The tendency to attribute outcomes to personal predispositions rather than situational factors is so widespread that in social psychology the phenomenon has been named the "fundamental attribution error." In American management, where the belief in the powers of individual effort and of the entrepreneurial spirit are articles of faith rather than hypotheses for testing, the fundamental attribution error seems to be endemic. At some level of abstraction, this is as it should be: Fatalistic cultures that do not believe in the ability of individuals to control their own lives typically struggle to develop vibrant economies.

At finer scales of analysis, however, the power of context cannot be dismissed so lightly. There are numerous instances of industries in which companies and managers are clearly constrained — the Big Three auto companies, integrated steel mills, and the major airlines come to mind immediately. In such firms and many others like them, there is little talk of activist, optimistic strategy making; managers are bound by the laws of the situations in which they find themselves. Lost in a maze of constraints, at times they appear to be waging a zero-sum game. It's a battle in which combatants make use of every stratagem available to them, from government support to the bankruptcy laws, to shed obligations incurred during better times and to avoid having their bones picked clean by the vulture capitalists circling overhead.

What executives in these industries, as well as others in less extreme competitive situations, need above all is to understand the contexts in which they operate. The most interesting new theories in management are those that are rooted in contextual analysis (Clayton M. Christensen's "Innovators" series, for instance, or, as a more recent example, "Format Invasions: Surviving Business's Least Understood Competitive Upheavals," by Bertrand Shelton, Thomas Hansson, and Nicholas Hodson, *s+b,* Fall 2005). The most interesting business books of the future will be those that keep in mind the unvarnished reality: Sound management advice needs to be based on real business situations. ✚

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