Will the REAL portfolio manager please step forward?
While our campus dealt with admissions issues this past summer, we never lost sight of our mission and our priority – the students, their education, and our collective responsibility to lead a world-class university to preeminence. When 4,000 bright, energized students reappeared on our College’s doorstep in late August, the inspiring business of teaching business consumed us once again. We’re proud of every student enrolled in the College of Business; each has the potential to meaningfully impact society and the world of business through their professions.

This issue of Perspectives addresses that world – from the debate over regulatory reform and tax policy to the economic realities facing workers as they plan for retirement. Throughout these pages, renowned academicians and industry experts provide insights on current marketplace conditions and reflect on what the future holds for the capitalist, the regulator, the consumer, the manager, and the worker.

These same academicians also focus each day on what the future holds for our students by sharing their expertise in the classroom. One example of that commitment is highlighted in our cover story on portfolio management and the students in Finance 419. This class and the many other real-world opportunities like it across the College prepare our students for their next steps as business professionals. Alumni assist us as well by sharing their experiences, serving as mentors, and providing internships for students.

We’re committed to ensuring that each student’s experience is a positive and successful one, and we appreciate the individual and corporate partnerships that help us deliver on that commitment every day.

Sincerely,

Larry DeBrock
Dean
SERIOUS BUSINESS
By Alice Shepherd

Finance 419 turns students into portfolio managers. Class alumni share some of the strategies they learned to minimize risk and maximize return.

GIVING UP THE GOLD WATCH
By Cathy Lockman

The current economic climate is causing more workers to delay retirement. What other factors weigh into this decision and what does the future look like for retirees?

THE BIG FIX
By Doug McInnis

When the economy has a meltdown, regulatory reform is often explored as a way to fix the financial system. What have we learned from past reform measures that can help guide current proposals?

FOOD FOR THOUGHT
By Cathy Lockman

College researchers examine what information and experiences make consumers more receptive to reevaluating brand messages.

STRATEGIC ALLIANCES
By Doug McInnis

For companies considering strategic alliances as a way to build profitable and successful businesses, communication and defined goals are key.

TO TAX OR NOT TO TAX
By Alice Shepherd

Tax policy objectives include raising revenue and driving desired behavior. Achieving both goals is a delicate and often difficult balancing act.
As a result of recent market volatility and the bear market of the early years of the decade, the S&P 500 is up only about 15 percent since 1999. Baby Boomers whose 401(k)s have turned into “201(k)s” are postponing retirement, and investors with now meager portfolios are reexamining their strategies. Is the stock market really a good place to build a nest egg, and if so, what are the keys to minimizing risk while maximizing return?

Students in Finance 419, the Real Client Managed Portfolio course, are learning the answers to those questions. In 1999, a real client’s portfolio was assembled by the first group of students, which has since been modified by each new class. Its value has increased by about 36 percent over the last decade – more than double the S&P 500. Finance 419 instructor, Kevin Waspi, CFA, and two former students share ten tips for successful portfolio management.
Ten tips for successful portfolio management

1. Be Conservative

“I stress basic fundamental analysis and encourage students to be conservative,” says Waspi, who holds B.S. and M.S. degrees in finance from Illinois and has 30 years of securities industry experience. “That might mean we miss opportunities. For instance, we never owned Google, whose stock price soared before profits did.”

Ben Hier, an equity research associate at Raymond James and a 2008 graduate in finance, agrees that sticking to the fundamentals is crucial. “The recent financial crisis has demonstrated that risk has to be managed appropriately. In Finance 419, we learned how to be diligent, prudent, and conservative in dealing with a real client’s money.”

2. Know Your Goals

“One of the learning objectives of the course is understanding the client’s goals in order to develop an appropriate investment policy,” says Hier. “That’s an essential starting point in portfolio management.”

Chris Ehley, an analyst with Busey Wealth Management and a 2007 graduate in finance and economics, agrees. “While our work in other classes affected only our grade, the decisions we made in this class had real consequences on someone’s real money,” he says. “This experience carried with me. Whenever I make a decision on a stock, I’m mindful of my clients’ goals.”

3. The Numbers Are Not the Story

“My toughest task with new students is to get them to understand that the numbers are not the story; the numbers support the story,” says Waspi. “You can’t identify a company’s strengths and weaknesses unless you thoroughly understand its business. If you cannot explain it well enough to make other students understand it, then you don’t really know the company. A concomitant is that if you can’t understand something because it’s too complex, then you have no basis to make a decision. Sometimes companies purposely make their accounting complex, and that’s a red flag.”

Ehley recalls his team becoming skeptical about AIG when management seemed to be saying one thing while the company was doing another. “When we tried to dig into the financials, they were a black box,” he says. “We sold our clients’ holdings just in the nick of time.”

“Financial accounting is not an exact science,” says Hier. “It’s often just the best estimates of management, accountants, and auditors. Sometimes the numbers don’t tell the whole story. You have to stand back and take a broader view.”

Similarly, if the motivation for an action is predicated on tax law, it’s already a bad path, says Waspi. “Taxes are an exogenous element, and if we base our decisions on them, we walk away from investment fundamentals,” he explains.

“We have to be cognizant of taxes, but we don’t invest in a company just because it’s headquartered in Bermuda and tax-advantaged.”

In Finance 419, Hier remembers learning how to identify accounting irregularities, as when companies restate or delay their filings. A prior group of students had purchased a stock in a company whose late filings raised a red flag for him and fellow students when they reviewed the portfolio. “We made the decision to sell the stock when it traded at about $23; now it trades at around $2,” he says.

“Only invest in companies that are fundamentally sound and benefiting from current economic trends,” recommends Ehley. “Accounting tricks may temporarily boost the bottom line, but if people aren’t buying the company’s products, it won’t succeed in the long run.”

4. Be Realistic and Manage Your Risk

“The class taught me how to set realistic expectations for public companies,” says Hier. “No business can be expected to grow 25 to 30 percent year after year. We created financial models and tested different future scenarios.”

Ehley’s typical client is retired and interested in income rather than growth stocks. “Many investment products offer outstanding yields, whether it be annuities or high-yield bonds,” he says. But he has learned to be cautious about the fine print on annuities and the risk that usually comes with higher yields. “Clients who are safely invested in FDIC-insured certificates of deposit often inquire about options for higher returns,” he says. “It’s our job to identify investments for them that bring the greatest reward with the least amount of risk.”

Waspi cautions his students: “A good rule of thumb is that if it sounds too good to be true, it probably isn’t true.”

5. Dig Deeper

What applies to getting an A in Finance 419 also applies to success as a portfolio manager. “If students are enthusiastic, inquisitive, and not afraid to work hard, then they have three of the necessary ingredients to be securities analysts,” says Waspi. “They have to ask why and be willing to dig until they find a satisfactory answer.”

So how does one dig deeper? “Get to know the individual companies really well,” recommends Hier. “Thoroughly understand the financial statements and how each company operates.”

Ehley stresses reading the footnotes. “Excessive footnotes can be a red flag that a company is trying to hide something,” he cautions. “They’re legally obligated to disclose certain information, but they may put it in footnotes which people often don’t read. It pays to maintain a skeptical attitude.”

Hier suggests creating your own projections “by starting with a general economic outlook and then researching a sector and a peer group, also taking into...”
account the general economic outlook and current events. We researched a company in class whose success depended on Baby Boomers selling their homes and moving into senior living facilities. Our analysis did not support that trend based upon our outlook for the housing market at the time.

6. Don’t Rely on Past Data

Ehley recalls how on the second day of the class, Waspì drew a hockey stick on the board and said, “This is exactly what I don’t want you to do.” Explains Ehley: “He meant that some analysts extrapolate one year’s worth of data out indefinitely. If a company has grown 20 percent year over year for the last couple of years, they assume it’s going to continue expanding at that rate for the next 30 years. In other words, don’t rely on past data. Starbucks, for example, could not sustain its meteoric growth when the economy forced people to tighten their belts.”

The class also learned to rely on their own research rather than on other analysts’ opinions. “If we liked a stock and we could persuade the class that it was a good investment, that was all we needed,” says Ehley. “Mainstream analysts have no special advantage over anyone else.”

7. Don’t Be Afraid of Missing the Boat

Waspì believes in the wisdom of not jumping on bandwagons. “If all your colleagues are going in one direction and you’re not, you’re probably wise,” he says. It’s a message that can be difficult for clients to grasp. “When clients are ready to jump in or jump out of the market, it’s crucial to remind them that investing is about the long term, not the day-to-day fluctuations,” says Ehley. “Sticking to your guns in investing is one of the most difficult things to learn. Sometimes the market is telling you you’re wrong right now, but in the long run you can end up being right.”

8. Be a Good Listener

The class taught students to listen to the client as well as to each other. “Everybody in the course had their own take, and it was valuable to hear all the different opinions on the issues we discussed,” says Hjer. “Listening is also an essential skill in the workplace. Other people’s views are important to your analysis and understanding of the big picture.”

9. Take the Sleep Test

“A diversified portfolio that includes stocks, bonds, and cash may not be very exciting because your bonds will hold you back when the stock market soars,” says Ehley. “But diversification also protects you on the downside. If you can’t sleep at night because of what your money is doing, then you need to make changes to your portfolio. The goal of investing is not necessarily to make the most money, but to obtain peace of mind and a sound future.”

10. Know What Matters

Waspì, who won the 2009 award of excellence for undergraduate teaching, agrees. “The business of portfolio management is much more than just a rate of return,” he says. “If you don’t keep the individual at the focal point of a career in the financial markets, then it’s only a matter of time before you lose sight of what’s important.”

~ Alice Shepherd

“FOR THE CLIENT, IT’S NOT SO MUCH ABOUT THE RETURN, ALTHOUGH THE STUDENTS HAVE DONE A GOOD JOB WITH THAT. IT’S ABOUT PROVIDING THE UNIVERSITY WITH AN OPPORTUNITY TO ENHANCE THE ACADEMIC PURSUITS OF ITS STUDENTS THROUGH REAL-WORLD EXPERIENCE. IT’S A UNIQUE WAY FOR ALUMNI AND OTHERS TO CONTRIBUTE TO THE UNIVERSITY, ITS MISSION, AND ITS FUTURE.”

~ SHARON ALLEN
A Seat at the Table

Allen, a 1994 finance graduate, established her business in 2004, with the goal of focusing on the relationship and the client, something she felt was taking a back seat to the industry’s increased focus on financial products. She takes that same approach in her work with the Finance 419 class.

“The interaction I have with the class is very relational,” she says. “Each semester we have a conversation about the client’s financial life and goals. I’m not there to provide information on financial products but rather to bring context to the class regarding the client’s overall financial picture and to be a safeguard for the client. Students have the opportunity to ask lots of questions, much like they would if they were sitting across the table from a client. That kind of real-world experience is not only unique but extremely valuable for students.”

According to Allen, the course also offers a valuable opportunity to alumni or others interested in supporting the University. “For the client, it’s not so much about the return, although the students have done a good job with that,” she says. “It’s about providing the University with an opportunity to enhance the academic pursuits of its students through real-world experience. It’s a unique way for alumni and others to contribute to the University, its mission, and its future.”

Waspi agrees and invites others to consider participating as clients in Finance 419. Alumni who are interested in allowing a portion of their wealth to be managed by students can contact him for more information. “It would give alumni an opportunity to stay connected to their alma mater and new generations of students,” he says.

– Cathy Lockman
– Alice Shepherd

Not Your Ordinary Classroom

Only 25 students are selected to participate in the real-world experience of Finance 419 each semester. Because of the sensitive nature of managing a real portfolio, there is a careful screening process. Only students committed to taking the Chartered Financial Analyst exam and becoming securities analysts or portfolio managers are enrolled. Students can take this capstone course up to three times.

“The course is unlike any other college course,” says Waspi. “It’s more like going to work. Students meet with the client, discuss their goals, and develop an investment strategy. After analyzing companies in small groups, they present their recommendations to the class. To protect the University, we manage the portfolio as a subcontractor to the client’s financial advisor, Sharon Allen of Sterling Wealth Management, who has been instrumental in making the class a success.”
Finance 419 isn’t the only example of the College’s commitment to helping students bridge the gap between what they learn in the classroom and what they can expect in the real world.

One of the first projects undertaken by the College’s Center for Professional Responsibility in Business and Society is an initiative to give accounting students a taste of what auditor independence is really all about. The Auditor Independence Education Materials (AIEEM) project, a collaboration among the Center, the Department of Accountancy, and Deloitte, includes a video, case studies, and an in-class laboratory market game that simulates real-world situations.

According to Mark Peecher, professor of accountancy and one of the developers of the AIEEM curriculum, it’s all about preparing students for what they’ll actually face as an auditor.

“Many of the young professionals learn about independence issues in the classroom in ways that make it difficult for them to envision how independence risks arise in their everyday work environment,” he says. “They have read that auditors should be independent, that society values independent auditors, and they have learned a set of rules about what auditors can and can’t do and still be considered independent. Still, students may not know what to do when a conflict comes up in real life, and additionally, they may not even recognize a conflict has arisen. We want to make them sensitive to these issues. The project is an attempt to link independence concepts and rules to the day when they are faced with real-life situations.”

Mark Chain, Deloitte partner and co-author of the education materials, agrees that providing the link is essential. “Independence is the cornerstone of the public accounting profession,” he says. “Understanding the concept of independence, and a public accounting professional’s responsibilities for maintaining independence, are key components of a student’s foundation for an accounting and business career,” he says. “Deloitte is committed to supporting the academic community in developing relevant curricula as they prepare our future professionals.”

Just what are some of the issues these future professionals will face? One obvious one is that auditors can’t hold stocks in companies they audit. But is it a conflict if your spouse owns that stock? How about if your spouse works for a company that has a partnership with your client or one that is a competitor? “An auditor must always worry not only about conflict of interest but also the appearance of conflict,” Peecher says. “An auditor must always worry not only about conflict of interest but also the appearance of conflict.”

And it’s not just University of Illinois students that the Center, the Department, and Deloitte are trying to reach through these efforts. AIEEM is available to any faculty member at any institution in the world to use as a teaching tool. In fact, to date, at least 149 different auditing instructors from 136 different higher education institutions already have accessed the materials for use in their curriculum. Gretchen Winter, executive director of the Center, says AIEEM is a natural fit with the mission of the Center. “The Center is committed to being a leader in establishing programs like this that promote professional responsibility and sharing those programs with others so that it benefits the accounting profession as a whole.”

For more information on AIEEM, visit the Center’s website at http://www.business.illinois.edu/responsibility/aiem//

– Cathy Lockman
When do you envision getting that gold watch and starting your retirement? If you’re like a growing number of workers, that date is a bit farther away than you might have thought just a year ago – especially if you’re a Baby Boomer. The current recession, the sharp decline in housing prices, the rising prices of food, gas, and other necessities, and the significant losses in the stock market have created a perfect storm – leaving many older workers with a much smaller umbrella of financial protection, or maybe none at all. And that’s forced many to wait out the storm by staying in the job market.

In fact, recent surveys conducted by the Pew Research Center found that four of every ten adults ages 62 and over who are still working are doing so because of the recession and 63 percent of workers ages 50 to 61 say they expect they may have to delay their retirement date because of current economic conditions. But the recession may be only partly responsible for this trend. According to U.S. Census Bureau data, the number of older adults remaining in the workforce has been slowly rising since the mid-1980s.

From Pensions to 401(k)s

So what are some of the other factors that might impact this trend? One culprit could be the decline in the number of companies offering defined benefit pension plans, which are basically a promise by a company, backed by federal insurance, to pay a specified monthly benefit to each employee at retirement. In 1980, for instance, there were nearly 250,000 companies offering such plans. Today, there are less than 38,000.
According to Jeffrey Brown, the William G. Karnes Professor of Finance and Director of the Center for Business and Public Policy, some of the smaller plans, covering fewer employees, were the first to disappear. “The bigger plans, which have a higher number of participants, are still hanging on,” he says. “But by any measure, there has been a tremendous and dramatic shift.”

Brown explains that companies started offering pension plans during World War II, when wage and price controls were in effect, as a way to compete for workers. The numbers of such plans grew as manufacturing and other industries began expanding their workforce in the 1940s through the 1960s. Then in 1963 the U.S. automaker Studebaker declared bankruptcy, leaving its retired employees with only about 15 cents on the dollar of their promised pension benefits. That’s when Congress began looking at how best to protect retirees in the wake of a company’s collapse. Their solution was the Employee Retirement Income Security Act (ERISA), which established the Pension Benefit Guaranty Corporation (PBGC). Since the passage of ERISA in 1974, companies have been required to fund their pensions at certain levels and pay premiums to the PBGC as insurance.

“The legislation was meant to be a guarantee for retirees, but it ended up increasing the complexity of the funding obligations as well as the costs and the risks,” Brown says. “It was an admirable policy goal, but the program wasn’t designed well.” At about the same time, employers began exploring the 401(k) provision of the tax code.

“It was a small provision of the tax code that corporate America drove a semi through,” says Brown. “Employers viewed it as an attractive way to offer their employees a retirement savings vehicle without taking on the risk and costs associated with pensions, and employees liked the portability and control over their money. So it was natural that employers, especially small businesses, began offering 401(k)s rather than pensions.”

The problem, says Brown, is that 401(k) plans are a way to save, not a way to guarantee retirement income. So though pensions offer better protection than 401(k) plans, most believe their days are numbered. “The genie is already out of the bottle,” says Richard Kaplan, the Peer and Sarah Pedersen Professor of Law at the University of Illinois and an expert on elder law and tax policy. “Employers do not need defined benefit plans to compete for workers, so they don’t see any reason to take on such a costly and cumbersome obligation.”

But just what does that employer calculation do to an employee’s own retirement calculations? “With a 401(k), there is no insurance, no promise of growth, no promise that what you contribute will be there when you retire,” says Kaplan. “Certainly, we’ve seen that with the recession and falling 401(k) values. In the current economic situation, there is no guarantee that employers who have made matching contributions to 401(k) plans will continue to do so. These plans were intended to be a supplement to defined benefit plans, not a substitute.”

Risky Business

If two legs of the three-legged retirement stool are too short and the third leg, Social Security, is shaky, it’s no wonder workers are looking at delaying their retirement. Kaplan worries that “there is precious little retirement security in the United States.” At this point, he says, Social Security is the most reliable...
though there are fewer companies offering defined benefit pension plans today, there are still over 44 million people in the private sector who will rely on them for their retirement. In 1974, the Pension Benefit Guaranty Corporation (PBGC) was established as a way to ensure that retirees receive their promised pension benefits. Companies are required to pay premiums to the PBGC and, in return, receive a form of insurance. In the event that the company cannot meet its obligations to the retirees, the PBGC acquires the company's pension plan assets and pays the required benefits from a combination of the assets and insurance premiums paid.

In 1974 with hundreds of thousands of companies paying into the system, it seemed like a workable plan. However, according to Jeffrey Brown, professor of finance, it was neither a well-designed nor a well-executed program. "The rules established to force companies to adequately fund their pensions have been inadequate," he says. "And premiums have never really been set at adequate levels or properly risk-adjusted." That combined with the declining number of companies offering pension plans and the PBGC's investment in stocks and real estate at a time when those markets declined precipitously, leaves the PBGC in a perilous position.

"In the future, it's very likely that the PBGC will be looking for a bailout," says Brown. "Even though there is no explicit taxpayer backing of the PBGC, such a bailout would come as no surprise since hundreds of billions of taxpayer dollars have already been handed out to financial services companies, automakers, and others in the past year." Brown believes it's unlikely that Congress will let the PBGC default on paying pensioners, but the result he says "will generate enormous taxpayer liabilities in the next decade, perhaps exceeding $100 billion."

...
some argue that the premium costs of long-term care make such policies a bad investment, Brown disagrees. “Insurance products are not investments,” he says, “they are a way of managing risk. If you have wealth to protect, it’s vital that you manage your risk, and if you don’t want all of your money to go to nursing home care then insurance can be the best way to ensure that doesn’t happen.”

Although Kaplan cites some very serious problems with the long-term care products currently on the market, including potential enormous rate increases after a policy has been issued as well as concerns about the financial viability and downgraded credit ratings of some carriers, he does believe that managing this risk is central to retirement security. “The biggest exposure that people have is long-term care, and most people don’t want to think about it or imagine themselves in that state of disability,” he says. “But the reality is that your entire life savings could be wiped out paying those bills, so you need to have a plan, whether it’s saving for this specific exposure, exploring affordable insurance policies, or talking with relatives about care options within the family.” Kaplan believes this is so critical for everyone that the government should consider adding chronic nursing home care as a component of Medicare, although, he says, “that’s extremely unlikely any time soon because Medicare has so many problems of its own already.”

Who Will Foot the Bill?

So just what will workers be able to expect from their employers in terms of retirement assistance in the future? Kaplan is concerned that it won’t be much. “It seems that employers are washing their hands of helping their employees to the extent that they possibly can,” he says.

Brown, on the other hand, sees employers continuing to play an important role by offering a hybridized form of retirement assistance that includes the elements of both defined benefit plans and 401(k) plans. But he suggests that it’s unlikely that employers will take on any of the funding risk for such plans, leaving the door open for the financial services industry to play a role as well.

“To be successful, any plan will need to have risk management as a central goal,” he says. “These new plans should focus on retirement income, like defined benefit plans do, while retaining the flexibility of decision making that is a component of 401(k) plans.”

Brown envisions a scenario that would include annuities as an investment option, something that is unavailable in current 401(k) plans. And he thinks it’s likely that employees would be automatically enrolled in plans but would have the opportunity to decide whether they would manage their own investments or leave that task to a retirement services provider or financial advisor.

But no matter what direction employers take, maybe the best retirement plan is not to retire at all. “I would like to see us move to a world where people stay engaged in the workforce even longer,” says Brown. “Obviously, it’s better for people’s financial security, but it also is good for the economy because as people exit the workforce, they go from being producers and savers to drawing down both their own assets and the government’s resources.”

— Cathy Lockman
When times are flush, Congress isn’t as inclined to impose new regulations on business. However, when the financial system hits the skids, as it did after the Great Crash of 1929, tough new laws and a heavier hand from federal regulators are often seen as the way to recharge the system.

So it isn’t surprising that Congress is once again talking regulation, after back-to-back stock market dives, chaos in the financial sector, and a meltdown in home prices.

But there is also continuing debate whether regulation is worse than the diseases it is designed to cure. “There are pros and cons of regulation,” says Ira Solomon, professor and R.C. Evans Chair of Accountancy. “The pure theorists believe that, in general, regulation creates distortions in the financial system. On the other side of the coin, there need to be rules of the game or you have chaos and anarchy. So there needs to be a happy medium.”

In addition, some experts think financial regulation is often a dollar short and a day late. “You put a rule in place, and people will figure out a way around the rule,” says Professor Charles Kahn, the Fred S. Bailey Memorial Chair of Finance. “You put another rule in place, and they figure out a way around it. That’s been going on forever. The financial system is creative, and the only way to stop that is to kill the goose that laid the golden egg. If you make the rules so restrictive so as to exclude
all problems, you’ve also excluded all innovation and creativity, and the financial markets will not be doing what you want them to."

In fact, that innovation is at work even as the fallout from other “creative” financial products continues. BusinessWeek recently reported that the nation’s largest banks have begun to roll out risky new financial products and services, including corporate credit lines tied to complex and volatile derivatives and payday loan programs for consumers short on cash. Time will tell whether the new ideas are good ones or are simply another wave of time bombs.

Learning from Mistakes

Laws aren’t the only things that help keep financial system excesses in check. The system is regulated to some degree by the marketplace. Consumers once burned are twice shy. For instance, there isn’t likely to be much of a market for subprime mortgage-backed securities, which were one of the causes of our current problems. So the kind of mistakes that have led to financial crises are usually not repeated – at least in the short term.

“We have periods in which people seem to have learned from their mistakes,” says George Pennacchi, professor of finance. For instance, the years after the Crash of 1929 and the Great Depression were marked by conservatism among the investing public. “But there’s always a new generation of investors who haven’t lived through a crisis,” continues Pennacchi. “So we may repeat some mistakes.”

One mistake that has been repeated within this decade is the use of off-balance sheet items. These were central to the Enron scandal and also central to the current debacle in mortgage-backed securities, Solomon says.

Crisis Equals Caution

One way to see how financial regulation evolves is to look at the years since 1900. History shows that new regulations tend to follow financial upheaval. For instance, the first decade of the 20th century was marked by scandals over the conduct of huge monopolies in oil, meat packing, and other sectors. The monopolies attracted the attention of “muckraking” writers such as Ida Tarbell, author of The History of the Standard Oil Company, and Upton Sinclair, whose famed novel, The Jungle, focused on meatpacking. Their revelations helped spur tougher antitrust enforcement, the court-ordered breakup of John D. Rockefeller’s Standard Oil, and the passage of the Clayton Antitrust Act (1914).

The decade was also marked by the financial panic of 1907, which began when two brokerage firms failed, spurring a six-week run on banks in October and November. The crisis abated when financier J.P. Morgan stepped in and organized a private effort to stabilize the banking system. By 1913, Congress had determined that something more official and permanent was needed to maintain stability in the banking sector, and it passed The Federal Reserve Act of 1913, which created the Federal Reserve Bank.

The Crash of 1929 and its aftermath produced the greatest spate of new financial laws and regulations in the nation’s history. These included the Securities Act of 1933 and the Securities Exchange Act of 1934 and the formation of the Federal Deposit Insurance Corporation.

After the wave of accounting scandals in 2001 and 2002, which included the collapse of Enron, Congress passed the Sarbanes-Oxley Act, which covered auditing and financial reporting practices and numerous other areas.
In Good Times and In Bad

While crisis often spurs regulation, efforts to reform the system may ease when times are good. “By the turn of the 21st century, the Depression-era cluster of restrictions on commercial banks had been substantially loosened,” Daniel K. Tarullo, a governor of the Federal Reserve Bank, remarked in a recent speech. The Depression-era restrictions had limited commercial banks to traditional lending activities. According to Tarullo, this was “intended to help insulate banks from risks that could be transmitted from securities and other non-banking activities.” However, administrative changes — and later the Gramm-Leach-Bliley Act of 1999 — eased these restrictions, allowing more extensive affiliations between traditional banks and investment banks, broker-dealers, and merchant banks, Tarullo says. Such loosening may have contributed to the recent banking crisis.

Pennacchi explains that allowing commercial banks to enter non-traditional activities creates problems. One relates to federal deposit insurance, which is provided at subsidized rates. “From 1996 to 2006, over 90 percent of all banks paid nothing for FDIC insurance,” he says. “And this cheap source of government-backed funding created an incentive for banks to aggressively expand into new, more risky activities.” Another worry is that by opening the door to new activities, banks will become larger and more complex, so that policymakers view them as “Too Big to Fail.” There is now a growing realization,

(continued on page 15)
Taking Aim on the Problem

**DID SARBAanes-oxLeY MISS THE MARK?**

Following the demise of WorldCom in 2002, Congress passed the wide-ranging Sarbanes-Oxley Act to fix the problem. But as sometimes happens with regulation, an attempt to solve one set of issues created a few problems of its own.

Ira Solomon, professor and head of the Department of Accountancy, points to Section 404 of the Act as an example of a regulation that not only doesn’t work but costs money and creates a new problem.

Publicly traded companies are required to give investors reliable financial statements through annual reports and filings with the Securities and Exchange Commission. To ensure that this happens, companies are supposed to maintain a system of internal controls over their financial accounting systems. Section 404 of the Act requires companies and their outside auditors to certify that these internal controls are reliable and effective.

Unfortunately, Section 404 doesn’t ensure that investors will get all the information they really need. There are two problems. One is that the annual reports and SEC filings include certain information but leave other information out. The second is that those reports and filings rely on estimates that may not prove accurate over the long haul. “The focus is too narrow,” says Solomon. “It’s possible for a company’s controls of its financial reporting to suggest that a company is healthy and profitable when it is neither. It’s like trying to watch a baseball game through a hole in the fence. Nobody told accountants and auditors that they couldn’t acquire a ticket and watch the full game as it is being played. But as a practical matter, Section 404 told them to look through the hole in the fence rather than to purchase a ticket and sit in the stadium.”

**Broad Problem, Narrow Focus**

The missing information can be critical, as Solomon and his colleague Mark Pecher, also an accountancy professor, wrote in a 2004 column for *The Wall Street Journal*. “The narrowness of 404 controls is evident when one reads complaints in major lawsuits against public companies and their auditors. Therein, one often finds allegations that management’s business controls, i.e. their dashboards of key performance indicators, had signaled dangerous changes in their operations. But management did not disclose these warning lights: a number of key stores were about to close, a major drug was about to be excluded from Medicaid formularies, major customers had just walked away, and so on.”

The kind of narrow focus found in Section 404 is a potential regulatory problem that can have far-reaching and unintended consequences. “The fact that so many investors lost money while relying on company reports that were supposedly enhanced by Sarbanes-Oxley has damaged the reputation of the U.S. financial system around the globe,” Solomon says. “Not only that, but billions of dollars were spent complying with Sarbanes-Oxley, and the next thing you know, you’ve got a bunch of corporations on the brink and in need of a bailout.”

— Doug McInnis

### History Repeats Itself: The Tie Between CRISIS and REGULATION

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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<tr>
<td>1904</td>
<td><em>The History of Standard Oil</em>, an exposé of John D. Rockefeller’s Standard Oil monopoly, is published.</td>
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<td>1907</td>
<td>Financial panic hits big banks. Financier J.P. Morgan intervenes to quell the crisis.</td>
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<td>1911</td>
<td>The Standard Oil monopoly is broken up by order of the U.S. Supreme Court.</td>
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<td>1913</td>
<td>Federal Reserve Act is passed.</td>
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<td>1914</td>
<td>Plans for antitrust initiatives are announced by President Wilson. Clayton Antitrust Act is passed.</td>
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<td>1929</td>
<td>Stock market crashes. The Great Depression follows.</td>
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<td>1933</td>
<td>Securities Act of 1933 passes. Federal Deposit Insurance Corporation is established.</td>
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<tr>
<td>1934</td>
<td>Securities Exchange Act of 1934 is passed.</td>
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says Pennacchi, “that regulation must be reformed to reduce the inter-connectedness within and between financial institutions so as to prevent more taxpayer bailouts.”

**Revving Up**

The Federal Reserve Bank, the Securities and Exchange Commission, and the FDIC are playing large roles in mopping up the current mess, but many in Congress believe still more oversight is needed. Already, Congress has passed new regulations for the credit card industry. Various proposals for new financial industry regulations are in the works, and President Obama has proposed a new Consumer Financial Protection Agency (see “Regulating the Two Extremes,” on page 13).

Still, Pennacchi says, “I doubt we’ll see the kind of strong, aggressive laws we saw in the 1930s. There’s too much disagreement between Congress, the Administration, and the regulatory agencies.”

That doesn’t mean that nothing can be done. Pennacchi says regulators already have the flexibility and power to make changes under existing laws and regulations. “I think now we’ll see more aggressive regulation. Regulators had the power; they just didn’t use it aggressively.” For example, Pennacchi explains that bank regulators already had the power to require greater capitalization for certain banking practices, such as off-the-books investments in mortgaged-backed securities. These off-the-books holdings came back to haunt banks when wary investors refused to refinance the debt that covered them, and the banks were forced to take these investments back on their balance sheets.

Still, some regulation is likely to come out of the recent trauma to the financial sector. But Kahn, for one, is hopeful that Congress will resist the temptation to go overboard. “I was really encouraged when I saw the regulations that will take effect for credit cards, given the temptation to make them really crazy. They came up with regulations that made sense, without damaging the industry. If we can do the same for the banking system, then that will be a really good outcome.”

– Doug McInnis

“IF YOU MAKE THE RULES SO RESTRICTIVE SO AS TO EXCLUDE ALL PROBLEMS, YOU’VE ALSO EXCLUDED ALL INNOVATION AND CREATIVITY, AND THE FINANCIAL MARKETS WILL NOT BE DOING WHAT YOU WANT THEM TO.”

– CHARLES KAHN

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**1935**

Unemployment compensation system is established.

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**2001**

Enron collapses. Stock market falls.

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**2002**

Sarbanes-Oxley Act is enacted.

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**2008-2009**


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**2009**

Credit Card Act of 2009 passes. President Obama proposes consumer financial protection measure.

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Sources: *New York Times, BusinessWeek, Smithsonian*
In recessionary times, the government wants to provide tax breaks and incentives to stimulate business and boost people’s purchasing power. But at the same time, when individuals and businesses make less money, they pay less tax. This creates a shortfall for the Treasury, which would normally call for tax increases. So what’s a government to do? The short answer is, achieve a tradeoff between the two primary objectives of the tax code: to raise revenue and drive desired behavior. And that’s perhaps the most difficult balancing act of all.

The Multinational Dilemma

In May 2009, the Obama administration released a comprehensive description of its tax proposals for the 2010 budget. The document identified over 40 provisions, ranging from revenue raisers to tax increases, to penalties, to new reporting requirements. Over the next several months, these proposals will be the basis for much discussion, and which components actually pass remains to be seen.

One of the proposals concerns the taxation of U.S. corporations doing business in other countries. “The U.S. has a ‘worldwide’ tax system, whereas France and Germany, and increasingly the U.K., have a ‘territorial’ tax system,” explains Petro Lisowsky, assistant professor of accountancy. “Under the worldwide tax system, income earned overseas by a U.S. company or individual is subject to U.S. tax. Under a territorial system, companies or citizens who do business overseas only pay the local tax of the country where they are stationed. U.S. firms argue that our worldwide system makes them uncompetitive, particularly since the corporate tax rate is already the second highest in the developed world.”

Of course, companies have devised strategies to minimize these taxes. For instance, firms may ordinarily defer paying current U.S. tax on overseas earnings until they bring back, or repatriate, those earnings to the U.S. They also locate their expenses in the United States, where they can shield 35 percent of their income. “The Obama administration’s anti-deferral provision proposes that any expenses located in the U.S. related to an overseas operation cannot be deducted until the overseas earnings are brought back to the U.S.,” says Lisowsky.

Howard Engle, a partner at Deloitte and a 1972 graduate in accountancy, explains the dilemma of a multinational system of taxation. “Defining a tax profile for multinationals that fairly taxes
them as U.S. companies with global operations and yet allows them to be competitive internationally is a tricky proposition,” he says. “The issue concerns the very fabric of corporate America’s competitiveness. If we get it wrong, the stakes are enormous. These companies are often the highest producers in their respective industries and are competing with very capable foreign counterparts. It’s in our best interest to keep the playing field level.”

In 1986, the Reagan administration faced a similar issue. Norma Lauder, currently the director of the College’s Master’s of Science in Taxation program and former Andersen partner and tax director at BankOne, explains: “The public was outraged because large corporations were paying little or no tax despite showing huge profits in their financial statements. This led to the enactment of the alternative minimum tax, which imposed a second tax regime on corporations which had been able to minimize their taxes through planning. It broadened the tax base and resulted in almost every corporation paying tax.”

It’s too early to predict what will happen to the Obama administration’s proposal for multinationals, but Lisowsky says we do have an example to watch. “The U.K. is pursuing policies to transition from a worldwide to a territorial system,” he says. “Observing how the transition plays out will be an interesting case study for our Treasury.”

**Driving the American Dream**

Closer to home, the tax code is already being used to drive desired behavior. One example is the tax credit of up to $8,000 for first-time homebuyers, which helps individuals realize the American Dream while stimulating the real estate market and the construction industry.

“Tax breaks targeted at specific markets and transactions can be more effective than simply mailing out checks hoping people will spend the money,” says Lauder. “The first-time homebuyer credit is a concrete action whose benefits can be understood and realized in the short term. The measure also boosts the confidence of the investing public.”

Previous administrations have encouraged homeownership as well. “The tax code has had sacred cows related to homeownership for decades,” says Lisowsky. “For example, subject to limits, you can exclude the gain you realize when you sell your home and you can deduct home mortgage interest. Interestingly, Canada does not allow this deduction because it has no policy to maximize homeownership. The country has had government surpluses for over 10 years, and its home prices seem to have been more stable, but perhaps that’s because Canada has no equivalent of Fannie Mae and Freddie Mac, which were driving the subprime market.”

Lisowsky is skeptical about the long-term benefits of the first-time homebuyer credit. “Sellers may simply raise their prices by $8,000, and ultimately, the government loses because it’s subsidizing this behavior,” he says.

**Energizing Business**

Perhaps more promising of long-term success are tax incentives that encourage energy efficiency and investments in sustainable technologies. “Making homes more energy-efficient benefits both homeowners and the construction industry,” says Lisowsky. “Incentives for the development of green technologies may also provide employment for engineers who lost their jobs in Detroit. Ultimately, these investments will also reduce our dependency on foreign oil, which helps retain capital in the U.S.”

However, while businesses can receive tax credits for making desirable investments, they have to pay tax in the first place in order to benefit, says Lauder. “Businesses that are losing money may not be paying taxes, and therefore can’t use the
credits,” she explains. “Although some companies have structured transactions to allow investors to use the credits.”

Among the policies aimed at promoting sustainable practices are the proposed cap-and-trade taxes on carbon emissions. Companies that exceed pollution limits would either be taxed or purchase credits from other companies whose pollution is below the limit. It sounds simple, but again there is a balancing act. “Take a company in West Virginia, for example, that produces energy from coal,” says Lisowsky. “It can upgrade its facilities, purchase credits, or pay tax on pollution. Whatever its choice, it may need to raise the rates for its consumers. Will that hurt people who are barely making ends meet? It’s a tradeoff between improving air quality and making sure people can afford electricity.”

Tax Tied

Another proposal on the business side is to allow companies to carry back losses for five years. “If a company loses money in 2009, it can only carry such losses back to 2008 and 2007 under current law,” says Engle. “If the carry-back period is lengthened to five years, it would cost the government over $25 billion per year. But if it saves businesses $25 billion, it could spur investment and help these companies get back on their feet so they can invest in their businesses, create more opportunities, and generate more income.”

What it really comes down to, according to Lisowsky is: “Are we propping up firms that would otherwise have closed and freed up resources and market share for competitors under the capitalist system. Many European countries don’t allow carry-back, only carry-forward.”

Another proposal is to make the R&D tax credit permanent. Although temporary until now, the credit has always been extended each year. “The R&D tax credit shields technology, biotech, and pharmaceutical companies in their high-risk projects, which increases their productivity,” says Lisowsky. “This drives the economy and helps the U.S. maintain its position as a leader in these fields.”

But claiming the R&D tax credit isn’t easy. “The problem with the R&D credit is that it’s very difficult to prove you’re entitled to it,” says Lauder. “Businesses have to decide whether they want to invest the time and effort in that process or forego the credit.”

Weighing the Costs

Another tax policy initiative proposed by the Obama administration is a surtax on high-income individuals to help fund national health care.

“A tax increase is difficult to reconcile with an economy that needs to rebound,” says Engle. “However, as promised during the Obama campaign, it won’t affect the middle class. Under current proposals, individuals whose income ranges from $350,000 to $500,000 are targeted for a 1 percent surtax; individuals earning between $500,000 and $1 million would pay another 1 1/2 percent; and those earning above $1 million would see a 5.4 percent increase on income above the $1 million threshold. This is expected to raise about $500 billion over the next 10 years to pay for overhauling the nation’s health care system.”

According to Lisowsky, “We may be able to fund health care reform and remain revenue neutral. But the question then becomes, how do we save Social Security and Medicare and decrease the deficit?”

What stimulates the economy more — lowering taxes or raising them? “One model is to lower the rate and broaden the base,” says Lisowsky. “For example, if corporate tax rates were lowered while eliminating the R&D tax credit, it would broaden the base by making more of corporate income eligible for taxation, although at a lower rate. Doing away with carve-outs might also lead to greater compliance.”

“The U.S. tax code is usually the barometer on which the systems of other countries are measured. That’s not to say that other systems are not effective, but the intellectual weight of our tax law dwarfs that of just about any other jurisdiction in the world. When you tinker with it, there are enormous trade-offs.”

– Howard Engle
In general, compliance would increase with a simpler tax code. One suggested simplification is to replace various itemized deductions with one large standard deduction for everyone. “If everyone had a standard deduction of, say, $50,000, people who earn $50,000 would pay no tax,” explains Lisowsky. “Those earning above $50,000 would pay tax on the difference, and low-income people would pay no tax at all. It makes sense in simplifying the tax code, but tax policy for economists is one thing and quite another for politicians. Besides, many special interest groups don’t want to see the tax code realigned. We hate everything you do, it benefits some and brings disadvantages for others. The outcome usually depends on who is more vocal.”

**Flip It Around?**

Another way to increase compliance might be to replace income tax with a consumption tax or a value-added tax (VAT). “A number of European countries use VAT to complement income tax,” says Lisowsky. “Rather than taxing and thereby penalizing productivity and savings, through an income tax, a VAT can in effect tax consumption. Although the Treasury department has explored this for decades, it’s doubtful that we can flip over our whole tax policy around. Our consumer-based society wants to encourage consumption.”

Engle believes there are serious challenges to any overhaul. “The U.S. tax code is usually the barometer on which the systems of other countries are measured,” he says. “That’s not to say that other systems are not effective, but the intellectual weight of our tax law dwarfs that of just about any other jurisdiction in the world. When you tinker with it, there are enormous trade-offs.”

**For the People**

The tremendous complexity of the U.S. tax code and the intricate interrelationships between taxation, business, government, and the economy make even the smallest change a balancing act to mitigate disadvantage to one constituency while supporting another.

“In a democratic system, it’s difficult to hit a home run with anything,” says Lauder. “Reaching a consensus is usually impossible. Generally, the most effective measures are those which target a specific segment to drive desired behavior. However, inevitably, what’s good for someone will be less good for someone else. It’s a balancing act and can be frustrating. I don’t know of any silver bullet, but the important thing is to get as much input as possible from the people who will be affected by the change.”

— Alice Shepherd
It’s noon. You’ve had meetings all morning and still haven’t gotten through your email, so you opt for a quick lunch, hopping in your car and heading to McDonald’s. The drive-through line is longer than usual, so you decide going inside will be quicker. But it seems everyone else had the same idea today. Feeling distracted and frazzled when you get to the front of the line, you quickly choose a salad and sweet tea instead of your usual burger and fries.

What made you select a menu item that isn’t typical McDonald’s fare? Was it a sudden urge to eat healthier, did you feel rushed into a decision, or were you influenced by the promotional messages featured prominently at the cash registers?

Research conducted by Sharon Shavitt, the Walter H. Stellner Professor of Marketing, provides some answers. Her recent paper, “Can McDonald’s Food Ever Be Seen as Healthful? Metacognitive Experiences Affect the Perceived Understanding of a Brand,” examines how consumers understand brand images and what makes them more receptive to reevaluating those images.

Co-written with Kyoungmi Lee, then a University of Illinois doctoral student in marketing and now an assistant professor at Kansas State University, the research finds that consumers who have to exert extra effort while considering a brand are more likely to be open to marketing messages. In this case, the research included surveying consumers about McDonald’s menu choices. Lee explains that some consumers were put under time constraints during the survey as a way to elicit a need for closure. In addition, some consumers were given a blurry survey as a way to create a sense of cognitive difficulty, which participants then attributed to their level of brand understanding. When they read something blurry about a brand, they felt difficulty in thinking about the brand, and they thought that meant they didn’t understand the brand as well as they should. “We found that people who are made to doubt their understanding are more motivated to listen to new information as a way to provide closure,” Lee says.

The new information itself also influences how the consumer perceives the brand. For instance, in Shavitt and Lee’s research experiment, consumers adopted a more favorable view of the McDonald’s brand, despite the time constraints imposed and the struggle to read the blurry survey. “The logical assumption would be that such negative experiences would lead to a less favorable impression of the brand,” says Shavitt. But because the researchers provided positive information for participants to seize on when they were led to question their sense of brand understanding, the participants had a more favorable brand perception, she explains.

There were some other surprising results as well, including the fact that consumers who felt a strong need for closure were the most willing to reexamine the brand after facing circumstances that create doubt. “People would have likely predicted that those who seek

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closure would be the most closed-minded,” Shavitt says. “But that wasn’t at all what we found. Those with the strongest need for closure wanted to eliminate doubt and so were most likely to change their views.”

**Beyond a Doubt**

Although it may seem counterintuitive that doubt leads people to be more open-minded, Shavitt explains that it’s all about the consumers’ need for clarity in their understanding of brand images. “Anything that distracts us or makes it hard for us to think when we’re processing information can create a sense of difficulty that can extend to our perceived understanding of the brand. You could be listening to a radio ad in the car while horns are honking and you’re watching street signs to make a turn,” she says. “A sense of difficulty threatens consumers’ metacognitive comfort zone and can lead them to doubt their understanding of an established brand. That doubt can lead them to be more open to reevaluating a brand.”

Dolores Albarracin, a University of Illinois professor of psychology who studies the cognitive and motivational processes associated with attitude change, confirms that doubt can set the stage for persuasion to occur. She also says the ability to persuade is more likely to occur in a situation where the information is objective, like a buying decision, than one where values are involved, like politics or religion. Swaying the consumer, it seems, is far easier than swaying the conservative or the liberal.

“For instance, you are more open to new information and more willing to process inconsistent information when you want to buy a car,” she says. “You want to be sure you buy the best car, not just one that is intuitively appealing. Or if you’re purchasing a home, you’re still going to get it inspected, even if that information might not confirm your decision to buy. These are ways for you to remove doubt.”

**Understanding and Rebranding**

So what does this mean for marketers? “The core insight is that people want to have an understanding of brands,” says Shavitt. “They’re constantly monitoring their sense of understanding because they’re motivated to retain and restore their perceived understanding of brands,” she says.

Unlike opinions formed on political, religious, or other ideological issues, where Albarracin’s research shows that people are less likely to be swayed and more likely to seek out the information that confirms their viewpoint, brand opinion formation is more malleable. “People don’t just form brand opinions and stick with them,” says Shavitt. “They may in fact be swinging between doubt and closure more often than we think.”

And that presents marketers with a chance to seize on the consumers’ willingness to reevaluate their brands. Shavitt suggests that ideas such as online or in-store surveys and contests that contain information that challenges consumers’ perceptions of the brand’s identity could be a rebranding opportunity.

“I think you can lead people to doubt their sense of understanding and in so doing be more open to the ideas you want them to embrace,” she says. “So I think McDonald’s can reinvent itself, as can other brands. And it might not be as difficult as once thought.”

— Cathy Lockman
When businesses form partnerships and strategic alliances, their top managers often speak of the profitable synergies to come. They don’t say that the venture has a one-in-two chance of failure — yet those are roughly the odds things won’t work as planned.

Those odds can be improved through a few common-sense measures, report College of Business professors Rajshree Agarwal and Joseph T. Mahoney. First, before companies link up — whether through an alliance, partnership, merger, or acquisition — they should agree on what they plan to get out of it. Second, they should assure first-rate lines of communication exist to work out the inevitable problems that arise.

Though it seems logical that two companies that don’t fit together would have little likelihood of forging a successful partnership, such mergers often go forward anyway because the lack of synergies is overlooked or even ignored; often the envisioned benefits are overplayed or unrealistic. The merger of Hewlett-Packard and Compaq, both major manufacturers of personal computers, was a case in point. “Even as the merger was taking place, there weren’t obvious benefits,” says Mahoney, the Investors in Business Education Professor of Strategy. “Maybe they thought they would get economies of scale, or unit cost reductions. But it just didn’t happen.”

**Value Driven**

The two researchers based their conclusions on simulations of business alliances and partnerships. More than 400 undergraduates and MBA students from the College of Business participated in these simulated alliances. The students were each assigned one of five simulated partnerships, in which the reward system and the degree of communication between exchange partners varied.

In simulations of high rewards for all and good communication, the partnership had a nearly 60 percent chance of success. In simulations with low rewards, failure was guaranteed. Simulations where communication was non-existent had only half the success rate found in simulations where the exchange partners communicated. The professors’ findings are contained in a paper forthcoming in the *Strategic Management Journal* titled “The Role of Incentives and Communication in Strategic Alliances.” It was written with colleague Rachel Croson of the University of Texas at Dallas.

Their work comes as more companies are linking up to weather the global financial downturn. “The financial crisis has triggered a whole spate of alliances,” says Agarwal, the John Georges Professor of Technology Management and Strategy. “In part, this is because they perceive potential value.”

Yet merely bringing companies together doesn’t assure a satisfactory outcome. Chrysler made more money per vehicle sold than any other carmaker in the period leading up to the merger with Daimler-Benz, but the results after the relationship proved disastrous. And AT&T’s merger with NCR fizzled. “One of the
things that motivated us to research this issue was the large number of deals that failed or fell below the potential value that could have been created,” says Mahoney.

In recent decades, companies have tended to join through mergers or takeovers. But as the economy has worsened, the deals have begun to trend toward alliances and partnerships. “In good times, you have a lot of free cash flow, and you can do an acquisition or a merger,” says Mahoney. “My sense is that you have more strategic alliances when companies have fewer resources. And if cash is tight, you don’t have the extra resources to be able to absorb a mistaken acquisition.”

A Successful Hunt
To find out what would work, Agarwal, Croson, and Mahoney set up an “assurance game” experiment based on the 1754 book Origin of the Inequality of Man by French philosopher Jean Jacques Rousseau. In it, Rousseau created an imaginary hunt, which begins with a group of hunters who have formed a circle around a stag they hope to kill and eat. Gradually, the hunters move toward the center. As long as all of them progress toward the center, they’ll catch the stag and they’ll all eat very well. But if just one hunter defects to catch a hare that is roaming the area, then the stag escapes through the gap. In that case, the defector gets one marginal meal, and no one feasts off the stag.

A fruitful stag hunt features several essential elements of a “social contract” that are also needed for a successful alliance — a defined goal, a defined strategy, and the prospect that everyone will win if they work together. If any of those elements are absent, the linkage won’t work well, the professors concluded. “Creating a win-win situation is a necessary condition for alliances and mergers to succeed,” says Agarwal. “You can’t expect to gain something if you have set up your partner to lose.”

But the researchers found that one additional ingredient was needed for success — communication. If the parties in a strategic alliance or merger couldn’t communicate, they couldn’t resolve things that went wrong and the deal didn’t work. “Communication is what trust is based on,” Agarwal emphasizes. “Once trust is gone, I won’t want to work with my partner.”

Management Matters
While these lessons are essential to successful corporate mergers and partnerships, they are also invaluable in day-to-day business. Mahoney cites Nucor, the highly regarded steelmaker, as an example of a company that has mastered them. Nucor sets its sights on efficient production and rewards its workers when production rises. The company also excels in communicating with its factory-floor workforce. “They keep the message simple,” says Mahoney. “Everybody knows what they need to do. And they know if output doubles, so will bonuses.”

So the key to a successful alliance or a successful company is good management. “The punch line of our work is that management matters,” says Mahoney. “Management can say if you take this action, you’ll be better off, but so will everybody else. But it’s not enough just to say it. First, management must set up a good system, and then it must explain to everyone involved why it’s a good system.”

— Doug McInnis

The partnership of the Ford Motor Company and Mazda, now in its 30th year, is one of the best examples of a strategic alliance that works. It began in 1979, when Ford helped to save the financially struggling Japanese automaker by buying a 25 percent stake in the company. Last year Mazda returned the favor. It joined with several partners to buy back most of Ford’s stake. That put needed cash in Ford’s coffers to fuel its ongoing turnaround plan.

By 1992, the relationship had led to a string of successful joint ventures. That year, BusinessWeek dispatched three reporters to find out why the relationship worked. Here’s what they found:

• The alliance was built on communication that began with top management and percolated downward through the ranks. The two companies did this despite the enormous linguistic and cultural gulfs between them.
• Joint ventures were set up so that both parties benefited. For instance, in 1992, the two automakers collaborated on ten models, including the Ford Explorer and the Mazda Protegé. Ford handled most of the styling, while Mazda made critical contributions in engineering.
• When things went wrong, the two partners came to each other’s aid. For instance, when a stamping press broke down at a Mazda assembly plant in Michigan, Ford let Mazda use its press at a nearby Ford plant. That allowed Mazda to keep its assembly line up and running.
• The two partners also traded technological and production expertise. For example, when Ford built a new factory in Mexico, it patterned the plant on Mazda’s highly productive Holu plant in Japan. In another instance, Ford allowed Mazda access to some of its advanced computer software, which measured noise and vibration.
An ancient Chinese saying observed that “a very long journey begins with a single step.” The same holds true for strategic alliances, according to new research from the College of Business.

Researchers found that newly formed alliances are more likely to build the mutual trust they need for large projects by first succeeding at small ones, says Matthew McCarter, the lead researcher on the project. McCarter earned his Ph.D. in business administration in 2009 and collaborated with Gregory Northcraft and Joseph Mahoney, both professors of business administration, on this research.

The finding is timely in light of the growing corporate interest in strategic alliances. “They are a very popular avenue for business because it is too costly to pursue mergers and acquisitions,” says McCarter, now an assistant professor of management at the Argyros School of Business and Economics at Chapman University in Orange, California.

But McCarter and his colleagues also found that the approximate size of the initial trust-building project makes a difference. If the test entails too little risk, members of the alliance are likely to attribute any success to the fact that the project was too easy. In that case, “it doesn’t prove anything to either party,” McCarter explains.

**Small Steps, Big Rewards**

The size of the first small project will be in part a function of the size of the companies in a partnership. Obviously, it would be much larger for Ford Motor Company and one of its suppliers than for two dry cleaners who have worked out an alliance. But determining the best size for an initial project is difficult. “It’s very hard to know how big of a first step to take,” says McCarter.

“**There is a trust issue there. So the idea is that maybe the place to start is not with a big project, but a small one, so that you can verify that your efforts will be reciprocated in kind. And that’s what builds the foundation for trust.**”

—Gregory Northcraft

These issues are playing out in corporate sectors like the automobile industry, where alliances are becoming more commonplace. In that industry, joint projects may be measured in tens of millions of dollars, or much more.

“If you have an alliance between an American and a Japanese automaker and they want to build a car jointly, they will wonder if their partner will put its best people into the venture – or their second stringers,” says Northcraft, the Harry J. Gray Professor of Executive Leadership. “There is a trust issue there. So the idea is that maybe the place to start is not with a big project, but a small one, so that you can verify that your efforts will be reciprocated in kind. And that’s what builds the foundation for trust.”

If a small project delivers a “win” for both parties, it sets the stage for something bigger. Conversely, a small project failure represents a large setback. “If it doesn’t work on a small test, the damage and mistrust is worse than if you hadn’t tried at all,” says McCarter.

The researchers based their conclusions on simulations using 161 undergraduate students in the College of Business. The research is an extension of earlier business studies that looked at the issue of trust between individuals within an organization. In an organization, employees who work very hard may wonder if their cohorts are doing the same. If they conclude that’s not the case, “they wonder why they are the only ones carrying the water,” says Northcraft. “Our project was one of the first to generalize this issue and see how it relates at the organization level. Organizations are filled with people, and the fears that people have can often become the fears that organizations have.”

The work is also an extension of research by Mahoney and Rajshree Agarwal, featured in the preceding article, which concludes that both communication and an incentive structure benefiting both parties are necessary ingredients in successful strategic alliances. “This research adds a different insight,” says Mahoney. “The emphasis here is on how you build trust between alliance partners. Well, you do it through small wins.”

—Doug McInnis

”**If it doesn’t work on a small test, the damage and mistrust is worse than if you hadn’t tried at all.”**

—Matthew McCarter
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Accountancy
Fair Value and its Impact on the Future of Accounting
November 19, 2009  Breakfast, 7:30-9:30am

Business Leadership
Healthcare
December 9, 2009  Breakfast, 7:30-9:30am

Twenty-Something Leaders in Business
Social Networking
January 20, 2010  Evening, 5:30-7:30pm

Deep Dive Workshop
Doing Business in China
February 17, 2010  Lunch, 11:30-1:30pm

Corporate Responsibility
Professional Responsibility and Environmental Ethics
March 10, 2010  Breakfast, 7:30-9:30am

Women in Business
Female Executives and How They Relate to Their Rising Female Stars
May 12, 2010  Lunch, 11:30-1:30pm

Join us, we have brilliant ideas to share!