The Business of the Olympics
A look inside the Chicago 2016 bid
In this issue of Perspectives, you’ll find an article entitled “Doing Good & Doing Well.” It focuses on how companies that consider the greater good when making business decisions can also do well for themselves in the process. This concept of corporate social responsibility has both quantifiable and unquantifiable benefits; it is also a philosophy that creates value for institutions of all kinds.

In the College of Business, we know the value of serving the greater good and we take that responsibility seriously. You can see it in our commitment to creating innovative programs like our Center for Professional Responsibility in Business and Society, which focuses on teaching students and professionals how they can serve the public interest in an ever-changing business environment. It’s also at the heart of our efforts to provide Illinois students with a depth and breadth of educational and practical opportunities that will prepare them to become thoughtful, knowledgeable, dynamic members of the workforce. And it’s obvious in our decision to be good stewards of the environment, building the first “green” facility in the University’s history.

We, too, are doing good and doing well. But challenging times, like the economic ones we are all now facing, provide us with an opportunity to assess how we can do even better. I am excited by the possibilities to build on our success. Our priorities for the future include: recruiting and retaining the best faculty; nurturing our undergraduate programs; building our portfolio of professional master’s degrees; reaching out to alumni and other constituents outside the College; and building our financial resources.

Over the years, previous leaders of the College and past and present partners have ensured that we invested wisely in our faculty, our students, our programs, and our facilities. We are working diligently and collaboratively to continue that tradition. I welcome your help in building our success.

Sincerely,

Larry DeBrock
Dean
OLYMPIC EFFORT
By Cathy Lockman

Chicago has put in its bid for the 2016 Summer Games. What are the economic risks and rewards of hosting sports’ premier event?

NAVIGATING CHANGE
By Alice Shepherd

Successful organizations embrace change and know how to manage it. What strategies do they use and how do they shape the environment to their advantage?

A WILD RIDE
By Doug McInnis

What has caused the recent volatility in the stock market and what will it take to calm the market’s jitters?

DOING GOOD & DOING WELL
By Alice Shepherd

Companies can serve the greater good and improve their own bottom line by committing to the concept of corporate social responsibility.

TIL DEBT DUE US PART
By Doug McInnis & Cathy Lockman

Burgeoning government and consumer debt has led to economic turmoil, but there are strategies that can help businesses and individuals be prepared for what comes next.
Sports is big business. And nowhere is that more true than in cities that host sports’ premier event—the Olympic Games. For weeks, the chosen city is center stage as it welcomes athletes and visitors from across the world as well as an audience of millions of international viewers. But those few weeks of fame are years and millions of dollars in the making. As one of four candidate cities for the 2016 Summer Olympics, Chicago has calculated the economic risks and rewards and has submitted its bid, making a strong move to host the XXXI Olympiad.
As a proud Chicagoan, a loyal sports fan, and a strong supporter of the Olympics, John Murray didn’t hesitate when he was asked to be part of the leadership team for Chicago 2016, the organization charged with preparing the city’s bid for the 2016 Summer Olympics. The 2001 MBA graduate has taken on the challenge, as gargantuan as it is, because he sees it as an opportunity to make a significant contribution to the history of the city and its residents. And that’s just what Murray and the other members of the team have been working to do since the effort began in 2006.

Their work has included determining venues, securing financing, rallying volunteer support, and addressing the needs and concerns of all the stakeholders, from city residents to the local and federal governments to the International Olympic Committee. For Murray, the executive vice-president and chief bid officer, the job has also meant overseeing the preparation of the official bid book, a 600-page document that details the Chicago plan for the XXXI Olympiad.

In the coming months, the IOC will be evaluating the bid books of each of the four candidate cities—Rio de Janeiro, Madrid, and Tokyo are the other finalists—and will announce the name of the host city in October. In the meantime, Murray and the rest of the Chicago 2016 team are preparing for the IOC’s visit to Chicago in the spring and hoping for the best.

“All four cities can do a wonderful job of hosting the Games,” says Murray. “But we believe that our city has some very unique aspects that make it an exceptional venue. We have the beautiful geography of our lakefront and 24 miles of park land. We have a strong infrastructure and a city that is designed for easy access. Plus, we have great sports fans and a diverse mix of people who are excited about the opportunity to welcome the world to Chicago.”

**Boon for Business?**

But just what does it mean for the city if it is chosen to host the world’s most coveted and high-profile sporting event? An independent report that was commissioned by Chicago 2016 and completed by Tootelian and Associates projects substantial economic benefits, predicting that the Games would generate $22.5 billion in new economic activity in Illinois—$13.7 billion in Chicago alone—from 2011, the five years before the Games, until 2021, five years after. Of that $22.5 billion, $7 billion is expected to come from the money spent by visitors, with the rest coming from business generated directly from the planning and operations of the Games as well as indirect business-to-business benefits from those who supply goods and services. In addition, the report projects this increased economic activity will result in $1.5 billion in incremental tax revenue for the state and local governments.

The Tootelian study also estimates the creation of 315,000 new job-years, a measure that converts the total hours of jobs created—permanent and temporary, full-time and part-time—into the equivalent of full-time jobs. Those jobs, most of which will occur in Chicago and its six collar counties, represent an estimated $11.2 billion in new labor income.

Certainly, such numbers would provide a welcome boost to the city’s economy, but just how realistic are these projections? Opinions are mixed. Some argue that the actual impact will be far less, while others contend that a successfully executed Games could create an even larger economic benefit. Geoffrey Hewings, the director of the Regional Economics Applications Laboratory at the University of Illinois, believes the actual impact is probably somewhere in between. “There are populist notions that the benefit would be overwhelmingly positive, and there are some economists, urban planners, and others who say it could even be negative. The advantages and disadvantages are likely to be inflated on both sides.”

Although Hewings believes the Games have the potential to create a significant economic benefit, he says an accurate assessment can’t be determined without considering the “crowded-out phenomenon,” the idea that
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- GEOFFREY HEWINGS

expenditures on one project displace what
would have been spent on other projects.
“You have to consider what the money that
will go to the Games would have been used
for,” he says. “For instance, it’s not a ‘new’
economic benefit if the money spent
constructing an Olympic stadium was
going to be used for other infrastructure
needs, like sewer or school repair.”

Larry DeBrock, dean of the College of
Business and professor of business
administration, agrees, saying the crowded-
out concept applies to the area of job
creation as well. “Noneconomists assume
there will be a boon in construction jobs
during the Olympics. But to economists,
that is only a benefit if it means new jobs.
If these people would have been working
on an office building project if the
Olympics didn’t come to town, then it’s
not necessarily a net benefit.”

Job creation numbers are particularly
important, DeBrock says, because most
economic analyses of this kind also use the
“multiplier effect.” This principle attributes
additional economic benefits for each of
the new workers to account for the money
they will spend buying groceries,
renovating their homes, going to the
barber, and otherwise contributing to the
economy. “Certainly, these effects are very
real, but only if the workers wouldn’t have
been employed otherwise,” he explains.
“The multiplier effect can serve to
increase the estimates of economic
benefits in a way that can be unrealistic.”

The Tootelian report recognized the
legitimacy of these concerns, noting that
previous economic impact studies done
for Olympic cities have been criticized for
not considering “crowding-out.” To
accommodate for this, the Chicago 2016
study says it “took care to measure only
the incremental impact of the Games.”
According to Murray, that means “there
were deductions taken into account for
typical construction projects that would
not occur because of the Olympic-specific
projects.”

Raising Revenue

Just as it’s difficult to estimate the
economic impact of an event that will
take place seven years from now,
projecting costs can be equally nebulous.
Preliminary budget estimates show a cost
of almost $4.7 billion: nearly $1 billion for
temporary venue construction and
operation; $2.4 billion for staffing,
technology, transportation, security, and
administrative costs; and $1.2 billion for
constructing permanent competition
venues as well as the Olympic Village.

Where will that money come from?
The IOC’s television and marketing
arrangements is one funding source,
providing an estimated $1 billion, but the
largest portion would be generated from
a joint marketing venture between
the United States Olympic Committee
and Chicago 2016. It would include
sponsorships, ticket sales, and licensing
and merchandising programs that would
net an estimated $2.5 billion for Chicago
2016. Other revenue would be generated
from the Paralympic Games, which
Chicago would host a week after the close
of the Olympic Games, as well as federal
funding for specific security planning and
operations. In addition, private and public
guarantees and contingencies, including a
$500 million guarantee from the city,
would help cover any cost overruns.

Members of the Chicago 2016 team
have reason to be optimistic when it
comes to believing there will be plenty of
private support should the city receive the
Games On

How will Chicago be transformed into an Olympic venue? The plan calls for the Games to use a combination of existing sports venues, new permanent facilities, and temporary installations. Some of those venues include:

- McCormick Place, which would host 11 Olympic disciplines, from volleyball to weightlifting to wrestling. It would also serve as the International Broadcast Center.
- The United Center, which would host gymnastics and basketball.
- The UIC Pavilion, which would be the site for boxing events.
- Soldier Field, which would host soccer.
- The Lakefront, where rowing and canoe/kayaking events would be held.
- An Olympic Sports Complex at Northerly Island, the site of beach volleyball, BMX cycling, and track racing.
- An Olympic Stadium in Washington Park, which would host the opening and closing ceremonies as well as track and field. It would accommodate 80,000 but after the Games would be reconfigured as a 5,000-seat amphitheatre.
- An Olympic Tennis Center at Lincoln Park.
- The Olympic Village, which would be built on the Near South Side as part of a public-private partnership. It would provide housing for 17,000 athletes and officials and be converted to mixed-income housing at the conclusion of the Games.

nud from the IOC. Already more than one million people have signed up at www.Chicago2016.org as donors, volunteers, and supporters of the bid. And the bid itself, which has cost $49 million over the last three years for staffing, services, and administrative expenses, has been financed entirely with private donations.

The Longer Legacy

In the current economic climate, it’s easy to see how important an infusion of jobs would be to the city and the state. But these would be relatively short-term benefits; after all, hosting the Games is a finite endeavor. So how do you help ensure that there is a longer legacy?

Michael Giardina, visiting assistant professor in the University of Illinois College of Media, says the press can play a role. “Chicago has a lot to offer and much to be gained by hosting the Games,” he says. “But it’s important that the media ask the tough questions, not as opposition, but as a way to help ensure a longer legacy.”

“There are intangibles, like enhanced reputation and civic pride, that you can’t put a dollar value on but that still represent a net positive for a city or a region. There is no doubt that if you host the Olympics, there are special dividends that are not easily measured.”

– Larry DeBrock
Using the Olympic Rings to Ring Up Sales

There is no doubt that the Olympic Games is one of the most effective marketing platforms in the world. Businesses are willing to make significant investments to link their products with the power of the Olympic brand. It’s a highly coveted relationship and one that is carefully managed by Olympic organizers.

In 1985, the International Olympic Committee formed The Olympic Partner (TOP) program, a select group of corporate sponsors that have exclusive worldwide marketing rights to both the Winter and Summer Games. Among the participants in TOP are McDonalds, Coca-Cola, General Electric, and Visa. The organizing committees in a host city and country establish additional marketing programs that include national partners, sponsors, and suppliers.

Michael Giardina, visiting assistant professor of advertising, says it’s these relationships that make it possible for cities to host the Games without putting the complete financial burden on the back of the public. He points to the difference between the 1976 Olympics in Montreal, which was publicly funded and incurred a $3 billion debt that wasn’t retired until 2005, to the 1984 Olympics in Los Angeles, which was the first to be privately funded and actually showed a budget surplus.

“Los Angeles provided the blueprint of how to fund a successful Olympic Games,” he says. “The public-private partnership that includes top corporate brands contributing goods, services, and dollars is one of the major factors that allows a city to pull off a Games without incurring significant debt.”

What do the sponsors get for their money? Plenty, says Giardina, who teaches a course on sports, culture, and advertising. “The value of Olympic sponsorship goes well beyond the benefits of global advertising exposure. There is a synergy that develops, and that synergy links the brand with the emotional ideals of the Olympics, of being part of bringing people closer together, of working hard and achieving success. You can’t put a dollar value on that association.”

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Carla Santos, co-director of the Tourism Laboratory for Economic & Social Behavior Research at the University of Illinois, also believes creativity and collaboration are key. “Chicago is the kind of city that can do this right,” she says. “We have strong neighborhoods and individuals who are committed to seeing their communities flourish. By bringing many people to the table, there is a collective vision and an opportunity for urban regeneration that protects the interests of the residents while creating even more vibrant neighborhoods. That would be a very powerful social and cultural legacy of hosting the Olympics.”

Santos says another long-term benefit comes from the media exposure provided by the Games. “Hosting the Olympics would give the city an opportunity to showcase its social and cultural richness, its architecture, its museums, and its beautiful geography. As the world sees what Chicago has to offer, it could have a long-term positive impact on local tourism as well as on the city’s reputation.”

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— Carla Santos

“Bidding has its benefits”

But are there dividends if Chicago doesn’t get the bid? Santos thinks so. “The dialogue that has been a part of the process arms the city a little better for the future, with or without the Olympics,” she says. “It has provided an opportunity for the decision makers to know how residents feel about their city, and that’s a positive for making improvements in neighborhoods and in living conditions, which is good for the city as a whole.”

Murray agrees that the city is better off having gone through the bid process. “Throughout this effort, we’ve seen how generous, creative, and committed the people of Chicago are. Regardless of the outcome, we’ve seen a great mix of people come together and bond as a result of this work. That’s an important benefit for the city and a legacy we can be proud of.”
— Cathy Lockman

Show Me the Money

Revenues are projected to cover the costs for temporary venues and services associated with hosting the Games; the remaining $1.2 billion in costs are for permanent venues and the Olympic Village, which will be financed through a public-private partnership and represent infrastructure improvements that are expected to be long-term revenue generators after the Games.
One home goes into foreclosure every 13 seconds. Nearly 3,000 Americans file for bankruptcy each day. On average, more than 21,000 people were added to the jobless rolls each day in February. As bad news rolls in, financial experts have pinned the blame largely on subprime mortgage loans gone sour.

But some observers think the United States is headed for even deeper problems as a result of a much larger debt bubble that has been building for decades. “A lot of people think our problems started in the early 1980s,” says David Sinow, a former banker who now serves as clinical professor of finance and director of Risk Management and Insurance Research at the College of Business.

Recently, he combed through a thicket of data to find out how bad the nation’s debts have become. “In 1980,” he says, “the national debt was $930 billion, or about 33 percent of the Gross Domestic Product of $2.8 trillion. Before any additional debts from the new federal stimulus package are tacked on, the debt stands at $10.7 trillion just 29 years later. That amounts to 75 percent of a GDP of $14.2 trillion. With the stimulus package and tremendous
Easy Credit, Tough Reality

If this was the only problem, the future might not look so bleak. But consumers have piled on debt as well—debt for bigger houses, credit cards, car loans, and more. In 1980, they owed about $300 billion for non-mortgage debt. Today, it’s $2.6 trillion. Business is in hock for $40 trillion, and state and local governments are in the hole as well.

Dealing with Deflation

As gas prices soared last year, the financial world worried about inflation. Now the concern is that the fast-failing economy will lead to deflation—a condition where prices actually fall. Though the idea of falling prices may appeal to consumers, economists warn that deflation could unleash widespread economic damage on a country where individuals, businesses, and governments are deeply in debt. The problem is the debt deflation scenario described by the economist Irving Fisher during the 1930s.

George Pennacchi, professor of finance, offers an example of how falling prices can hurt business. "Even if firms sell the same number of products as they did before deflation began, their revenues will be less if the prices of their products are falling. That means they have less cash flow to pay the fixed interest and principal payments on their debts."

This was a sizeable problem in the Great Depression, when businesses were hit by a one-two punch. "Because of the Depression, there was a decline in spending in real terms," Pennacchi explains. As a result, businesses had declining unit sales.

While the sales decline hurt businesses, they were also hit by debt deflation as prices declined as well. "During the early 1930s, prices declined by about one-third," Pennacchi says. "So when companies were paying back bonds, their real payments were in essence one-third higher than they had been. In many cases, they couldn’t make the payments." This was one contributing factor to the large number of business failures in the early 1930s.

Today, wage and price deflation would threaten anyone who owed money, including consumers. But Pennacchi says there is some wiggle room for certain types of debt; should deflation take hold. For instance, interest rates tend to fall with deflation so homeowners could refinance their mortgages at lower rates. And many corporate bonds are callable. So if interest rates fall, businesses could call in the old higher-rate bonds and issue new ones at lower rates.

– Doug McInnis
A View from the Field

In the world of three years ago, debt was a springboard to better things. If you wanted more credit, you could get it. If you had an asset, you could leverage it. As an investment advisor and senior vice-president at Smith Barney’s Chicago office, Rhonda Belson Salins, a 1976 marketing graduate, came to understand this world well. Now, she sees the aftermath of the debt boom everywhere she looks — in the stock market collapse, in newspaper stories, in casual conversations, and at parties where the market dominates the evening.

One acquaintance volunteered that her credit card debt exceeded $75,000. Another allowed that she is still spending well over her annual income despite the failing economy. A third has combined debts of more than $1 million for a first mortgage and a home equity loan. Salins recently learned that her old house, which she sold a few years back, went into foreclosure after being leveraged for far more than its current worth.

The collapse of the great debt bubble, beginning with the meltdown in subprime mortgages, devastated the investment world. “It didn’t matter what they were in — international stocks, mid-cap, large-cap. I want to call it a tsunami,” says Salins. “Everything got swept away. The only things that seemed to work last year were CDs, treasuries, and cash. Unless you had your assets in those, chances are you lost money.”

“People are trying to hang in there. They realize their net worth is down. They want to cut back spending. But I don’t know if they’re saving. They might not have the money to save.”

All of this has produced stress. “I hear it in people’s voices. I wish I had a dollar for everyone who told me they couldn’t sleep at night. A lot of people are up at two or three in the morning. I hear that often.”

But then she injects a note of reality; even the worst of times eventually ends. “Things will get better,” she says. “They always have.”

The views expressed here are those of Rhonda Belson Salins and do not necessarily reflect the views of Smith Barney or its affiliates. Smith Barney is a division of Citigroup Global Markets Inc.

It’s become apparent that the gradual accumulation of straw has crushed the camel’s back. For instance, banks that were struggling with bad subprime loans are now contending with defaults on consumer loans. Meanwhile, business bankruptcies are mounting, and the government is being called on for ever-growing amounts of bailout money.

If individuals and governments began to live within their means, it might help keep debt in check—or it might make things worse. In fact, many consumers have already cut back, and the initial results have been disastrous.

“The minute the consumer stops spending, look what happens to our economy. Over 70 percent of the economy is based on consumer spending,” says Sinow.

As consumers clamped down, tax collections fell, car sales slumped, and retail sales plummeted. In response, business cut back investment and slashed payrolls, and the economy has gotten worse, with deflation of prices and wages becoming the immediate concern.

“Look what deflation is doing,” says Sinow. “If you lose 20 percent of your home’s value and 50 percent of your investments, do you feel like going out and buying anything? I don’t feel like going out and buying as much as I did two years ago.”

With consumer spending and business investment going down, where can we look for a lifeline? “We’re really on the horns of a dilemma,” says Sinow. “The only area that can shore up the Gross Domestic Product right now is government spending. The problem with government spending is that it’s all borrowed money. There will be no way for the government to pay back that debt without stoking up the presses and printing lots and lots of money.” It might seem like a simple solution, but as Sinow explains it can have some very serious consequences. “Monetizing the debt just adds more cash into the system without adding any actual economic production, and that will ultimately lead to substantial levels of inflation.”

“Everything got swept away. The only things that seemed to work last year were CDs, treasuries, and cash. Unless you had your assets in those, chances are you lost money.”

– Rhonda Belson Salins
Preparing for the Future

So, if bad mortgage debt got us into a mess that’s led to deflation and government debt will likely lead us to bear the burden of inflation, what’s the consumer to do? While we can’t undo the debt crisis, Sinow says there are some steps we can take to protect ourselves from an inflationary future. First and foremost, make sure you don’t have any adjustable rate loans. “Interest rates can easily go to 22 to 25 percent during times of inflation, and if you have an adjustable mortgage it could really push you over the brink,” he says. “Of course, the last time loan rates were that high, we also had passbook savings rates of 15 percent, so you’ll want to keep some cash to take advantage of that.”

Sinow also suggests that investors build a disaster hedge by buying the only type of instrument that has held its value against inflation—gold. “If we get into a period of hyperinflation, gold will run up,” he says. “Having 10 percent of your portfolio in that asset class would create a good disaster hedge.” But how do you go about doing that? Sinow suggests that you decide on a timeline—either the next 18, 24, or 36 months—and buy gold coins every month until you’ve reached that 10 percent goal. It’s a slow and steady plan that will allow you to buy in at different prices and establish some protection from inflation.

Protecting yourself in a rough market

If the burgeoning debt will eventually lead to a period of inflation, as many economists believe, what can you do to protect yourself? Some ideas include:

1. Make sure you have no adjustable rate loans.
2. Keep some cash to take advantage of the higher rates of passbook interest that are likely to come during inflationary times.
3. Build a disaster hedge by buying gold.
4. Consider borrowing now to lock in the low interest rates that will be unavailable if high inflation returns.

A third step that Sinow recommends is to continue investing in the stock market. “This is a time of historic opportunity to buy stocks,” he says. “While they are trading at lows, stocks will ultimately recover. If you look at the S&P index, you’ll see that from 1928 until 2008, the annual total return on stocks was 9.7 percent. We’ve had periods of war, inflation, recession, and lots of other economic issues, but over time the smart money is still in stocks.” However, you have to be disciplined and maybe even detached for this strategy to work.

“If you’re going to be an investor, you have to be a legacy investor,” says Sinow. “You have to think in perpetuity. Buying stocks is about share accumulation, not price accumulation. If you have a diversified portfolio of stocks and you consistently invest, you won’t worry about timing the market because you’ll have the chance to dollar cost average and benefit from buying at the lows.”

Sinow also mentions that he’s heard that some consumers are looking at today’s low interest rates as an opportunity to lock in a favorable rate now to help protect them from inflation later. After all, today’s 5 percent borrowing rates will look pretty good if we return to the 22 percent loans we saw during the last hyperinflationary period of the early 1980s.

But speculating on when and where and how much to borrow, even now with low rates, requires caution. If we’ve learned anything from the past year, it’s that there is always a price to pay for debt, whether you’re a mortgage holder, a corporation, or, in the case of government borrowing, a taxpayer. Someday, the bill will come due.

- Doug McInnis
- Cathy Lockman

For more on the debt crisis and the strategies that firms can follow to manage cash during this economic downturn, see the accompanying story on page 12.
There was a time, only months ago, in fact, when a cash-rich firm might have been labeled conservative or even risk averse. But the credit crisis has changed all that. What might have been considered a cautious strategy last year, looks exceedingly wise today, as the debt disaster has severely restricted access to external capital and sent its cost soaring.

According to Brooke Elliott, assistant professor of accountancy, “The current economic downturn has led to a renewed focus on liquidity and reminded us that cash really is king. Today, a company’s success is dependent not only on its ability to generate revenues and earnings, but also cash flow, especially free cash flow.”

Obviously, cash allows a firm to make acquisitions, retire debt, and pay dividends, but equally important is the fact that liquidity creates peace of mind for employees, customers, suppliers, creditors, and investors. In times like these, cash creates confidence, and that makes managing cash flow a critical task for today’s businesses.

The Thirst for Liquidity

How can your company make the most of this tough environment? Elliott suggests that the following cash management strategies can help:

1. **Develop accurate cash flow forecasts.** In a recent survey by CFO Magazine, 75 percent of finance executives ranked forecasting cash flow as a top priority in liquidity management. The best companies get a clear picture of where they are headed, monitor their cash flow forecasts closely, report the accuracy of forecasts, and use this to refine future forecasts.

2. **Understand the risks you face.** Risk management should be a top priority for companies, and that means not only understanding the risks but quantifying them. For every key performance indicator, companies should be tracking a key risk indicator, Elliott says. For example, if sales are down 20 percent, the company must determine how that will affect cash forecasts and what actions will be taken in response.

3. **Ensure adequate sources of liquidity.** The cheapest and most flexible source of liquidity is internally generated cash, but given the current financial crisis, firms must consider other options. Some ideas include: working with four or five banks as opposed to one; drawing down credit lines; seeking non-traditional sources of funding, such as private equity; and accessing the corporate bond market.

4. **Ensure efficiency in working capital.** Improve liquidity by reducing the need to finance working capital. Improvements to receivables, payables, and inventory processes can result in lower operating costs, improved forecasting accuracy, and improved cash cycles.

5. **Establish discipline in capital spending.** Be sure you have a rigorous process for determining overall capital spending, allocating it among business lines, evaluating individual projects, and monitoring the efficiency of capital expenditures.

6. **Seize opportunities created by crisis.** Elliott explains that a recession can be just the right time to launch innovative products, because the marketplace is less crowded and it’s easier and cheaper to create awareness of the product. For companies with strong balance sheets, it can also be an opportune time to purchase strategic assets.

7. **Monitor credit exposures.** Know the credit quality of your financial and insurance partners and diversify your banking relationships to help reduce risk. Assess the reliability of the links in your industry value chains and determine what is in your best interest (e.g., provide financial assistance to vendors, hold excess inventory, seek alternative sources of supply).

8. **Communicate with key stakeholders.** Elliott cites social psychology evidence that indicates individuals are less likely to take information at face value during pessimistic times. Regulators, likewise, will carefully scrutinize disclosures about liquidity and access to capital. Credible external communications are critical in times like these.

– Cathy Lockman
Amid relentlessly evolving technologies, accelerating globalization, and the shift to knowledge-driven markets, the very nature of organizations is changing. Shorter job tenures, disappearing benefits and pensions, and new models of employee engagement are transforming the employment relationship. Add to that a churning economy and uncertainty in capital markets, product markets, and job markets, and it’s no wonder businesses today find themselves navigating some very rough terrain.

In this challenging environment, it takes a resourceful organization to stay afloat and prosper. At the heart of that challenge is the ability of the organization to embrace and manage change.
attributes, such as strengths that define the organization, along with flotsam. “Know what you want to preserve about your identity, what needs to be tweaked, and what needs to be changed substantially,” Agarwal says. “Then, plan course corrections leveraging existing resources.”

Equally important to a successful journey is knowing your destination. Joel Cutcher-Gershenfeld, dean and professor of the School of Labor and Employment Relations, echoes Stephen Covey’s advice to “begin with the end in mind.” According to Cutcher-Gershenfeld, “Organizations need tools and systematic methods to create a vision of what success will look like. They need to analyze their current state and then develop a strategic plan with milestones to the goal.”

Get the Crew on Board
An essential component of strategy development is getting buy-in from employees. “Begin by consulting with your key thinkers and implementers,” says Agarwal. “They often represent the very strengths you want to retain. Modify your strategies based on their input, and leverage their collective knowledge and influence to obtain buy-in from everyone else.”

Creating a “chain of communication” is key to managing people, says Agarwal. “Leaders should identify three or four people to form a change leadership team. These people should not only have the necessary expertise, but they must also be able to empower and enable others. They will each reach out to three or four more people, and so on, to create a pyramid that emphasizes communication rather than hierarchy.”

As change is initiated, it’s important not to view employees’ initial reluctance to change as a mutiny. “Those who associate individual denial or resistance to change with recalcitrant or irrational behavior may be dismissing what are valid considerations that need attention,” says Cutcher-Gershenfeld. “Individuals need to go through a process of adjustment and letting go before they can embrace change.”

Terrence Sullivan, a 2007 Executive MBA graduate, agrees. He heads the Global Project Management Office (PMO) of Motorola’s Home and Networks organization and has recently led a global change effort to raise the bar for the deployment of Motorola systems. “Getting people on the same page is paramount,” he says. “You don’t need full agreement, and you don’t need absolutes. What you want is movement in the right direction. Different parts of the world may operate a bit differently, but the fundamentals of good project management will remain similar—for instance, executing around an understanding of customer requirements and allocating the right resources at the right time.”

Take Out Your GPS
Rajshree Agarwal, John Georges Professor of Technology Management and Strategy, encourages companies to initiate change rather than merely adapting to an evolving environment. “Today, no firm can confidently predict that it will not face dramatic shifts in its external environment,” she says. Major changes, as in technology or customer demand, can require that companies fundamentally alter their strategies and business models in what Agarwal calls “discontinuous strategic transformation.” Further, she explains that “proactive firms also undertake incremental strategic renewal, which enables them not only to cope with external changes, but to shape the environment to their advantage.” Such forward-looking renewal can include acquisitions, new products, or experimentation outside the core business.

An organization that has resolved to change must first determine exactly where it is; it needs a kind of organizational GPS. Agarwal suggests that such a compass can be created by first starting with a basic SWOT analysis—an examination of strengths, weaknesses, opportunities, and threats—and then creating a TWOS matrix of strategies that pair organizational strengths and weaknesses with environmental opportunities and threats. Assessing your position is key to setting the right course because wholesale change could lead to jettisoning valuable
Keys to success for Sullivan’s initiative have been a strong platform that focuses on gross margin erosion, the creation of a virtual team across the regional PMOs of Motorola’s three major businesses, and ongoing open communication with the people needed to drive the change. “If employees wonder how the change will benefit them, give them many examples, not just one,” Sullivan recommends. “Show them how it will mean less work, more fun, or greater efficiency in the long run. Change ultimately occurs at an individual level, team by team and region by region.”

Cutcher-Gershenfeld emphasizes the need to appreciate the varied perspectives of all stakeholders in a change initiative. “Begin with the fundamental question: Who should be in the room when?” he suggests. “Everyone wants to be part of every stage of the process, and for legitimate reasons. Sometimes that may not be feasible. But ultimately, every stakeholder should have a voice.”

At Motorola, Sullivan’s team developed a five-day “academy” that laid out management expectations to regional teams. “We had not just project managers, but engineers, sales, finance, all in the same room discussing ways to optimize the deployment of systems,” he says. “Within months, we began to see dramatic results.”

Arran Caza, assistant professor of business administration, has studied the results of one big organizational change—downsizing. “Organizations downsize to improve performance, but only one in four obtains better performance,” he says. Organizations that have done so successfully share the following best practices.

Take responsibility. Managers who explain the reasons for downsizing and apologize to the “surviving” employees for the damage that has been done receive more support and effort from the workforce. “In difficult times, managers tend to stress the needs of the business,” says Caza. “They forget that businesses are made up of human beings who have emotions. That can backfire and exacerbate the problem as survivors withdraw their support.”

Be honest. When a company is in trouble, leaders sometimes put on a happy face to show courage and build morale. The result is that employees consider their leaders disingenuous and withdraw their trust. “If there is bad news, deliver it up front,” recommends Caza. “Then, honestly lay out the possibilities—no doomsday scenario or unrealistic positive spin.”

Give employees a voice. Take advantage of employee input in planning the downsizing. People will be much more supportive of change if they can have a say in how it will evolve. Even if their particular suggestions are not implemented, being able to communicate their thoughts to someone with authority, and feeling they have been listened to, is psychologically important.

Along with Caza, collaborators on these best practice strategies include: Kim S. Cameron, University of Michigan; David S. Bright, Wright State University; and Lu Wang and Gang Zhang, both from the University of Illinois.

“In difficult times, managers tend to stress the needs of the business. They forget that businesses are made up of human beings who have emotions. That can backfire and exacerbate the problem as survivors withdraw their support.”

— Arran Caza

“Begin with the fundamental question: Who should be in the room when? Everyone wants to be part of every stage of the process, and for legitimate reasons. Sometimes that may not be feasible. But ultimately, every stakeholder should have a voice.”

— Joel Cutcher-Gershenfeld
Chart the Course

Establishing the form a change initiative will take is also integral to strategy development. Cutcher-Gershenfeld distinguishes three types of change: top-down reengineering or restructuring, bottom-up continuous improvement (e.g., Kaizen), and mid-level development of protocols and standards. Ultimately, every change effort involves some combination of all three, he says, and mixing them effectively requires great skill.

Agarwal has observed that organizations using exclusively a top-down approach are less adaptable than those that incorporate bottom-up input as well. “A top-down approach requires the leader to be knowledgeable about each and every aspect of the business,” she explains. “That, in today’s world, is very difficult. Thus, asserting that the CEO or owner knows best means foregoing opportunities that are visible only from the employees’ vantage point.”

In Agarwal’s model, the creation of strategies and tools for transformation derives logically from the SWOT analysis. For example, strengths can be leveraged to negate threats or can be matched to opportunities. She cites the example of IBM, which has reinvented itself at least three times in its history. “Among IBM’s traditional strengths have been brand recognition, strong customer relationships, and good R&D,” Agarwal explains. “Weaknesses have revolved around lack of expertise in new areas it wanted to enter.” Agarwal provides an example from IBM’s very first strategic transformation from an electromechanical accounting equipment company into an electronic computing company. She discusses how IBM successfully accessed the external opportunity represented by U.S. government research on electronics during World War II and matched it with the company’s historic strengths. As a result, while several other accounting equipment firms failed to weather the external technological change, IBM prospered by navigating through it with an internal transformation.

According to Sullivan, charting a course for change is threefold—you have to initiate it, manage it, and measure it. “Change not only needs to be planned, designed, and executed, but also managed, monitored, and sustained,” says Sullivan. “Continued reinforcement through training and communication is essential as is measurement. Change does not end when you finish a project.” Sullivan’s team used a Digital Six Sigma process as a guiding framework to define and analyze its problem and to implement, measure, and control change. Measurement went beyond internal assessments to customer transaction surveys, which affirmed significant progress in communication and execution. “Although each region of the world did things slightly different, the project reviews were reporting the same metrics and issues for improving project gross margin,” says Sullivan. “This enabled the entire organization to speak the same language.”

Weather the Storm

Huseyin Leblebici, professor of business administration, studies the natural evolution of industries and the outside factors that force organizations to change. He disagrees with the Darwinian model, which holds that organizations don’t adapt easily and that the environment selects the fittest. “Managers are resourceful, and enterprises have the ability to transform in response to exogenous change,” he argues. “For example, by forming new coalitions of shareholders, employees, creditors, and customers, politically savvy leaders can generate the energy to create new products and services.”

Agarwal and Cutcher-Gershenfeld also believe that organizations, like individuals, have a great capacity to learn and adapt. “For example, when hardware became a commodity and the software industry became fragmented at the turn of the 21st century, IBM transformed itself to become a software powerhouse.”

“Bad times may be the best times to be innovative. More effective use of resources is key, rather than cost-cutting and increasing efficiency.”

– Huseyin Leblebici
Complex organizational change situations elicit complex emotions. It’s not as simple as dividing people into those who embrace change and those who fear it.

Naomi Rothman, assistant professor of business administration, studies the role of emotions in organizational change. “Giving up what you hold dear for an unknown future may elicit anxiety,” she says. “But that emotion is often mixed with a feeling of hope. When confronted with change, people are usually pulled in multiple directions by simultaneous strong emotions, such as hope mixed with fear or optimism mixed with resentment.”

One focus of Rothman’s research is the response elicited by managerial ambivalence. “Managers are caught in the middle of the change process,” she explains. “How they respond to the change that is occurring all around them impacts how their subordinates react because employees who feel uncertain about the future look to their managers for guidance.”

Managerial ambivalence has both negative and positive consequences. On the downside, Rothman argues, an ambivalent manager may be perceived as indecisive, which may diminish his or her influence. On the upside, ambivalence signals that the manager is not an impulsive decision maker who moves forward on single resolute emotions, such as anger or enthusiasm. It also suggests that the manager is a deep thinker, which in turn motivates employees to take charge of their areas of responsibility, according to Rothman.

“When harnessed strategically, the complexity of emotions associated with change can help managers empower their teams to think proactively, embrace ambiguity, and take the helm in change management initiatives,” says Rothman.

Negotiating the Maze of Emotion

When new technologies cause industries to become extinct, the consumer need usually survives in altered form, to be filled by innovators with new business models. “For example, if newspaper printing were to become extinct, people would still get their news—perhaps from newspaper companies that survived by transitioning to electronic media,” says Leblebici.

Forge Ahead

Navigating change can be daunting. “There is a golden middle,” says Cutcher-Gershenfeld. “If conditions are too static, it’s difficult to get unfrozen and change. If circumstances are too chaotic, people become immobilized by immediate survival needs. In the present climate, quite a few organizations are fortunate to be in that healthy middle range where old processes are thawing out and key changes are on the table.”

According to Agarwal, challenging times can be an opportunity for forward-thinking organizations to really shine through and forge ahead. “In prosperous times, it’s easier for competitors to survive,” she says. “It’s when times are lean and tough, and when others cut costs and focus on short-term gains, that proactive organizations with long-term renewal strategies are more likely to flourish.”


– Alice Shepherd
Corporate social responsibility (CSR) comprises all the initiatives that serve a greater good but goes far beyond “doing good” for society. It includes activities in areas such as: philanthropy, workplace safety, product safety, environmental stewardship, supply chain sustainability, fair trade, ethics, labor rights, human rights, volunteerism, and the whole range of subjects under the heading of professional responsibility, such as risk management, accountability, and operational transparency.
The Triple Bottom Line

“CSR is about the triple bottom line,” says Ruth Aguilera, associate professor of business administration. “Responsible companies are concerned not just with maximizing the traditional financial-economic bottom line, but also with maximizing their social performance and environmental sustainability.”

Watching a triple bottom line may seem like triple the work and triple the expense, but according to Aguilera, the components of the triple bottom line actually complement and enhance each other. “Progressive companies have realized that broadening their focus beyond economic efficiency and shareholder value, to social and environmental concerns, is not only good for business, but is also good public relations, which is again good for business,” she says. “On the other hand, firms that have omitted consideration of one or more triple-bottom-line components have paid the price by losing both reputation and customers.”

Concern for the Greater Good

What is it that motivates a company to pursue a CSR agenda? It’s all about decision making and stakeholders.

“Individuals, companies, and governments make decisions based on three types of factors,” says Aguilera. “One is self-interest. Another is relationships among group members, taking into account, for instance, how the outcome of a decision may benefit colleagues, customers, suppliers, or other company stakeholders. The third way to make decisions is based on ethical standards and moral principles.”

Factors from more than one category may come into play in decision making, says Deborah Rupp, associate professor in the Department of Psychology and the School for Labor and Employment Relations, who collaborates with Aguilera on CSR research. “Aspects of an individual, such as their personality, values, and attitudes, interact with aspects of the environment, such as the corporate culture, ethical climate, and normative pressures, in complex ways,” she says. “Empirical studies have shown that concerns for justice, ethics, and fairness are universal—to some degree, all people in all cultures have a visceral reaction to injustice. This is not just a matter of survival or selfishness, but people also have strong reactions when others are victims of unethical acts—even when they do not know the victims or in no way identify with them. In short, all people have some level of concern for the greater good.”

This concern for justice on the part of employees and leaders can play an important role in motivating a company to implement policies that focus on CSR. Employees consider an organization’s CSR activities as indicative of its commitment to justice and fairness, according to research conducted by Aguilera, Rupp, and Cynthia Williams, professor in the College of Law and currently the Osler Chair in Business Law at York University in Toronto. And that’s the kind of organization employees want to be associated with. “Employees view a socially engaged organization as one that is fair and concerned with all people, both internal and external to the company,” Aguilera says.

There can be additional benefits related to employee morale and work ethic for companies that commit to the principles of fairness and justice associated with CSR. For instance, employees who perceive their organizations to be fair are more likely to be committed, trusting, loyal, and hardworking. “This positively affects both employee well-being, such as job satisfaction, stress, health, and emotion, and organizationally relevant outcomes, such as employee commitment, turnover, absenteeism, performance, and citizenship behavior,” says Aguilera.

Adds Rupp: “There is a growing literature that looks at workplace fairness as a social contagion. Leadership fairness can ‘trickle down’ and impact how fairly employees treat each other and treat external stakeholders.” In short, CSR is a strategy that can serve to attract and retain the best, most responsible talent for optimum performance on all three bottom lines.

Consumers Are Watching

Customers, too, prefer to buy products and services from socially responsible companies. On an individual basis, consumers have boycotted genetically engineered foods, clothing manufactured in sweatshops, and rugs made by child labor. United as activist groups, they have compelled manufacturers to change irresponsible practices.

Aguilera cites the U.S. Paper Campaign in 2000 to end production of paper from endangered forests and increase the sale of recycled paper as an example of how members of a consumer activist group built a collective identity to achieve their goals. “Also, research on brand image shows that, given a choice, some consumers will pay more for a product from a ‘good’ company,” Aguilera adds.
It’s not the only instance where the consumer is putting his money where his mouth is. There is also a growing interest on the part of investors to align themselves with socially responsible organizations through their investment dollars. According to a 2006 report from the Social Investment Forum, between 1995 and 2005 investments of professionally managed assets grew from $7 trillion to $24.4 trillion, while the share of these assets invested in socially responsible investments grew from $639 billion to $2.29 trillion. Since the emergence of the shareholder rights movement in the late 1980s, institutional investors have become particularly active owners, including “noisy” pension fund activists, such as the California Public Employees Retirement System, which have acted as catalysts for CSR initiatives.

The public also continues to take notice as national and industry magazines assemble yearly rankings of companies, not for how their profits stack up but for how their reputations do. Fortune, for instance, compiles an annual list of America’s Most Admired Companies, and CRO Magazine announces its Top 100 Best Corporate Citizens each spring. The CRO list specifically ranks companies on such attributes as commitment to human rights, climate change, philanthropy, and environment, among other measures.

The Value of a Long-Term View

How do CSR efforts in the United States compare to those around the world? Research conducted by Aguilera, Williams, and Rupp provides some insights. For instance, their study of the differences between institutional investment in the United States and the United Kingdom provides an explanation of why CSR is more of a consideration in Britain. “Insurance companies and pension funds predominate in the U.K., while mutual funds and money management firms are the largest institutional investors in the U.S.,” Aguilera explains. “With long-term payout obligations and therefore a longer-term outlook, the former are more likely to see a company’s social and environmental behavior as material to investment decisions. They look at the triple bottom line. By contrast, America’s mutual funds and money managers are driven by short-term profit motives, the single bottom line.”

Whether the U.S. market will eventually move beyond its narrow focus on financial returns toward the British approach of long-term investing remains an open question, says Aguilera. However, she suggests that the developing British notion of “enlightened shareholder value,” with its focus on longer-term economic issues, is actually much closer to U.S. mainstream investment thinking. “Besides, given the influence of the London Stock Exchange on global capital, and the power of British non-governmental organizations to move world public opinion, it may simply prove more efficient for multinational companies—including those based in the United States—to live up to British standards,” she says.

Rupp indicates that CSR is also gaining popularity in Asia as well. “Many Asian countries are considering who is more responsible for social welfare—government or industry—ways in which profit-only-driven attitudes might be shifted to more triple-bottom-line thinking, and ways in which executive attitudes toward CSR can be shifted from CSR as a luxury, that is, only for good economic times, to CSR as a necessity,” says Rupp, who is currently teaching organizational behavior as a visiting professor at the Lee Kong Chian School of Business at Singapore Management University. “In a country as young as Singapore, the future of CSR really lies in its future leadership—today’s business students who will soon be tomorrow’s CSR advocates in the corporate milieu.”

Bad Times, Good Decisions

Will CSR survive these trying times? “Sometimes external factors, such as a rough economy, force companies to chart a new course,” says Gretchen Winter, the executive director of the College’s Center for Professional Responsibility in Business and Society. “Some may think that CSR will add costs because they believe they need to create a CSR department. That’s not the idea. Rather, they should step back and reexamine their business model, listen to customers, take a 360-degree view of the changing environment, and develop products and services that contribute to a more economically, socially, and environmentally responsible American enterprise.”

Aguilera says it’s in everyone’s best interest for organizations to be pursuing CSR initiatives. “Firms are increasingly expected to exhibit greater social responsibility in their human resources policies, in their global supply chains and labor policies, and in their environmental policies,” says Aguilera. “I hope that increased consumer demands for more responsible practices will ultimately improve everyone’s quality of life. CSR has to permeate the entire supply chain and be embedded in the strategic decision-making process with an eye toward the triple bottom line.”

- Alice Shepherd
Taking Responsibility

Responsible decision making is a hallmark of a strong company, and teaching responsible decision making is a focus of the College’s Center for Professional Responsibility in Business and Society. The mission of this interdisciplinary Center is to develop a vision that articulates societal expectations of a professional’s responsibility and accountability at both the individual and organizational level.

“Our goal is to teach students who are going to be accountants, auditors, financial analysts, doctors, lawyers, business leaders, and other professionals about their professional responsibility, not only to their employer, but to their chosen profession and to society at large,” says Gretchen Winter, the Center’s executive director. “For instance, an accountant’s professional responsibility is to the capital markets because they rely on the information generated by accountants. If the information is inaccurate, poor decisions are made that affect everyone. We want our students to view their actions through a very broad lens and practice making sound judgments that reflect their individual commitment to professional responsibility. It’s what good companies expect from their employees,” she stresses.

And it’s what the University expects of its students. “Once our students enter the workplace they will be challenged with ethical decisions,” says Ruth Aguilera, associate professor of business administration and a fellow at the Center. “Accounting, for instance, is not as simple as adding numbers. There are many different ways of presenting information. We want to engrave in the students’ minds the advantages of making ethical decisions which assess all three dimensions of the triple bottom line.”

Winter agrees. “A corporate culture that encourages employees to live up to their professional responsibility will make a company successful in more ways than it could imagine,” she says. “The key is for individuals to own these ideas and to act on them in day-to-day decision making.”

**Best Corporate Citizens Top 20**

1. Bristol Myers-Squibb
2. General Mills
3. IBM
4. Merck
5. HP Co.
6. Cisco Systems
7. Mattel
8. Abbott Laboratories
9. Kimberly-Clark
10. Entergy Corp.
11. Exxon Mobil
12. Wisconsin Energy
13. Intel
14. Procter & Gamble
15. Hess
16. Xerox
17. 3M
18. Avon
20. Monsanto


**U.S. Companies Listed in the Global 100**

- Advanced Micro Devices
- Alcoa
- Amazon.com
- Baxter International
- Coca Cola
- Dell
- Disney
- Eastman Kodak
- FPL Group
- Genzyme
- Goldman Sachs
- Hewlett-Packard
- Intel
- Nike
- PG&E
- Pinnacle West Capital
- Procter & Gamble
- Prologis
- State Street
- United Technologies

Source: Announced at the World Economic Forum, January 2009, and published in Corporate Knights, February 2009. These U.S. companies were selected for leadership in social responsibility, environment, and governance and are listed in alphabetical order.
On any given day, the downward movement of some stocks is roughly offset by the upward movement of others. Sometimes this placid state lasts for years. From 2004 to 2006, for example, there was not a single trading day when the Dow-Jones average went up or down by more than three percent.

Since then, investors have been subjected to an ulcerating, stomach-churning ride. The surges of one day, when hopefulness overtakes investors, have been more than offset by equally sudden shifts downward, producing a steady state of volatility. And the Dow-Jones average, which hit a record 14,164 on October 9, 2007, has recently fallen below 7,000.

The Shock and the Aftershocks

When volatility strikes the market, it can be a brief phenomenon. The great but short-lived crash of 1987 spurred a period of sharp shifts in stock prices, but it didn’t last. The collapse of hedge fund Long-Term Capital Management in 1998 brought another bout of turmoil. But Long-Term Capital was ultimately rescued by a consortium of banks, and the volatility soon stopped.

This time the ride has lasted much longer. It began with a single cause, the collapse of the subprime mortgage market, says Tim Johnson, associate professor of finance. “The precursor to this mess that really matters is the process by which major banks and investment banks took on a lot of toxic subprime mortgage waste. And in the process they became victims of their own game.”

Now there’s a massive wave of aftershocks from the subprime meltdown. “Subprime loans have basically vanished, so I don’t think that’s causing any more bleeding,” Johnson says. “So the bleeding we’re seeing now is due to the second wave of repercussions. This mostly boils down to banks at the center of the financial system having inadequate capital to cover subprime market losses and to businesses and individuals either falling

THERE ISN’T A BUSINESS THAT DOESN’T NEED CREDIT. AND ALL OF A SUDDEN, THESE LINES OF CREDIT STARTED GETTING PULLED. IN A VERY SIMPLISTIC WAY YOU CAN SAY, ‘ONCE THEY STOP LENDING, THERE GOES THE ECONOMY.’”

– DAVID LEHMANN
THE BLEEDING WE’RE SEEING NOW IS DUE TO THE SECOND WAVE OF REPERCUSSIONS. THIS MOSTLY BOILS DOWN TO BANKS AT THE CENTER OF THE FINANCIAL SYSTEM HAVING INADEQUATE CAPITAL TO COVER SUBPRIME MARKET LOSSES AND TO BUSINESSES AND INDIVIDUALS EITHER FALLING BEHIND ON PAYMENTS OR DEFAULTING ON THEIR LOANS.”

– Tim Johnson

behind on payments or defaulting on their loans. You can be somebody with good credit who winds up missing a payment because you got laid off."

As banks began to feel the pain of a subprime strategy gone sour, they abruptly tightened the reins on credit, sending further shocks through a rolling stock market. “There isn’t a business that doesn’t need credit,” says David Lehmann, a 1984 business administration and marketing graduate who heads the Chicago office of Knight Capital Group. “And all of a sudden, these lines of credit started getting pulled. In a very simplistic way, you can say: ‘once they stop lending, there goes the economy.’”

The subprime morass bludgeoned banks two ways. It led to increased defaults on loans of all types as subprime problems spread to the mainstream economy and led to waves of layoffs. And the mortgage mess left the banks with once-valued subprime assets suddenly turned toxic, as the value of these loans had to be written down or, worse, written off.

Since banks are required to maintain a favorable asset-to-liability ratio, they found themselves on ever-thinner ice as the gap between assets and liabilities narrowed. Now, instead of making loans that would help to revive the economy, “they are banking their money while they continue to revalue their balance sheets,” Lehmann says.

Another jolt of market chaos erupted as the so-called quant shops made U-turns in their investments strategies. Quant shops are hedge funds that run on secretive and very sophisticated mathematical trading models. Often these models produce high returns, but as pandemonium struck the real estate markets, the strategies didn’t work. So the quant shops made rapid tactical shifts. Unfortunately, they all tended to make the same tactical shifts—buying, selling, or selling short at the same time, says Lehmann. And that brought on still more volatility. “It was,” he says, “the perfect storm.”

Stuck in the Bad News Loop

As the pain spread from real estate and Wall Street to the general economy, the mood among investors grew ever more tense. On one day, they would react to a snippet of good news and send the market up. On another day, a dose of bad news spurred a market downturn.

Sometimes, things simply seemed to be falling apart. Consider September 2008. In that month, the government bailed out mortgage giants Fannie Mae and Freddie Mac, Lehman Brothers filed for bankruptcy, troubled Merrill Lynch was acquired by Bank of America, and the Federal Reserve announced an $85 billion rescue of insurance giant AIG. In addition, regulators seized foundering mortgage lender Washington Mutual, lawmakers announced a $700 billion rescue package for the financial system, and Citigroup acquired battered Wachovia.

In better times, neither good news nor bad would likely have caused much of a reaction. “This sort of cycle typically doesn’t start when a lot of good news is coming out because the good news sort of offsets volatility, and investors don’t panic,” says Prachi Deuskar, assistant professor of finance.

“When times are bad, there’s a lot of bad news that comes out, and the initial pieces of bad news get the process going,” she says. Gradually, a feedback loop forms so that volatility and bad news combine to produce still more volatility. “If markets are volatile, then investors are nervous, so they react more to any news,” says Deuskar. “And that makes the markets even more volatile.”
And that’s what happened after the bumpy September of 2008. The markets turned particularly volatile. In October, the Standard & Poor’s 500 index rang up a record nine days in which stocks rose or fell 4 percent or more, eclipsing the monthly record of eight set in September 1932.

While the enormous volume of bad news has generated volatility, the speed with which news arrives these days via internet and cable TV apparently has not had an influence. “When the amount of news is the same, but it arrives quickly, it doesn’t make markets more volatile,” says Johnson. “The markets were enormously volatile after the crash of 1929 when the news didn’t come quickly at all. Back then all they had was the ticker tape, the radio, and the daily newspapers.”

The new bouts of volatility haven’t been limited to the United States. Markets worldwide have been shaken as the economic crisis has spread, and as this happened the ups and downs of U.S. markets has had an impact elsewhere.

“Markets across the globe move together during bad times,” says Deuskar. “So, the Indian stock market tends to go up or down with the U.S. market.”

Calming the Market’s Jitters

Opinions vary on how to quell volatility. Deuskar believes a consistent flow of good news would settle investors’ nerves, thus reducing investors’ reactions to the news in general. “And that would calm markets down,” she says.

Others think the United States must swallow its medicine and reduce massive individual and corporate debt loads. This would require consumers and corporations to tame spending. In the short term, that would inject still more distress into the economy. “It may cause pain to restaurants, manufacturers, and retailers who hope not to take a hit,” suggests Johnson. “But in the long run, it’s a stabilizing force.”

After all, he says, it was debt that triggered the subprime debacle and got the country into trouble in the first place.

— Doug McInnis

Statistical and chronological information for this story came from The Vanguard Group, The BBC, and The New York Times.
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Justin Spring, a 2006 graduate of the University of Illinois, was a member of the 2008 U.S. Olympic Gymnastics team, which won a bronze medal in Beijing. As a Fighting Illini, Spring was also a Big Ten Conference Champion, an NCAA Champion, and a two-time recipient of the Dike Eddleman Athlete of the Year Award. Currently an assistant gymnastics coach for the Illini, Spring continues to train on campus, where you might find him working on the rings at Kenney Gym or, in the case of our photo shoot for this issue of Perspectives, hanging out on the stairway at the new Business Instructional Facility.