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Organizational Ecology
Challenging Old Assumptions about the Life Cycle of Business

AN ECONOMIC PORTRAIT OF TERRORISM

Paul Romer
on Economic Growth

John McMillan
on Markets

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An Economic Portrait of Terrorism
A Stanford political scientist and a Business School economist share their understanding of where terrorism comes from and how it affects global political and economic health.

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Organizational Ecology
How do companies survive their life cycle phases? How do companies influence one another? And how do whole industries change over time? These are some of the questions organizational ecologists ask and try to answer.
BY CHERIAN GEORGE
about this issue

Taking Stock After a Bad Year

I hope you are reading this in a hammock with a tall glass of lemonade and enjoying August, the traditional vacation month, for 2002 has been a year in which we’ve been drenched in a monsoon of headlines about business scandals. Gloomy weather can make one appreciate sunshine, but if we slush around in it too long, it plays havoc with our sense of who we are and our worldview. August is a good time to step back and ask not only how good people go bad but also how we might make it easier for them to stay good.

In a short time, we have gone from a plethora of business news praising celebrity CEOs and stock analysts to daily tirades about scoundrels. Given the evidence of corporate greed and mismanagement, it is hard to call this yellow journalism, but this year’s business headlines portray a kind of hopelessness that may be just as unjustified as the previous irrational exuberance (detailed on page 13 by Ronan McGovern, Sloan ’96). As Professor James Van Horne makes clear on page 7, the current problems have subtle differences, but they are not really new. In fact, our scholars at the Graduate School of Business have been telling us for some time that we were overconfident in the transparency of U.S. market systems. Past issues of this magazine have described GSB research related to problems with stock analysts, CEO pay, accounting conflicts of interest, corporate governance—in other words, nearly all the hot business topics of 2002. Empirical research by Harrison Hong on stock analysts (page 31 in this issue) and by Eric Zitzewitz on stale pricing in international mutual funds (page 28) are just the latest entries in a tradition of research aimed not only at uncovering problems but at making improvements.

Some folks think this research is too dry—we all love a good story about sex, greed, and avarice in high places. But when the gossip dies down, somebody has to be there with substantive information to help us put Humpty Dumpty together again.

Kathleen O’Toole

Letters to the Editor

When Enron declared bankruptcy, the business community suffered its most severe financial and moral sentinel event since the 1929 Crash. The impact of this event sent shock waves through the stock market, financial centers, auditing and consulting firms, Enron shareholders, employees, and graduate schools of business administration and legal colleges. This GSB alumnus with 56 years of postgrad experience has been troubled by the muted response of the GSB to this crisis.

The only GSB response [that I am aware of] has been Dean Joss’s comments in the May 2002 issue (“A Commitment to Lead”). His staunch defense of GSB Dean Emeritus Robert Jaedicke was waffling, considering the compelling evidence of Jaedicke’s complicit role in approving Enron’s false financial endeavors. Jaedicke’s expertise was in accounting/auditing, the very disciplines ignored by the Enron board.

An analysis of the GSB’s courses reveals a paucity of ethics, financial accountability, and moral discipline subjects.

Eugene Danaher, PhD ’46
Tallahassee, Florida

Response from David M. Kreps, Senior Associate Dean for Academic Affairs: When Dr. Danaher writes that an analysis of the GSB’s course offerings reveals a paucity of ethics courses, it is important to know what sort of analysis he undertook. As part of the required (core) curriculum, students begin with 10 classroom hours on ethics. And there are a few electives in our course catalog with names such as Ethics in the Biotech Industry and Ethics and Global Business.

But having specific courses on ethics is, ultimately, the wrong way to teach the subject. Students regard one-off courses as just that—something that doesn’t fit in with the bulk of their lives. Having electives is good, but only if students elect to take the electives, and often precisely the students who would benefit the most from such courses are the students who avoid these electives.

The approach that we take is to weave discussions of ethics and ethical issues into our entire curriculum. The example I know best, because I designed the course and am in the pro-

Continued on page 7 >
A Premium Program Comes at a Price

A YEAR AGO, we concluded a thorough review of whether the operational model at the Stanford Graduate School of Business was still the preferred way to achieve our mission of being the best at providing future leaders with the critical skills needed for lifelong professional challenges. With strong support from you, the alumni, we made a strategic choice to remain small in size but at the top in quality and impact. You told us overwhelmingly that the culture, experience, and success of the School are built on the unique learning experience we achieve through our intimate scale.

That premium formula (high quality, high impact, small size) comes at a price—and at a time when the general costs of education continue to rise relentlessly. It is a constant struggle to generate revenues to keep pace with costs. Although we have raised MBA tuition 40 percent since 1997, tuition and fees in the 2000–01 academic year covered just 51 percent of our $84 million annual operating costs, and we ran a small deficit. This year, I anticipate a deficit of roughly $5 million on an operating budget of $91 million before we close the books in August.

With a smaller student body that distinguishes us from competing institutions (we graduate about 365 MBAs yearly; Harvard and Wharton produce 900 and 800, respectively), we have a smaller revenue stream but similar, rising infrastructure costs. What has driven the increases? First, we’ve invested heavily in faculty. Competition for increasingly scarce faculty has driven up salaries more than 25 percent over the past five years, and we have little endowment support for junior faculty. Medical benefits and teaching support costs have increased even more. Housing costs in the Bay Area exacerbate the problem. But faculty are crucial to a high-quality model with small class size. As new areas of teaching emerge, such as behavioral finance and supply chain management, others do not go away, forcing us to expand our faculty to provide the best curriculum. Despite the difficult recruiting environment, we have been able to attract the right people, and the faculty has grown from 83 to 95 over the past three years.

Second, we have invested in our centers for Entrepreneurship, Electronic Business and Commerce, and Social Innovation. The centers house innovative research, have produced more than 200 new teaching cases, and spearhead community outreach. Third, we have put nearly $12 million into new technology over the past three years just to remain competitive. This includes basic classroom tools such as built-in projection equipment, online course registration, Web technologies, and enhancements to the computer lab.

Finally, over the past five years we have spent $19 million to refurbish our facilities, which do not compare to those of many competing schools, such as Harvard, Wharton, or the University of California, Berkeley, where new buildings have been constructed. Our budget includes no funds to replace our inadequate 36-year-old GSB South building.

Other schools have bolstered revenues with high-priced “executive MBA” programs that allow students to earn an MBA degree part time. At Stanford, we have chosen to stay exclusively with a full-time, two-year, residential program. We simply don’t see how students can achieve the same high-quality transformational learning experience that we offer while coping with a full-time job.

While tuition covers half of operating costs, the contribution from our endowment, which is healthy and safe, has increased from 21 to 28 percent over five years, thanks to gains in investments and gifts. However, our Board of Trustees prudently has fixed the amount of funds we draw annually from the endowment at 5 percent. As a revenue source, annual giving now covers 16 percent of operating costs, compared with 18 percent in 1997.

Reserves will cover this year’s deficit, but dipping into such funds is not a permanent solution. Like our peer schools, we have raised tuition for the coming year—to $33,300, up 7 percent. Expense budgets are being pared back. These moves will help shrink the deficit for next year, but our model cannot persist without sustained financial support. In past years, we positioned the School as the clear leader among schools of management. Consequently, many competing schools moved more closely to our educational philosophy. I greatly value all that the alumni have done in the past year. Today, we have an operating deficit, but I am confident your support will enable us to close this gap so the School can keep investing in the future.

To contact our development office, email or call David Kennedy, associate dean for development, at kennedy_david@gsb.stanford.edu or 650.723.3355.
Diamonds Are the Bachelor’s Best Friend

The Washington Post called it “trainwreck television” and the TV critic for the GSB Reporter called it just plain “boring,” but 10 million Americans watched the School’s most famous bachelor winnow 25 wannabe wives down to one winner on ABC’s six-week series The Bachelor last spring.

Alex Michel, MBA ’98, played the role of Mr. Right, planning everything from sushi dates to horseback riding with each of the women who agreed to move into a Malibu house and compete for his attention before TV cameras. Michel’s classmate David DiDomenico said his friend was the perfect choice for the role: “He’s an incredibly brilliant guy, and he has a level of charisma that is Clintonesque.”

The serious financiers among Michel’s GSB classmates and current MBA students participated in betting pools that were organized like basketball elimination tournaments around the show. (During each episode, Michel chose which women would be permitted to compete for his attention the following week. In one case, a rejected woman hyperventilated and an ambulance was called.)

“One short one woman?” one MBA student asked student pool organizer Dan Ho. “We do not allow shorting,” he responded in an email, because “it would hurt her feelings if she found out. But if you really must, set up a side bet with someone else.” One group of Michel’s friends reportedly were trading options on various contestants in a $1,200 pool that included conference calls, the New York Times reported.

During the hoopla period, Michel came back to campus to attend a conference of media executives and agents hosted by the MBA Arts, Media, and Entertainment club. First-year student Sanam Lari tracked him down for the Reporter to ask if he had any dating wisdom for “GBS boys.” His reply was quick and simple: “Having a diamond necklace on hand never hurts.”

Chalk Leaves PowerPoint in the Dust

MARKETERS PRAISE the latest information technologies as learning tools, but after 27 years of teaching, Professor Edward Lazear believes “the blackboard is far more effective than overhead transparencies or slick PowerPoint presentations.”

“Writing on the blackboard is a signal to students that a point is particularly relevant, and it constrains the instructor to present the material at a rate closer to that at which students can absorb material,” he writes in the introduction to a Hoover Institution book on education reform that he edited. “An overhead or slide presentation often offers too much information in one short interval and, by overwhelming the students, ends up putting them to sleep.”

As for formal research on classroom aids, Lazear writes, “Although it is difficult to argue that additional resources do not have some value, the evidence on technology has been weak at best and more often negative.” His book, Education in the 21st Century, includes a critique of many popular educational reform ideas. It can be downloaded at www-hoover.stanford.edu/homepage/books.ed21st.html.

React, Don’t Overreact

EXPECT ACCOUNTING FIRMS to “walk away from clients, even well-respected clients, when they have a different opinion” about accounting practices, the chief financial officer of Costco Wholesale told MBA students at this spring’s Arjay Miller Lecture.

Richard Galanti, MBA ’82, also said he had noticed a change at meetings of the audit committee of the retailer’s board of directors since the Enron/Arthur Andersen accounting scandal erupted. “I see a much greater level of seriousness in their view and more interest in what they should be understanding.”

While he views the fallout from the scandal as “good for everybody,” Galanti said he was dismayed by the number of companies “who early on dumped Arthur Andersen as their auditor after 30 years of doing business with them.” Costco management supported Arthur Andersen, he said, because of loyalty to the Andersen employees they had worked with for 18 years. “The individuals we have worked with have done nothing wrong,” he said. They worked in Andersen’s Northwest regional office, now acquired by KPMG.

TV May Be Good for Your Health

IF YOU ARE one of those TV viewers who swears your government should never have permitted prescription drug companies to advertise their wares directly to you, the CEO
of Pfizer Inc. has some statistics he’d like to share:

Pfizer’s ads for Viagra during the past three years convinced 3 million men to see their doctors. Of those, 50,000 had seriously elevated blood pressure and 40,000 had undiagnosed diabetes. “We estimate that [direct-to-consumer] advertising will save 10,000 lives a year,” said CEO Hank McKinney, Sloan ’66, MBA ’67, and PhD ’69. The media have ignored this, he complained during a View from the Top lecture spring quarter. “If we killed 10,000 a year, that would be considered big news.”

Finding the Gold in Sports Management

For many professional athletes, the decision to retire is like crashing into a brick wall at 50 mph. “I’m one of the best in the world at what I do, and now I’m not doing it anymore,” Steve Young, former San Francisco 49ers quarterback, told a Business School class. “That’s the cliff every professional athlete eventually falls off of,” he said.

Young was one of dozens of sports figures who shared their experiences with MBA students in the winter quarter course Sports Business Management, co-taught by management professor George Foster and Bill Walsh, former 49ers general manager. Class sessions focused on the formation of the Women’s National Basketball Association, major league contracts with network television, corporate sponsorship of athletic events, and the relationships of top athletes to sports agents, among other topics.

Guest speakers helped students delve into all levels of sports business, from international competition to amateur organizations. Visitors included Rich Kelley, MBA ’89, a former NBA player who is currently an adviser to the San Francisco Giants baseball team, and Anne Cribbs, an Olympic gold medalist in swimming and head of the Bay Area Olympic bid for 2012. “My favorite case was ‘Life as a Minor League CEO,’” said one student. “That was where the intrinsic passion and excitement of sports—the reason I am interested in sports management—came through.”

Finding the Gold in Sports Management

How to Beat the Chill

Sounding reminiscent of the generation that survived the Great Depression, venture capitalist Geoff Yang recently gave would-be entrepreneurs some advice on how to survive an economic winter. A founding partner of Redpoint Ventures, Yang, MBA ’85, helped start such media companies as Ask Jeeves, Excite, and TiVo, all struggling in 2002.

Speaking at a campus banquet of the Asian American Business Students Association, Yang predicted no major economic recovery until 2003. In the meantime, he offered the following tips: Reduce your cash burn rate to survive the winter, raise money before you need it, focus on the one thing you do best, and take longer to get your product to market if it saves cash.

Whereas the entrepreneurial mindset in the late nineties was to think of “return on equity as a function of time,” Yang said, today’s entrepreneurs see it as “a function of tangible business progress reaching real milestones.”

Ebay’s History Shaped by Alums

The rise and enduring success of eBay can be attributed to its founders’ idealism about community, technological know-how, blind luck, and business smarts. A large dose of the latter, according to a new book about the Internet’s most profitable e-business, came from Stanford Business School alumni.

The Perfect Store (Little, Brown and Co., 2002) by former Time reporter Adam Cohen recounts how, in eBay’s early days, Jeff Skoll, MBA ’95, “was convinced that no matter how well eBay was doing, its success could evaporate at any time.” Skoll, the firm’s first full-time employee, held this cautious outlook, informed by observations of the too-rich-too-fast mistakes made by fellow GSB alumni with their Internet startups. His conservative approach allowed Skoll to steer the fledgling company through uncharted territory at the dawn of the Internet age.

Other Business School alums who played pivotal roles in eBay’s success include Steve Westly, MBA ’83, and Bob Kagle, MBA ’80. Kagle, who is a partner at one of Silicon Valley’s leading venture capital firms, gave the nod to the deal that “led to one of the most richly rewarded investments in the history of business,” according to Cohen. And Westly’s hire, along with associates Tom Adams, MBA ’95, and Richard Rock, MBA ’96, signaled the company’s transition from flaky startup to professionally run business.

Though Skoll and founder Pierre Omidyar had relinquished day-to-day operations by the end of 2001, their guiding principles remain as object lessons for the next generation of entrepreneurs: “Spend the money like it’s your own” and “The community knows best.”

Harrell Chronicled

EBay’s History Shaped by Alums

Thomas Harrell, the Business School professor who reported that athletic, outgoing MBAs were more likely to succeed in business and that marriage helped men’s careers but hurt women’s, died at age 90 at his home in Portola Valley in April.

An applied psychologist who joined the School in 1952, Harrell spent much of his career publishing studies of Stanford MBAs who graduated from 1961 to 1965. Among his findings were that high-wage earners and general managers tended to be communicative, outgoing, energetic, and athletic. Harrell’s work, much of it done jointly with his late wife, Margaret, a statistician, also disproved the stereotype that businesspeople have to step on others to get ahead.

“This was a very distinctive piece of research,” said colleague V. Seenu Srinivasan, a marketing professor who also studies successful business managers. He praised Harrell for tackling slippery variables such as personality and choosing long-term study rather than quick snapshots.

Harrell’s research on disparities between men and women with Stanford MBAs grabbed headlines in the early 1990s. His 1993 study showed that women were soon earning less, getting fewer promotions, and reporting less job satisfaction than men, although they started out on relatively equal footing at graduation. In 1991, he reported that marriage helped men’s careers yet hurt women’s.
FOR THE RECORD

Class of 2002 Commencement

DEGREES GRANTED
MBA ............................................ 368
JD/MBA ............................................ 6
PhD .............................................. 9
Master’s In Business Research ........... 9
MS (Sloan) ..................................... 48

CERTIFICATES
Global Management ...................... 100
Public Management ....................... 88

MBA AWARDS
Alexander A. Robichek Award
Achievement in finance courses: Robert Scott Berg

Ernest C. Arbuckle Award
Contributed most to the fulfillment of the goals of Stanford Business School in and out of the School: Damon Vangelsis

Henry Ford II Scholar
Top scholar: Robert Scott Berg

Arjay Miller Scholars
Top 10 percent of the class: Julian Niall Abdey
Robert Scott Berg
Nathan Winfield Brown
Richard Tad Callister
Aaron Joseph Cheris

Boom Time for Public Management

Eighty-eight members of the MBA Class of 2002 were awarded certificates from the Public Management Program (PMP) this year, up from last year’s record of 36. On top of that, nearly all Stanford MBA students are taking at least one of the 35 public management electives now offered.

In recent years, more students had wanted to earn the certificate but found it hard to meet all of the required courses. In late spring 2001, students and staff worked with faculty to restructure the requirements.

“The newly expanded course offerings reflect the School’s leadership and commitment, not only to abundant PMP curricular and extracurricular opportunities, but to learning in the classroom as well,” said program director Julie Juergens. “It is one of the areas that differentiates the gsb.”

Besides general courses, the program now includes sector-specific offerings related to the environment, education, health care, international development, ethics, and entrepreneurship.

Advertisers Target Videogames

Videogames are less risky to develop than movies and can draw more viewers than television shows, speakers said at the School’s annual Future of Content Conference winter quarter. That has prompted advertisers to come up with “advertgamed” —sponsored games used as a marketing medium.

Keith Ferrazzi, president and CEO of game company YaYa, said games can be an effective way to “bribe” people into providing personal information. Online games also can be used to reveal aspects of consumers’ psychology. “You put a lot of yourself into a game,” he noted.

Among YaYa’s products is Spinopolis, an Internet game created for the electronics and engineering company Siemens AG to reach out to customers of its infrastructure services. Players work to build an efficient city. According to Ferrazzi, high-scoring Spinopolis players include Michael Bloomberg, the mayor of New York City.

Parting Words

At the Dean’s Reception last fall, Kathy Nicholson found herself talking with Jack Kolodny and Sarah Stein, all MBA ’02, about how much they had enjoyed the inaugural Second-Year Seminars, small week-long courses that preceded the start of the academic year last fall. Wouldn’t it be nice to end their year, one said, on a similarly strong note. That led to the idea of a “last lecture” series by their favorite professors. The threesome took the idea to David Kreps, senior associate dean, who offered to support the series if the students would organize it.

“We were hoping to fill a classroom with 66 students and were ecstatic when the demand reached more than 100,” says Nicholson. Offered as a 1-credit course involving no tests but mandatory attendance at two back-to-back lectures on Thursday evenings for each of five weeks, the series drew 130 registered students and dozens of faculty and staff.
The 10 professors, who each delivered one lecture, tended to speak less formally than in their usual classes, students said. Whether they were talking about entrepreneurship, leadership, or accounting, “the passion shown by the professors created an overwhelming, positive response” from students, Kolodny said.

The administration was impressed too. “I thought it was a considerable success,” said Kreps, “and I’d like to make it a tradition of the School.”

**New Board Advises on School Operations**

“In addition to striving to be the best school of management in the world, the gsb also aspires to be the best-run school of management in the world,” begins the mission statement for the School’s new Management Board, which holds its second meeting Sept. 19.

Composed of graduates of the School, the board will provide external perspective and advice to gsb senior management on key operational issues.

The establishment of the “highest character and competence,” but he certainly got rolled by management. Whether he did anything illegal is not the question.

The connection to the piece on markets? Some have said that Enron’s collapse proves that the market works. Is it working when billions are lost, California electricity consumers get shafted, jobs go down the tubes, pensioners lose their all, and a financial industry can do nothing but point fingers at others? I like McMillan’s final paragraph, which begins, “Markets are not miraculous.”

**No Shortcuts Around the Balance Sheet**

The Enron Corp. collapse may have been the “neutron bomb” of accounting problems, but today’s financial statements in general can be misleading, according to James Van Horne, the A. P. Giannini Professor of Banking and Finance.

Instead of looking to income statements to determine a company’s true worth, Van Horne recommends investors pay careful attention to the balance sheet. “In the final analysis, one must turn to an in-depth evaluation of the flow of funds through the balance sheet,” Van Horne suggested during a Last Lecture series presentation (see “Parting Words” on page 6).

While most of the public attention has been on allegations of fraudulent accounting and business practices at companies like Enron, the problems with income statements go far beyond such egregious examples, he said. “Even without fraud, the financial statement can be misleading.” He suggested being wary of an increasing debt ratio, recurring write-offs, multibusiness companies that aggregate sub-businesses to hide information, and unusual quarterly patterns and expenses.

Evaluating the balance sheet involves taking the time to check “the conversion of inventories into revenues, then into receivables, and finally into cash. On the other side of the balance sheet, the conversion of purchase orders into accounts payable, and then into the payment of accounts payable, and, ultimately, debit to cash. The combination of these two conversion cycles gives us the overall operating cash cycle of a company.” For more details from the lecture, see http://www.gsb.stanford.edu/news/vanhorne.html.

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**Letters Continued**

I write in response to Dean Joss’s May column, “A Commitment to Lead.” Joss notes that it is too soon to judge ex-dean Bob Jaedicke, head of the audit committee of Enron’s board of directors, I find it ironic that it should appear in the same issue as John McMillan’s piece on markets.

Loyalty to Jaedicke is commendable, but he failed to do his job. Jaedicke may have been of the “highest character and competence,” but he certainly got rolled by management. Whether he did anything illegal is not the question.

The connection to the piece on markets? Some have said that Enron’s collapse proves that the market works. Is it working when billions are lost, California electricity consumers get shafted, jobs go down the tubes, pensioners lose their all, and a financial industry can do nothing but point fingers at others? I like McMillan’s final paragraph, which begins, “Markets are not miraculous.”

**On page 29 of the May 2002 issue** writer Helen K. Chang quotes Romain Wacziarg, assistant professor of economics: “Trade economists know that a country opening up to trade will specialize in certain sectors, putting resources into producing goods and services that are more efficient, and abandoning those that are relatively inefficient.”

This businessman and Stanford MBA (from a class exposed to professors of business economics Theodore Kreps and Jesse Allen, who were also involved with the real world) has observed that the many countries opening up to international trade in the last 10 years have mainly specialized in low wages and unenforced labor and environmental laws. Multi-nationals built or leased many maquiladoras along our Mexican border to produce a wide range of goods at substantially lower costs than their U.S. employees did.

Then plants started moving to the Philippines, to Indonesia, and now to China for government subsidies and extraordinarily low wages. (At present, more than 50 maquiladora facilities have been vacated in pursuit of lower wage and bribery costs.)

Now there are some 800 tech support centers in India taking advantage of relatively low wages for English-speaking engineers there.

None of the foregoing are examples of “comparative advantage”—at least not in any benign meaning of the term.

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David M. Kreps
Wanted: A Company to Call Their Own

For those entrepreneurial types who aren’t keen on starting a company from scratch, creating a search fund to buy an existing business may be the way to go.

Josh Greenberg remembers the day he sat down in a Los Angeles conference room to talk to three men about buying their company. All three owners were in their sixties, while Greenberg and his partner, John Fowler—both Business School Class of 2000 alumni—were half their age.

“I want to be tactful here,” said one of the owners as the meeting began, “but I have daughters who are older than you. What makes you think you can sit in this chair and run this company?”

A new MBA, Greenberg couldn’t say he’d had years of experience or that he knew the industry inside out. He had just formed his search company, Montebello Capital, a few months before. Yet his goal was indeed to sit in the CEO’s chair and run a business that someone else had built, to get to know it and make it his own.

In the course of the meeting, Greenberg realized he would have to sell himself before the company’s owners would even think of selling their business to him. But that challenge is just one part of Greenberg and Fowler’s endeavor: They have raised a search fund and are seeking to buy an existing company, which they plan to manage themselves.

Search funds consist of money raised to allow an entrepreneur time and resources to research, find, and buy a company. Despite the uncertainty inherent in the model—it can be difficult to find a good company to buy and tough to convince its owners to sell, among other challenges—search funds are rapidly gaining in popularity among Stanford MBAs and those still studying for their degrees. Search funds are a remarkable shortcut for today’s new entrepreneurs who want to own and run a business.

“It’s the most direct route to owning a company that you yourself manage,” says H. Irving Grousbeck, Class of 1980 Consulting Professor of Management, who pioneered the search fund model. Since search funds began in the mid-1980s, Grousbeck has promoted them as an ideal way for new MBAs to get management and operational experience quickly.

The first search-funders were students who approached Grousbeck when he was teaching at Harvard Business School in 1984. They began with $80,000 they planned to use to pay their expenses while seeking a company to buy and soon raised more money. After their success, the model began gradually to gain followers. Today, the GSB’s Center for Entrepreneurial Studies has knowledge of about 60 individuals who have raised search funds, about 25 of them Stanford MBAs. Searchers do not need an MBA—theoretically, anyone could raise a fund—but the MBA stamp “gives investors some comfort,” Grousbeck says.

And a Stanford MBA seems to help most of all—especially for those students who encountered Grousbeck, who has made himself available to advise many prospective search-funders. A search fund begins with the prospective entrepreneur talking with previous search-funders and reading about their experiences. Most launch their project at the School’s Center for Entrepreneurial Studies, where Linda Wells, MBA ’93, director of programs and resources, keeps the most extensive

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JOSH GREENBERG REMEMBERS THE day he sat down in a Los Angeles conference room to talk to three men about buying their company. All three owners were in their sixties, while Greenberg and his partner, John Fowler—both Business School Class of 2000 alumni—were half their age.

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files in the country on search funds. (She gets calls not just from Stanford students and alumni but also from Harvard and the University of Chicago.)

Wells has seen the number of inquiries skyrocket of late. “For a while, I was handling five inquiries a week,” Wells explains. In the past year, five Stanford groups have begun to raise funds, and at least two additional sets of graduating students have formed groups.

After doing the preliminary research, the next step is raising an initial round of money, usually around 15 units of $15,000 or 20 units of $20,000 in seed capital. Entrepreneurs use this money (the “search fund”) to pay expenses for the approximately two years they plan to spend searching. Investors buy an option to invest further once the company is found (they are given pro rata right of first refusal on the investment) and often get a stepped-up investment as well (their $20,000 could be worth a $30,000 chunk of the company). To acquire the company, investors chip in, and the balance of the transaction is financed through equity or debt.

But how can recent graduates who have no real experience step in and run a company? That question is at the forefront of many sellers’ minds, as Greenberg learned. It may not be as hard as it sounds. Grousbeck has a favorite metaphor he uses to describe his approach.

“The company is like a horse and jockey going around a track,” he says. “Very gradually, you change jockeys. Your objective is just to keep the horse running around the track until you familiarize yourself with the situation. Then, after one or two years, you can make changes,” Grousbeck explains.

It’s a model that worked for Jim Ellis, MBA ’93. Working after graduation as a casewriter for Grousbeck, Ellis overlapped with Kevin Taweel, MBA ’92. Although Ellis had worked as a consultant and Taweel had been an investment banker, both knew they wanted to pursue entrepreneurial careers. But they realized that they lacked specific ideas for forming a startup and began to consider buying an existing company.

Ellis liked the fact that older companies are more stable than brand-new companies. “It seemed like a lower-risk approach to being an entrepreneur,” Ellis says. “The idea behind the search fund is that you’re purchasing a successful, ongoing business.”

Ellis and Taweel raised a fund together and started investigating the towing business, admittedly an “unsexy” industry. After making offers on 20 towing companies, they decided to seek farther afield, delving into the dispatch business. “That turned out to be a pretty good business for us—it’s not as difficult; there aren’t as many bad capital issues,” Ellis says. They made an offer on Road Rescue, a 40-employee company in Houston, Texas, in 1994 and were owners by 1995.

Today, their company—now relocated and called Asurion—has expanded into wireless services and grown by 40 times. Last year it won Ernst & Young's entrepreneur of the year award for Northern California. The investors are happy—they have received from 30 to 40 times their original equity investment in return. Taweel and Ellis plan to keep the company until they can no longer grow it. Grousbeck is still a mentor: He sits on the company's board.

For the past five years, search funds had been losing favor as company owners asked outrageous sums for their businesses in light of the stock market’s heady rise.

But today, search funds are back in play as company valuations have come down to earth. It also has become easier to find investors as the search fund model has gained more exposure. Some investors already have been part of a previous search fund and know what to expect.

There are a few issues, however, that should make prospective search-funders think twice. First, it can be impossibly hard to find a good company to buy. Locating the right company to purchase—and convincing its owners to sell—can take years, and at times, it never happens at all. Then investors lose out completely, and searchers have seen years of their lives vanish. Stanford grads sometimes have a tough time sorting through companies because they tend to have more insight into the pitfalls of a business, Grousbeck says. “They’re such good analysts,” he remarks. “Those that don’t buy a company are maybe too picky.”

Gaining bank financing is another hurdle—more of an issue today after many banks were burned with bad debt in the dot-com bubble. In addition, small deals never have been much of an attraction for investment bankers. Many search-funders are turning to sellers and asking them to provide financing options through installment payments and sellers’ notes.

Another downside is that the long months of searching for a company can be lonely and isolating, Grousbeck says. Ellis advises joining industry trade groups and doing as much networking as possible—a convenient way to do research and be social at the same time.

But the upside at the end of a search fund—owning and running your own business within, say, two years after forming the fund—keeps pulling them in. Josh Greenberg knows that search-funding is taking a toll on his wife, Susanna, MBA ’00. For now, she is the primary breadwinner in the family, and she must live with the thought that her husband may have to move to Ogden, Utah, or even farther afield, to be near the company he eventually buys. But it’s still worth it, for a few reasons. Not only does Greenberg get to work every day with his dog, Dignan, and one of his best friends, Fowler—he also is grateful whenever he walks into his office and sees the “Montebello Capital” sign on the door.

“Every day I see that placard, I think, this is great,” he says. “There are little nuggets of gold out there. With a search fund you buy the time to turn over the rocks and look for them—that’s an incredible experience.”

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SEARCH TIPS
Dos and Don’ts

- Both Irving Grousbeck and Jim Ellis have a lot of advice for search-funders seeking companies to buy. Their wisdom can be boiled down to these essential points:
  - Focus on a growth industry where there are a lot of candidates.
  - Pick a business without one dominant competitor.
  - Avoid businesses that are complex and have slim margins. Business should be simple and easy. Eliminate those deep in high tech, with multiple locations or complicated manufacturing processes.
  - Consider “unsexy” businesses, such as towing, cardboard boxes, and liquid waste.
  - Target businesses that generate $10 million to $25 million in sales.
  - Avoid businesses subject to risks you cannot control, such as intense federal regulation.

- Look for a business that is stable and profitable, with recurring revenue.
THROUGH THE YEARS, the Business School has benefited from employing staff members who understand the School’s environment from a student’s perspective. Currently there are 18 alumni/ae, hailing from the Classes of 1975 to 1999, who serve in full- or part-time positions in various departments around the School. We thought you’d like to know who they are.

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<td>David Hoyt, ’79</td>
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<td>Dan Rudolph, ’81</td>
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<td>Director of Programs &amp; Administration, Center for Entrepreneurial Studies</td>
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<td>Laura Moon, ’96</td>
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<td>Sharon Hoffman, ’91</td>
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<td>Victoria Chang, ’98</td>
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<td>Libby Driscoll Havka, ’92</td>
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Photographed by Peter Stember
Living in Limbo with “Don’t Ask, Don’t Tell”

A long court battle leaves Zoe Dunning, MBA ’93, the lone openly gay member of the United States military. She’s fighting to change that.

On Saturday, Jan. 16, 1993, Zoe Dunning, a lieutenant in the U.S. Naval Reserve, was a second-year student at the Graduate School of Business, and William Jefferson Clinton was about to become President of the United States. During his campaign Clinton had promised to lift the ban on gays in the military. Dunning, a U.S. Naval Academy graduate with six years’ active service, decided to nudge him along. Appearing at a rally at California’s Moffett Field, Dunning publicly declared herself a lesbian. The following week she was informed that discharge proceedings would be brought against her.

“I don’t think anyone knew gays in the military would become a major issue of Clinton’s first year,” Dunning says. “And I didn’t really know what I’d signed myself up for. I never thought it would be the two-and-a-half-year legal battle that it turned out to be.”

Dunning won the battle, but in a larger sense she lost the war. The Navy has promoted her twice since she came out—once, ironically, while she was still fighting to remain in the reserve—and she now holds the rank of commander. She also holds the distinction of being the only openly gay member of the U.S. military. Which, of course, is part of the loss.

“The reason I did it was to change the military’s policy, not just to win my own case,” Dunning says.

Dunning’s successful defense—that identifying oneself as homosexual represents status rather than conduct—cannot be used in any other cases. “What they did after I won was to send out a memo saying the defense I used was no longer valid. Typical military!” She laughs. “If they lose, then they change the rules.”

As for the military’s antigay policy, it is more entrenched than ever. When Clinton took office, a presidential order could have overturned it. But the furor surrounding the issue became so great that Congress augmented the policy with legislation. Now only the courts or the Congress can change “Don’t ask, don’t tell.”

Unfortunately,” she notes wryly, “no one is ever held accountable for asking.”

While Dunning’s case was still before the Navy, the newly graduated MBA joined consulting firms Deloitte & Touche and A.T. Kearney before following the e-commerce rush to Webvan. “Webvan wasn’t quite the Internet glitz that everyone made it out to be,” the former supply officer says. “Basically, I found myself chasing down Cheerios in a 300,000-square-foot warehouse. Webvan was a great experience because it was a new business. But after a while I felt stagnant doing the same job with the same responsibilities.”

Dunning now consults independently on a variety of situations but has an understandable interest in diversity training. In April, for example, she worked at a three-day conference put on by IBM for their gay, lesbian, bisexual, and transgender managers and executives to build leadership skills. The previous weekend she had been a keynote speaker at the annual Reaching Out Gay MBA conference in Chicago. “They wanted to know: ‘Do I go out and prove myself and make myself indispensable and then come out? Or do I come out immediately and find out what happens?’ There is no one answer, she says. “But to the extent they can be out
I think it’s great, because it facilitates workplace equality.”

Fairness and equality in the workplace are major concerns for Dunning, and she draws on her experience with the military when she addresses the subject. “The military is the nation’s largest employer and it discriminates,” she says. “Not only does it discriminate, it is forced by law to discriminate. Last year 1,250 service members were kicked out. Given 9/11, you’d think they would want many of our most talented people. But even as they’re calling up reservists, they’re kicking out gays and lesbians.”

Dunning is now entering her 11th year in the Naval Reserve. Currently, she is working with a unit that acts as an internal management consultant for the commander in chief of the Pacific Fleet. It’s a unit that calls for business consulting, finance, and high-tech experience. “We bring business best practices to the military for the Navy and the Pacific Fleet,” she explains.

“When 9/11 happened, like everyone else I felt a desire to contribute,” Dunning says. “I spent a week down in San Diego helping to mobilize troops for Naval Coastal Warfare Group One, which does harbor defense and security. Then I spent five weeks with the commander of the Third Fleet and his staff on board the USS Coronado in San Diego. Last year 1,250 service members were kicked out. Given 9/11, you’d think they would want many of our most talented people. But even as they’re calling up reservists, they’re kicking out gays and lesbians.

We had a couple of ships off the coast of California that were providing surveillance and first line of defense against anything incoming toward the United States. I also spent five weeks preparing the John C. Stennis Battle Group for accelerated deployment to the Middle East. They were not scheduled to deploy until January or February. They left in November, the day after we were done.”

Relaxing after work in her brown-shingled San Francisco cottage, built as a haven for survivors of the 1906 earthquake, only Dunning’s wrinkle-free blouse and spit-polished shoes give away her years in the military. Looking back on the choices she’s made, she says simply: “I have no regrets.”

From all reports, Dunning is respected by her fellow officers. She doesn’t hide the fact she is a lesbian, nor does she push it. “The role I’ve settled into,” she says, “is this: to be the only openly gay member of the military and by my actions try to disprove the foundations of the argument against gays in the military, that they are disruptive to unit cohesion and morale.

“Part of my original attraction to the military was that it gave me a sense of greater purpose. My greater purpose now is to change its culture, person by person, with every single interaction I have. You know, we MBAs have a tendency to make grand gestures and create visions and do things on a macro scale. We can change policies, but I think in the end what truly creates cultural change is one-on-one interaction.”

first person

BY RONAN MCGOVERN, MS SLOAN ’96

It’s the Cash Flow, Stupid!
A dot-com investor confesses to a fit of irrational exuberance.

E conomists are sometimes defined as people who don’t believe things work in practice until they can be proven in theory. Not surprisingly, during the dot-com bubble the behavior of investors befuddled these economists. Very few dot-com investors consulted their financial theory textbooks before making investments in the stock market. In fact, many did not even understand the businesses they were investing in. To understand the dynamics of valuations during the bubble, it is necessary to look at investor practice.

Like many others, I had a rush of “irrational exuberance.” With hindsight, my only regret is not that I joined in the gold rush but that I became exuberant at a time when the bull market was 95 percent of the way up the incline. Although it went against everything I ever learned in finance, I began to believe that I was missing the much-touted “New Era Economic Thinking.”

During the boom, the stock market valued dot-coms that were incurring negative cash flows more highly than companies generating profits and positive cash flows. We had irrationally exuberant investors driving stock prices beyond what cash flows could justify and so-called professionals trying to rationalize why this was correct! Later, cash flows acted on valuations the way gravity acts on matter: The lower the cash flow, the greater the downward pull on valuation. The Bill Clinton mantra, “It’s the economy, stupid,” kept his people’s focus on the central role that the U.S. domestic economy plays in American voting behavior. I could have done with an adviser reciting a mantra about the fundamentals of company valuation: “It’s the cash flow, stupid.”

In the aftermath of the roller-coaster ride, I returned to my finance books and re-learned the basics of how to value a business. According to “efficient markets” theory, the stock market valuation of a firm is the outcome of all available economic information about that firm. But the theory is based on the assumption that investors act rationally and therefore stock prices are always a reflection of value. The dot-com bubble presents a challenge to efficient markets theorists because of the obvious stock mispricing that lasted for quite some time without a correction by the market.

When the cash flow performance of Internet companies became clear and reliable estimates of cash flow became possible, two things changed that had an impact on stock market valuation: Investor enthusiasm for dot-coms collapsed, and valuations became aligned with the emerging reliable estimates of future cash flow performance. In other words, in the aftermath of the dot-com crash, long-established valuation principles were restored, and a new generation of investors has learned old lessons in finance.

Ronan McGovern, MS (Management) Sloan ’96, is associate director of the corporate finance division of Allied Irish Bank in Dublin, Ireland. The full text of this article was published in Ireland in the Jan. 13, 2002, Sunday Business Post.
Jon Abbott, MBA ’88

has its digital version, while the other easily will meet the FCC deadline. His experience facilitating change, some of it obtained while he was at the Business School, is clearly paying off.

When the president of KQED Radio, San Francisco’s public station, came to lecture at the School in 1987, Abbott offered his help in converting the station’s format from a combination of newscasts and classical music to all-news. “They didn’t have the money [for an intern],” Abbott recalls, so he volunteered to apply for summer internship assistance through the Stanford Management Internship Fund (SMIF). Previously student-funded, the 20-year-old program that supports students who choose to work in nonprofit summer jobs is now funded also by the School.

“It was a great summer. I just lived at the studios,” Abbott says of 1987. Working on a marketing plan, he facilitated the format change by mapping its potential benefits and stayed on after graduation.

“It’s great when you take a set of resources and try to figure out how to make the most of them,” Abbott says. “Television is changing and it’s fun [to figure out] how to change with it.” — BRIAN EULE

Laura Esserman, MD, MBA ’93

Laura Esserman pushes back from her computer and swivels toward the desk. Like every other surface in her office, it is covered with physician stuff and kid stuff, research papers mixed with family memorabilia. Perched on a bookshelf, a cookie-tin carousel with tongue depressor struts completes the theme.

Esserman has been working on a grant proposal, due the next day. “This part of my life is all about management,” she reflects. “Managing my house, managing the people who work for me, managing my expectations of what I can accomplish.”

Esserman, mother of a 7-year-old and an 11-year-old, is associate professor of surgery and radiology at the University of California, San Francisco, and director of the Carol Franc Buck Breast Care Center.

Collaboration is the key to care at the Buck Center—among specialists in a dozen fields as well as between doctor and patient. The center, which has as many as 30 different clinical studies going at any given time, offers one-stop, multidisciplinary care—from single-day assessment of suspicious lumps to a multidisciplinary second opinion panel through medical and surgical care and follow-up. “We offer all the possible services you could need for a person who is worried about or has a diagnosis of breast cancer,” Esserman says.

Using information technology, Esserman is trying to extend the concept of real-time collaboration to other medical centers. She has been working with the data visualization company Maya Viz and database giant Oracle as she plans a database where medical centers can share information instantly to help patients identify trade-offs, evaluate risks, and make informed choices about their own treatment. She also is working with Business School Professor Emeritus James R. “Jerry” Miller, who has developed a methodology to create individually tailored patient prognoses from a database.

“Medicine is about risk management and information,” Esserman says. “The tools we learned in business school are applicable to medicine. The problem is, in medicine we have not yet learned how to leverage technology in an appropriate way.” She leans across the desk for emphasis. “You know, if the CEO of Macy’s can know how many red dresses a sales clerk in Wichita is selling at any given time, we ought to have that kind of capability in medicine, where the stakes are far higher.” — JANET ZICH
Executive Education at the Stanford Graduate School of Business can make a difference to the future of your organization. Our highly interactive executive programs offer an intensive learning experience with the world’s foremost business faculty. You will explore leading-edge management concepts, test ideas against peers, challenge assumptions, and ultimately leave with an in-depth understanding of critical issues and frameworks for problem solving.

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April 27 – May 2, 2003
An Economic Portrait of Terrorism

ELEVEN MONTHS AFTER THE DISASTROUS ATTACKS ON THE WORLD TRADE CENTER, the American government and its allies are grappling with how to wage an international “war on terrorism.” It would help to know more about how terrorists are created, why they operate the way they do, and how they affect the globe’s economic health and political stability. We asked a Stanford political scientist and an economist, each of whom have studied some of the causes and effects of post–World War II political violence, to apply their insights to the current situation with terrorism. Their remarks to a Business School audience in March are excerpted here. Political science Professor James Fearon finds evidence to dispute some of the commonly suspected triggers of political violence, and he suggests that government responses to terrorist actions are critical to terrorists’ success. The Business School’s Romain Wacziarg, assistant professor of economics, highlights how political violence affects a country’s economy. While military spending can expand an economy in the short run, he says, “it’s hard to find a measure of violence that actually has a positive effect on economic growth.” GSB Professor David Brady, a political scientist whose expertise is American politics, moderated the discussion.

PHOTO ILLUSTRATION BY EDWARD GAJDEL
JAMES FEARON  Almost all deliberate attacks by organized groups on civilians occur in the context of civil wars. (That isn’t a great definition of terrorism, but it’s a decent start.) In my research with another Stanford political scientist, David Laitin, we define civil wars by several criteria, but basically as a conflict internal to a state that kills at least 1,000 people. Over the whole post–World War II period you see a steady, gradual increase in such conflicts.

There are about 25 such conflicts going on now; about 122 or so since 1945 have reached the 1,000-dead threshold. They have killed—this is a very rough but probably conservative estimate—about 16.5 million people, compared to about 3 million for interstate wars in the same period. We don’t have exact numbers, but certainly a very large majority of the dead are civilians who were killed in the context of what looked on the local level like terrorist attacks—by rebel forces or by government forces in reply.

Why so many civilians dead? Overwhelmingly, these wars are fought as guerilla wars. If the environmental conditions are right, you need very few people to get a significant guerilla war going, in some cases hundreds but typically 1,000 or 2,000 people. Such small numbers of rebels can survive by hiding among the general local population or in rough terrain. A standard rebel tactic, especially at the start of these wars, is to intentionally provoke violent retaliation by government forces, hoping that they will burn, loot, pillage, and kill in an indiscriminate fashion. This helps small rebel groups recruit more people to the movement.

There’s a parallel with Al Qaeda. We should think about the 9/11 attacks more as a recruiting effort directed at a Muslim audience than as just an expression of hatred of the United States. As in the early phase of a guerilla war, the idea was to provoke a big response that the terrorists hope will be highly indiscriminate. The idea was to give credence to the notion of a war against Muslims in which the alleged enemies of Islam—the U.S. and the western powers—are aligned with the Muslim governments in the region that Al Qaeda doesn’t like.

Why do some states have civil wars and others don’t? One very common theory argues that countries at risk for civil war and terrorism are states that have lots of ethnic groups or religions. We don’t find much evidence for this hypothesis. We have coded the average number of civil wars in about 160 countries over this whole postwar period by degree of ethnic diversity and by level of per capita income. You don’t see any consistent relationship with increasing ethnic diversity when you compare countries that are at roughly the same level of economic development. On the other hand, if you look at the effect of income while controlling for ethnic diversity, you see at every level of diversity a very pronounced effect of higher per capita income. Namely, richer countries have fewer civil wars.

The second story one often hears about the causes of civil war seems overwhelmingly plausible at first glance: The claim is that we find civil wars and terrorism where some segment of society is being oppressed or suffering discrimination. If that were true, one would expect that the greater the degree of democracy in a country, or the greater the degree of observance of civil liberties, the less likelihood of civil war occurring. Interestingly, this doesn’t appear to be the case either. Among countries at similar levels of economic development, there is no tendency for the more democratic or civil-liberties–observing ones to have fewer civil wars. Once again, the dominant factor is per capita income, which is associated with less civil violence at every level of democracy.

There are several other factors that we have found to matter, even controlling for income differences. More mountainous countries with rough terrain where guerrillas can hide are more likely to have civil wars. Political instability matters a lot, as it creates weakness at the center of the state that provides an opportunity for rural guerrillas. Newly independent states are more likely to have civil wars for similar reasons. External, third-party financing for guerrilla groups and secure base areas over a border also appear to help. But the single most powerful correlate, and the one most robust across regions of the world, is per capita income.

One reason is that in a very poor country, poverty makes it easier to recruit fighters for a rebel band because the alternatives are worse. We think, however, that there may be a more important reason. We suspect that per capita income is really standing in for state capabilities and coherence: the degree of administrative, military, and policing competence of states.

In weak states—Indonesia or Sierra Leone, for example—that don’t have the capability to pursue intelligent and effective counterinsurgency, the state takes the bait of the rebels. The military leader says to some military people, “Go out and deal with it.” The military then “pays itself” by looting, pillaging, raping, or even by starting businesses as they did in East Timor. Of course, these activities tend to exacerbate and keep the civil war going. You see this pattern in a broad range of cases from Colombia to Indonesia. Bad counterinsurgency tends to drive people off the land, giving them fewer alternatives except becoming rebels, and it also angers them, understandably, and drives people into rebel groups that way.

Sept. 11 is not exactly analogous to this scenario of how civil wars get going. For one thing, Al Qaeda has international, interstate dimensions that have no exact parallel in the typical civil war scenario. Let me develop parallels and contrasts by asking: What do economic factors have to do with Sept. 11?

On first glance, it would seem not very much. Some of the attackers were educated and relatively well off for where they were coming from. The things that seem more relevant than money are a sense of rage, religious fanaticism, hatred of the United States, hatred of Israel. I certainly wouldn’t discount those factors.

On second glance, there are indirect and important ways that economics did and do matter here. The key word is “oil.” Twenty-eight percent of the world’s supply comes from the Gulf region, almost half of that from Saudi Arabia. This is incredibly important to the world economy and an easy source of unbelievable profits.

The Gulf monarchies are not really like other states. It’s better to think of them as private firms that are very narrowly held by ruling elites. They are thus particularly attractive as subjects of hostile takeover bids.
What would your policy recommendations be for post-9/11?

WACZIARG We have some good lessons on what improves the economic growth of countries. Trade openness is one, having good institutions, good governance, policies that don’t distort the economy, exchange rate regimes that aren’t completely out of whack with reality. Conditioning the aid that rich countries give to poor countries on getting your act together on those fronts, more than is done now, would be, in my view, the long-term response.

DAVID BRADY That sounds good, but across the world that’s precisely what countries object to. When you read Robert Bates’ work on Africa, it’s perfectly clear that throwing money there is not going to be very useful unless they set up markets, but we don’t know how to get people to accept that. It was much easier after the war in Europe and Japan because there was a tradition of a capitalist economy that could be built back up. Building a nation and the concomitant economic development that characterize modern nation-states is not so easily done.

FEARON Some people have talked about a Marshall Plan for terrorism based on the notion that poverty is causing this. I don’t think that’s true. This isn’t quite correct but it’s probably not far from it: People who are interested in committing terrorist acts may be randomly distributed with respect to income. Rich countries are able to keep the threat at the level of the Red Brigades in Italy, but in poor countries you get this escalation process that produces the violence.

The big question in Afghanistan is, How do you reconstruct order in a country that’s been divided and destroyed by horrible civil wars for more than 20 years? Some kind of international intervention is necessary to make it possible to rebuild state institutions. It’s a costly job that few countries are willing to pay for, and even if they were, it’s not clear that we have great ideas about how to do it.
BITTEN BY THE TECHNOLOGY BUG and drawn by the scent of riches, 10 men got together in a garage on Alma Street, Palo Alto, to launch a start-up company. They never made it. The venture collapsed before any sustained manufacture of their dream product.■ The year was 1908, and the new, new thing that drew these entrepreneurs was the internal combustion engine. Their firm, the Stanford Automobile and Manufacturing Co., shared the same fate as the Divine Motor Car Co. of Chicago, McHardy of Detroit, and more than 1,600 others that entered the industry between 1900 and 1920, only to fade into oblivion. ■ For one group of scholars, however, the very existence and varied fates of these myriad enterprises do matter. With the dogged determination of census takers, these researchers enumerate whole populations of organizations—not just the Fords and Chevrolets of an industry, but also the lesser-known and short-lived businesses that make up the majority of firms. ■ They call their approach “organizational ecology.” This perspective tries to capture the full range and diversity of corporations, through their birth, growth, transformation, and mortality. Organizational ecology yields insights into how industries develop and change over time. Many of the findings in the field have challenged conventional wisdom about competition, demanding the attention of policy makers and business leaders alike.

Change, Easier Said than Done

What makes some businesses sprout, grow, adapt, and succeed, while most never get off the ground? Researchers in the growing field of organizational ecology say it is not enough to study the companies that thrive. Answers lie in the stories of failure.

By CHERIAN GEORGE

ILLUSTRATIONS BY GENE GREIF
This December, proponents of organizational ecology will celebrate the discipline’s 25th anniversary at a conference to be held at the Stanford Graduate School of Business. The Farm has provided a particularly fertile ground for scholars working within this research tradition. Organizational ecology can trace its birth to a 1977 paper coauthored by Stanford sociologist Michael Hannan, who is now the StrataCom Professor of Management at the Business School.

One of Hannan’s students, Glenn Carroll, has been prolific in adding to the organizational ecology literature. Carroll, who is the School’s Lane Professor of Organizations, in turn taught William Barnett, now a colleague in strategic management and organizational behavior—creating, so far, a three-generation chain of organizational ecology scholars under one roof at the Business School’s Knight Building. “They’re calling me the grandfather of the conference. They joke that it’s my retirement event,” says Hannan, hastily adding that he is not quitting anytime soon.

The research program grew out of a mounting unease with organizational studies’ prevailing focus on large, dominant firms. Hannan’s intuition was that there is a lot of diversity within industries, with hundreds of firms that people don’t notice. He also took a source of inspiration,” Carroll says, “but not as a source for understanding organizations.” The ecological twist to organizational studies includes an emphasis on the fact that each organization’s environment is made up of other organizations.

Most industry studies would define the relevant players as companies that have opened for business. This doesn’t satisfy the organizational ecologists. They note that before an organization is formally launched, the founders have to work hard developing their plans and assembling resources. Some of these activities culminate in successful births, but others are aborted or stillborn. Studies that begin at the organization’s legal incorporation or commencement of production thus underestimate mortality rates and the degree of difficulty involved in entrepreneurial activity.

The automobile industry is a case in point. In a 1994 study, Carroll, Hannan, and their collaborators looked at producers and preproducers—defined as firms that had begun some form of organizing effort but had not reached production—for almost a century since 1886. They found that historians and economists have tended to overlook the astonishing number of hopeful producers, especially in the industry’s early years. They counted 3,845 preproduction organizing attempts in the United States, of which only 11 percent succeeded in transitioning to the production stage.

Collecting data of this kind is no walk in the park. It usually involves hundreds of hours of interviews and archival research. Tracking down members of a population and recording their characteristics requires the tenacity of a detective on a chase and the attention to detail of an archaeologist on a dig. Clues come from unlikely sources. For the auto industry study, researchers relied partly on the 1,568-page Standard Catalog of American Cars 1805–1942 published for vintage car hobbyists and collectors. Carroll’s study on the microbrewery movement drew on collectors of beer mats.

Organizational ecologists suggest that the failure to appreciate the full diversity of organizations within an industry may translate into weak policy. “For example, in current policy debates concerning the competitiveness of a nation’s firms in the international marketplace, this issue often gets analyzed on the basis of a few anecdotes or highly publicized cases,” Carroll and Hannan write in their book, The Demography of Corporations and Industries. Similarly, discussions about the ability of Western nations and Japan to meet the pension burden of baby-boomers tend to focus on national social security systems and large old corporations, when in fact the greatest needs are generated by small new firms lacking private pension coverage.

Today, there is an international network of some 100 scholars working through an organizational ecology perspective. The approach has merited an entry in the forthcoming International Encyclopaedia of the

The ecological twist to organizational studies includes an emphasis on the fact that each organization’s environment is made up of other organizations.

issue with the assumption that organizations are plastic and changeable—if so, why is failure so common? Organizations are characterized by inertia, he felt, and there are good reasons for this. Reliability and accountability are valued attributes of organizations. These qualities are strengthened by predictable routines and structures, which create inertia as a byproduct.

Hannan was looking around for conceptual models for working out these kinds of arguments when he came across exciting new work in what seemed a totally unrelated field: population ecology. Ecologists in the early 1970s were exploring several new approaches. “That had a big impact on me,” Hannan says. With John Freeman of the University of California, Berkeley, he wrote the seminal paper “The Population Ecology of Organizations.”

The research tradition’s name tends to provoke suspicion. Business people might say that it’s a jungle out there, but surely serious scholars shouldn’t confuse man-made organizations with the world of plants and animals. The academics stress that, indeed, their approach is not about turning organizational studies into a natural science. “Ecology was used as

OLD ASSUMPTIONS CHALLENGED

1. Organizations change easily and often. Actually, the research shows inertia reigns.

2. The relevant players in an industry are companies that have opened for business. Industries are also shaped by ideas from companies that are aborted or stillborn.

3. Companies without competitors have the best chance of survival. Companies with enduring competition are better survivors.

4. New organizations are the most likely to fail. It is not their youth but their small size that is the biggest risk factor.

5. Personnel changes at the top of a company are disruptive. It is more disruptive for existing executives to change the company blueprint.
Make Mine a Microbrew

The Story of Change in the Life Cycle of the American Beer Industry

Twenty years ago, the number of brewing firms in the United States was only around 40. It looked like an open-and-shut case of industry concentration. Management guru Michael Porter, in his classic book *Competitive Strategy*, cited beer brewing as a typical case of an industry in which economies of scale created high barriers to entry. Then, a funny thing happened. More and more firms entered the market. They were seemingly undeterred by the dominance of Anheuser-Busch, Miller, and the like. From 43 firms in 1983, the number of breweries operating in the United States rose to more than 1,400 by mid-2000.

For Glenn Carroll, the story of brewing is no aberration. The life cycles of various industries—ranging from airlines and auditing to music recording and newspaper publishing—tell the same paradoxical tale. Increased dominance of large firms actually creates an environment that is hospitable to the entry of smaller, specialist organizations. In the case of brewing, almost all the new entrants in the last two decades have been “microbreweries”: small firms that concern themselves with craftsmanship and taste.

With Anand Swaminathan of the University of California, Davis, Carroll has studied the emergence of the microbrewery movement to try to understand its dynamics. Carroll and Swaminathan use the idea of “resource partitioning,” which looks at how organizations target different segments within a market. Generalist companies tend to go for the market center, where resources—namely customers—are most abundant and which promises increasing returns to scale. Competition is fiercest there, and in line with conventional wisdom, the larger firms tend to kill off the smaller ones. However, the winning firms may not take over the entire market segments of the losers. This is because their target areas may not have been identical in the first place. Although all had an eye on the market center, some may have been slightly more downmarket, and some more upmarket, for example. The surviving firms may find it too costly to spread their efforts to cover the segments freed up by the death of their competitors. These spaces become available for smaller specialist firms to colonize.

Thus, concentration in the brewing business was associated with what some called pejoratively “industrial beer”—brands with virtually indistinguishable taste. Small, craft brewers moved in to provide consumers with a greater variety in taste, color, foam, alcohol level, and serving temperature. “The people behind the microbrewery movement, in an almost moralistic and evangelical way, thought that beer had become disgusting,” Carroll says. The movement has given the U.S. industry more firms and more product diversity than even Germany, which has a strong reputation for beer quality and is one of the world’s highest per-capita consumers of the beverage.

In their study, Carroll and Swaminathan introduce a twist to the resource partitioning theory. The market space cannot be thought of in terms of entirely objective product characteristics, they say. Instead, the appeal of microbreweries can be fully understood only by referring to cultural factors. They note that after observing the specialist market double annually while the overall beer market remained fairly flat, major breweries tried to develop their own specialty beers. Some of these products were as good as the microbrews and sometimes more consistently so. Yet the large breweries were unable to stem the tide of small firms. The microbreweries’ very identity as small-scale, underdog producers seems to give them a competitive edge in the specialty market. Catching on to this, major breweries have gone so far as to conceal their links to their specialty labels or to use contract manufacturers.

The researchers have found that fans of microbreweries react strongly against the mass producers and value the “authentic” quality of craft beers, which are perceived as standing for values other than just profit. Consumption of little-known craft brews also is associated with expertise and thus a certain social status—the parallel of being an aficionado of wine, cheese, or music.

This identity factor does not work the same way in all industries. In the airline industry, for example, small affiliates have found it beneficial to flaunt their ties with the giants (such as American Eagle with American Airlines). Even within the beer industry, the preference for handcrafted brews is not universal. In Hong Kong, the researchers found, traditional production is not romanticized as it is in the United States. Instead, home brewing is remembered by the locals as a source of irregularity in quality and even hygiene.

—Cherian George
Given the benefits of staying the course, the scholars recommend entrepreneurs pay more attention to picking an appropriate organizational model from the start.

The Nature of Competition

One of the main insights of organizational ecology is that the environment of a firm is made up largely of other firms. Scholars in this tradition therefore have looked closely at how organizations affect each other. A key theory put forward in the original paper by Hannan and Freeman is “density dependence,” which says that organizations’ vital rates—their founding rates, growth, and mortality—depend on the total number of organizations within the relevant population. Population density is said to have two separate effects: through legitimation and through competition.

Legitimation is the process by which a certain way of doing things comes to be seen as natural or taken for granted. Legitimation increases founding rates and reduces mortality rates. Competition arises when organizations need to rely on the same pool of resources, such as capital and customers. Competition has the opposite effect of legitimation: It reduces founding rates and raises mortality rates.

Rising population density increases both legitimation and competition. However, the force of legitimation is stronger when the population density is rising from a low base, such as in the early history of an industry. The competition effect is stronger at higher densities. Combining both effects, the theory predicts that founding rates will show an inverted-U-shape relationship with density, first rising as legitimation increases, then falling as competition kicks in. For the same reason, mortality rates should show a U-shape pattern, falling at first, then rising. The basic tenets of density dependence theory have been widely accepted and demonstrated to apply in many contexts.

A newer take on the organizational environment is the “Red Queen” theory, which highlights the relative nature of progress. The theory is borrowed from ecology’s Red Queen hypothesis that successful adaptation in one species is tantamount to a worsening environment for others, which must adapt in turn to cope with the new conditions. The theory’s name is inspired by the character in Lewis Carroll’s Through the Looking Glass who seems to be running but is staying on the same spot. In a 1996 paper, William Barnett describes Red Queen competition among organizations as a process of mutual learning. A company is forced by direct competition to improve its performance, in turn increasing the pressure on its rivals, thus creating a virtuous circle of learning and competition.

Barnett and David McKendrick of the University of California, San Diego, have tested this theory against data on the global hard disk drive industry. Tracking more than 1,500 firms over four decades, they found that those with a history of enduring competition had a higher chance of survival than those that avoided competition by technological or geographic differentiation. In line with Red Queen theory, it appears that isolation from competition, while having short-term advantages, deprives an organization of the long-term benefit of an ecology of learning, thus stymying innovation. Their study also suggests that a lack of domestic competitive experience can prove to be a critical disadvantage when a firm is thrust into global competition.

Aging and Adapting

Organizational ecology has helped to illuminate what happens to industries over time. Many other studies have suggested that young organizations suffer a so-called “liability of newness” and have a higher risk of failure than old ones. Research in organizational ecology challenges this conclusion. Its more comprehensive data suggest that what seems like the effect of age might really be an effect of size: Infant companies may be vulnerable because they are small, not because they are young. When size is taken into account, the liability of newness often is canceled out by the liability of obsolescence.

One of the key challenges that organizations face as they age is the need to adapt to changing circumstances. Hannan’s original hunch continues to be borne out by organizational ecology research: Change is easier said than done. The social and economic environment at the time of an organization’s founding can have an enduring impact on its mission, structure, and operation. Those that try to transform core elements of their structure often experience increased risk of failure.

The scholars do not claim that organizational change is always dangerous. In the context of dramatic environmental shift, it may be necessary and beneficial to change core organizational features. However, in most cases the process of change itself can be so dis-
ruptive in the short term that the organization never gets to see the long-term benefit.

The opposing view, that organizational change is helpful and simple, may arise from case studies of successful organizations—the kind found in popular management books. These star firms may have undergone successful transformations, but their experience is not representative of the vast population of firms. “It is tempting—and many analysts succumb—to infer from this information that, had other organizations attempted the same changes, they too would have experienced success. Unfortunately, this inference comes from considering data that are heavily biased toward the successful firms,” Carroll and Hannan write.

Of course, an enduring industry, taken as a whole, can be seen to adapt to its changing environment. But organizational ecology holds that the driving mechanism for an industry’s evolution is unlikely to be the adaptation of its individual firms. Instead, it is through the selective replacement of outdated organizations that industries adapt. In the airline industry, for example, the once-dominant Pan Am, TWA, and Eastern are all no more. Old household names in retailing such as Montgomery Ward, Sears, and J.C. Penney have given way to Wal-Mart and Target. And steel giants such as Bethlehem and U.S. Steel have lost out to mini-mills such as Nucor. Thus, companies die while industries evolve.

One of the current forays in this research direction is the Stanford Project on Emerging Companies, or SPEC, which Hannan directs together with James Baron, the Walter Kenneth Kilpatrick Professor of Organizational Behavior and Human Resources.

The project tracked the evolution of nearly 200 high-technology startups in Silicon Valley between 1980 and 1996, and was later extended to mid-2001, creating probably the most comprehensive database on the histories, structures, and human resource practices of this global center of entrepreneurship.

The study found several different basic models for employment relations. The most common was what the researchers call the “engineering” model, which involves selecting staff based on specific task abilities, using challenging work as the basis for employee attachment to the firm, and controlling and coordinating employee effort through peer groups. Some firms later transitioned to a “bureaucracy” model, in which control becomes more formalized.

The researchers have found that—in line with organizational ecology’s theories about the disruptive effects of change—companies that reorganized their human resource blueprints tended to suffer higher employee turnover and diminished performance. Enterprises in which the blueprint changed were more than twice as likely to fail as similar firms with blueprints that were stable. Over a three-year period, the latter firms grew at almost triple the rate of the former.

Personnel changes at the top are not disruptive as such. It is when chief executives change employment relationships that staff turnover increases. In fact, changing the blueprint seems to be most disruptive when it is implemented by the company’s first CEO, who then stays on. This could be because the founder—CEO’s continued presence serves as a reminder that the organization has deviated from its original model.

The findings are especially significant, the scholars note, because it is hard to imagine a setting in which constant flux is more prevalent and where organizational change seems more justified than Silicon Valley. Given the benefits of staying the course, the authors recommend that entrepreneurs should pay more attention to picking an appropriate organizational model from the start. The study challenges the view—popular in the heyday of Silicon Valley’s “built to flip” ethos—that steady organization-building is passé in a new economy flying at Internet speed.

They add that the initial blueprint at founding should be a compromise between the current and the expected future needs—a point that few company founders seem to care about. “It’s by no means uncommon to see a founder spend more time and energy fretting about the scalability of the phone system or IT platform than about the scalability of the culture and practices for managing employees,” write Hannan and Baron.

A quarter-century since the publication of his seminal paper, Hannan says his own thinking has evolved. As one looks more closely at what exactly these organizational forms are that make up a population, it is clear that they are not merely manifestations of formal technical features. “It’s clear that they are social constructions, rooted in identities, and at some level as cultural as you can get,” he says.

Hannan does not claim to be setting the agenda for organizational ecology. The scholars in this area draw on certain shared analytical ideas but, like the industries they study, organizational ecology today is marked by theoretical diversity. This is good news, Hannan says: “It assures that talented young people still join it.” It may not be long, therefore, before they start calling him a great-grandfather.
Students Pay Tribute to Teachers, Mentors

Since he has spent much of his academic career studying how managers can get the most from human resources, it perhaps is no surprise that Charles O'Reilly III was chosen by MBA students to receive the distinguished teaching award for the year. Clearly, the professor of organizational behavior knows how to get effort out of students too. He received the most nominations by far—33 percent more than the next closest candidate. Students in the Sloan Program chose Professor John Roberts to receive their 2002 Teaching Excellence Award, and doctoral students honored Larissa Tiedens, assistant professor of organizational behavior, for her exceptional teaching and advising efforts.

Nearly one-third of first- and second-year MBA students made the effort to nominate about 60 professors and lecturers for this year’s award, a strong showing of support for the School’s tradition of honoring the best teaching each year. Many of the Sloan and doctoral students also took the time to identify qualities that were the hallmarks of their favorite teachers.

Second-year Roan Kang, who chaired the MBA student committee responsible for the final selection, said that students praised O’Reilly for his enthusiasm, skill in guiding classroom discussions, thorough preparation, ability to integrate current research into discussions, and his availability to help students outside of class.

Doctoral students who nominated Tiedens pointed to her mentoring abilities and her willingness to collaborate, not just advise, on research projects.

The mid-career executives enrolled in the Sloan Program said they thoroughly enjoyed learning strategy from Roberts, the John H. and Irene S. Scully Professor of Economics, Strategic Management, and International Business. In presenting the award, Stan Kanarowski, one of the Sloan student academic co-chairs, said Roberts brought “the best out of the class by tapping into the rich knowledge base and experience among us.”

Former students and friends of Business School Professor Robert Wilson descended on Stanford from all corners of the globe May 18 to honor the well-respected game theorist on his 65th birthday with an academic conference and banquet.

The daylong conference titled “Market Design in the Tradition of Bob Wilson,” which took a year to plan, included a group of scholars who critiqued the design of energy and telecom markets. Wilson, the Adams Distinguished Professor of Management, has been involved in designing the rules for energy markets used by countries and states as they deregulate. Along with several of his former students, Wilson also has worked on public auctions of airwaves spectrum used for cell phones and other services.

During the banquet, Wilson’s daughter Jennifer Wakefield told what it was like to live with a dad who was a theorist. After each of his contributions was recognized in some way, she said, he would announce at the dinner table: “That’s it. It’s all downhill from here.”

“She doesn’t realize all theorists are that way,” says Paul Milgrom, PhD ’79.

While theorists may be pessimists about their own future, Wilson was certainly an optimist about his students, according to their recollections. Chris Avery, now a professor at the Kennedy School of Government at Harvard, earned his doctorate under Wilson’s guidance in 1993. Discouraged at one point and considering dropping out, Avery went to Wilson to tell him he had reached the conclusion that he had no interest in 98 percent of economic theory, and the other 2 percent was too hard for him to do. According to Avery, Wilson appeared delighted. “Good for you!” he cheered. “You’re really catching on!”

Harking back to a tradition begun at Oxford in 1502, endowed chairs have been the highest accolade a university can bestow upon a faculty member. In honor of the School’s 75th anniversary and in response to the need to provide more support for a growing faculty, Business School alumni have established two new endowed chairs that only recently have been filled.

Seungjin Whang has become the first Jagdeep and Roshni Singh Professor of Operations, Information, and Technology, and Hau Lee has been named the first Thoma Professor of Operations, Information, and Technology. Two other professors have been named to existing chairs—Stefan Reichelstein is the William R. Timken Professor of Accounting, and James Lattin is the Robert A. Magowan Professor of Marketing.

Jagdeep Singh holds a master’s degree in computer science from Stanford and participated in the Business School’s Sloan Program in 2000. A hardware inventor and networking entrepreneur, he previously was a venture partner at InterWest Partners, specializing in the communications and tele-communications sectors. He has since co-founded several companies including OnFiber Communications and, most recently, Infinera Corp., where he is president and CEO. Infinera has created the first integrat-ed photonic circuit. Roshni Singh is a prac-ticing internist.

The Thoma Professorship was endowed by a couple particularly interested in the enormous impact new technologies have had on business practices such as management, marketing, accounting, and finance as well as on the creation and growth of new business. Marilyn J. Thoma, MBA ’74, runs Van Duzer Vineyards, the family’s winery in
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N. P. Mulani and Hau L. Lee

Selling to the Newsvendor
Martin Labriere and Evan L. Porteus
*Manufacturing & Service Operations Management* (Vol. 3, No. 4) FALL 2001

Oregon’s Willamette Valley, Carl D. Thoma, MBA ’73, is managing partner of Thoma Cressey Equity Partners, a private equity investment firm that has been helping executives build companies since the 1970s.

Mary Barth, the Atholl McBean Professor of Accounting, joined the Dean’s Office July 1 as senior associate dean. A highly respected researcher of how accounting standards work to aid or hinder markets, Barth was the only American academic named in 2001 to the then-new International Accounting Standards Board. She still is a member of the board, which has the responsibility of working toward a single set of high-quality global accounting standards.

Barth also is respected by students for her teaching skill and was named the School’s 1996 Teacher of the Year.

Barth will have oversight responsibility for the accounting, finance, marketing, and political economy areas. She also will oversee the PhD Program, the Center for Electronic Business and Commerce, and the Center for Entrepreneurial Studies. She succeeds Joel Podolny, who has taken a faculty position at Harvard.

The American Marketing Association has bestowed its award for best article in the area of services marketing on consumer research coauthored by marketing professor Itamar Simonson and Chezy Ofir of the Hebrew University School of Business Administration.

The research, which examines the limitations and biases a survey itself can introduce, found that when people are told in advance that they will be asked later to evaluate any service or product, they provide more negative evaluations and are less satisfied with that service. The research by Ofir and Simonson, the Sebastian S. Kresge Professor of Marketing, was featured in the *Journal of Marketing Research* (May 2001).

William Beaver, the Joan E. Hornogren Professor of Accounting, was awarded an honorary doctorate from Athens University of Economics and Business at a May 14 ceremony in Athens, Greece. And Glenn Carroll, the Laurence W. Lane Professor of Organizations, was awarded an honorary doctorate in applied economic sciences from the University of Antwerp at a May 17 ceremony in Antwerp, Belgium.
Stale Pricing Hurts Mutual Fund Savers

Blame it on globalization: That stock markets around the world are both more volatile and more closely correlated in their up-and-down movements than ever before is clear. Notably since the onset of the Asian economic crisis in 1997, followed by the Internet bubble collapse in 2000 and the Sept. 11 aftershocks, global equity markets have swung faster, farther, and in closer tandem than ever. That this volatility presents greater risks to market players attempting to stay ahead of the curve is no surprise. What is shocking is the extent to which such volatility, combined with the standard industry practice of pricing mutual funds just once daily, has allowed arbitrageurs to profit handsomely—to the tune of $4 billion annually in dilution—at the expense of long-term investors.

Arbitrageurs profit handsomely—to the tune of $4 billion annually in dilution—at the expense of long-term investors.

For example, on Oct. 28, 1997, in the midst of the Asian economic crisis, Asian markets closed sharply down following a 9 percent drop in the S&P 500. However, after those markets closed, Wall Street rallied by 10 percent from its morning low. Most U.S.-based Asian funds had set their NAVs according to Asian closing prices—allowing arbitrageurs to earn one-day returns of 8 to 10 percent.

Zitzewitz adds that there are smaller but still significant returns to be had in domestic small-cap equity and convertible and high-yield bond funds, which tend to trade less often than large-cap stock funds. Their relative illiquidity means their prices also can be stale. “The fact is, no one arbitrages in small caps, because if they know about the [illiquidity] problem there, they know about the international funds. And you can make more money in the international,” he notes. “But 10 years from now, when they fix the problem in international funds, there’s going to be a problem in small-cap funds too.” Meanwhile, the cost to long-term shareholders, whose investments are diluted by these market-timers’ inflows and outflows, is as much as 2 percent annually, adding up to a whopping $4 billion.

Stale pricing has been known in the industry for some 20 years. Only a few funds have taken any steps to correct it, and those measures are only partially successful. The most common solution is the imposition of short-term trading fees ranging from 0.25 to 3.5 percent. The net result of such fees, Zitzewitz has found, is that they lessen, but do not eliminate, large profits.
From the long-term investors’ perspective, their dilution in funds with short-term fees in place is 50 percent lower than in funds without them, but still not zero. Short-term fees also can be difficult to apply in 401(k) plans and impossible in certain variable annuity products where the annuity contract was signed prior to imposing the fees and rules prohibit modifying the existing contract. Other funds use American Depository Receipt (ADR) prices to set foreign security prices in determining fund NAVs. Zitzewitz says that most ADRs are fairly illiquid, so this is a partial solution at best.

The only satisfactory solution, Zitzewitz argues, is fair-value pricing—updating prices to take into account market-moving events. Some funds do a partial, top-down variant of this—more of an ad hoc adjustment to the overall portfolio value. A better approach is to fair-value each security; fair-value NAVs will thus fully reflect recent portfolio changes. Vanguard’s Pacific Index fund is one of the few that seems to be correctly adjusting its NAV, in conjunction with aggressive monitoring of short-term trading.

Until fair-value pricing becomes standard, the best way individual investors can protect themselves is to seek out funds with low expense ratios and a healthy proportion of outsiders on the board of directors—both signs of good fund management, according to Zitzewitz. He has found that funds with one or both of these attributes are most likely to have partial remedies like trading fees in place. And if investors are still determined to hold international funds for diversification’s sake, he suggests sticking to broad global funds rather than region-specific ones, not likely to have partial remedies like trading fees in place.

In another 20 years, the industry may get around to fixing the problem. In the meantime, long-term buyers beware. —ANDREA HAMILTON


Challenging the Value of Global Labor Standards

Economists, politicians, and activists have long debated whether countries that do not adopt international labor standards gain an advantage in trade and investment at the expense of those who do. This issue is at the heart of the protests at recent meetings of the World Trade Organization (WTO).

The debaters have strong opinions but little evidence to support their views, says Robert Flanagan, the Konosuke Matsushita Professor of International Labor Economics and Policy Analysis. Flanagan recently tested the arguments through a comparative study of about 100 countries at various stages of development from 1980 to 1999. He looked at how these nations adopted standards developed by the International Labor Organization (ILO), such as abolishing forced labor or granting workers the right to bargain collectively.

One view, held by many politicians in industrialized countries, is that nations face competitive pressures to have the lowest labor standards possible in order to increase their share of exports and investment—known as “the race to the bottom.” This view assumes that when a government ratifies one or more ILO standards, labor costs rise. On the other hand, advocates of free trade argue that labor costs and conditions are determined by other factors, and that standards created by the ILO, a United Nations agency, only reflect the working conditions that already exist.

Some advocates of the race-to-the-bottom position have argued that countries that refuse to adopt the standards should be denied the lower tariffs established in WTO negotiations. Many politicians in developing countries oppose linking trade negotiations to labor standards, Flanagan says, because they see lower labor costs as their country’s comparative advantage.

Flanagan compared labor conditions in the selected countries to those in the same nations five years earlier. “I did not find that earlier ratification influences later labor conditions,” he said. “On the other hand, when I reversed the process, I did find that labor conditions, say, in 1975, influenced the number of ratifications a country had made five years later. By time-ordering the data, I’ve straightened out the causality.”

Flanagan’s research showed that economic development and an open trade policy—not ratifying ILO standards—improve labor conditions and wages. In other words, domestic policies can raise labor productivity, which, in turn, creates higher wages.

Take, for instance, the lowest and highest wage countries—Kenya and the United States. “In my data, the U.S. wage was 183 times higher than the wage in Kenya. Kenya has ratified more labor standards than the U.S., but the productivity difference between the countries is very similar to the wage difference, which implies that the best way for a country to raise wages is to improve productivity,” he said. Flanagan also found that countries suffer negligible penalties for failing to ratify ILO conventions, not surprising since there are only weak mechanisms for enforcing the standards. The United States, for example, is one of four countries—along with China, Armenia, and Myanmar—that ratified only two of the eight conventions devoted to fundamental human rights. This is despite the existence of strong domestic laws in that category in the United States.

When you look at the list of countries that have ratified all the standards, about a third of those studied, Flanagan said, “you realize there has to be something fishy in the race-to-the-bottom argument, because these are often fairly undeveloped countries with poor labor conditions,” such as Botswana and Senegal.

Based on his research, Flanagan said, it would be best if the WTO negotiations were conducted as they always have been: focused primarily on trade policy between countries, while labor standards issues are left to the ILO or non-governmental organizations. —DEBORAH GARDINER
On election eve, political campaign managers wanting to know how their candidate or issue will fare could pay big money and call a pollster. Or better yet, suggests new research by Justin Wolfers, call a sportsbook. Especially if the race is tight.

Wolfers, an assistant professor of political economy who as a youth worked for a bookmaker in his native Australia, followed a hunch about the predictive power of betting markets in forecasting the outcome of political elections. With Andrew Leigh of Harvard’s John F. Kennedy School of Government, he coauthored a study examining the effectiveness of three tools for forecasting the outcome of Australia’s 2001 federal elections: economic modeling, opinion polling, and betting odds.

While the study found that all three methods performed reasonably well, it introduced, for the first time in Australia, a new source of data for predicting elections—betting statistics from one of the country’s largest bookmakers. The study’s provocative conclusion is this: Particularly in marginal seats, the press might better serve its readers by reporting betting odds than by conducting polls.

Wolfers sets the scene: “Throughout much of the election cycle the candidate on the left, Kim Beazley of the Australian Labor Party, had been expected to win as prime minister in the November election. John Howard, the incumbent and leader of the Australian Liberal Party, saw the tide turn in his favor in the days following the Sept. 11 terrorist attacks on America when the population rallied around its leader. At about the same time—so it’s hard to untangle the two events—a boatload of Afghan refugees was found off the coast of Australia. Howard took a strong stand against allowing them to immigrate, while Beazley chose something in the middle ground and was perceived to be a weak leader. This was argued by many political commentators in Australia to be the turning point of the election.”

When the election was held on Nov. 10, 2001, the Liberal-National Party gained 50.5 percent of the vote and John Howard was re-elected prime minister.

So, how did the three forecasting tools perform? In the medium term, which Wolfers identifies as one to two years out, economic modeling—based on predictions of how voters will react to various economic conditions—can be effective in picking the election-day winner. This is somewhat surprising, he notes, because election forecasting models have had mixed success, confounding political science researchers studying the impact of such economic indicators as unemployment and inflation on 18 postwar elections in Australia. However, if accurate economic measures are available, the forecasting power of economic modeling is quite substantial.

Using election-eve measures of economic indicators, Wolfers found that three econometric models performed extremely well, nailing precisely the predictions of an incumbent victory in one model and missing by 0.1 percent and 0.4 percent in two others.

Pre-election opinion polls should be more accurate in Australia than in countries like the United States, he points out, because voting in Australia is compulsory, eliminating the key variable of whether respondents will actually show up at the voting booth. Past experience indicates that opinion polls taken close to the election are quite accurate. Yet the lesson from Australia in 2001, like America’s 2000 election imbroglio in Florida, points to the potential pitfalls of polling, particularly in very tight races. “The night before the election, Howard was ahead in two of three major polls,” says Wolfers.

In contrast, data from Centrebet, Australia’s largest bookmaker, demonstrated the impact of current events on the betting odds throughout the nine months leading up to the election by reflecting immediately the electorate’s seesawing response to such events as leaders’ televised debates and the Sept. 11 attacks on the United States. “By election day an enormous amount of money had been pumped into the betting market. More money had been bet on the election than on the football grand final, and Howard was the favorite with odds of $1.55, suggesting a 64 percent probability of his winning the election,” says Wolfers. Howard won and Centrebet lost money on the election.

Digging deeper, Wolfers found the data yielded even more impressive results for oddsmakers. Centrebet also offered odds on the outcomes in 47 regional races. In 43 of 47 cases, the betting favorite won the election, even in the marginal seats. Moreover, in the three regional
Earnings Forecasts Can Be Biased

One of the hallmarks of the U.S. market economy is its transparency: Companies report public balance sheets so investors are willing to take risks based on information they can trust to be true. But in our post-Enron world, that transparency has been called into question. How does the investor, especially the individual investor, know which voices to listen to in the clamor of financial information? And what regulations of securities analysts would restore the climate of trust? One big step is to identify a predictable pattern of bias in the work of successful financial analysts and understand how that bias is rewarded.

A recent paper by associate professor of finance Harrison Hong does just that. Many people have known by casual observation for years that market analysts tend to issue optimistically biased earnings forecasts for the stocks they recommend. Hong’s research attempts to explain why this is the case. He notes three possible explanations: The “career concern perspective” (analysts are somehow rewarded for their optimism by their employers); the “selection bias” (analysts tend to cover the stocks they can recommend over stocks they cannot); and the “cognitive/behavioral bias” (analysts tend to like the stocks they cover). “If you listen to the Enron debate,” Hong says, “all the senators and congressmen are going for the first reason; but the analysts point to the second and third explanations of this bias.”

A number of the School’s professors have researched various aspects of information and the markets. Maureen McNichols (“The Trouble with Good News,” Stanford Business, March 1997) and Ezra Zuckerman (“Why Analysts Don’t Rock the Boat,” March 1999), for example, also have examined securities analyst bias. All these studies are relevant to regulators who base their rules and conventions in part on the quality of available corporate information.

Hong and his coauthor, Jeffrey Kubik, assistant professor of economics at Syracuse University, compared brokerage house employment and earnings forecast histories of roughly 12,000 analysts working for 600 brokerage houses between 1983 and 2000.

Other studies in this area had argued that analysts’ forecasts are, on average, optimistically biased. Alleging rewards for this optimism, researchers pointed to evidence that an analyst from a brokerage house that has an underwriting relationship with a stock tends to issue more positive predictions than analysts from non-affiliated houses.

Hong’s work takes this a step further. His research points to a reward system for optimism that is more implicit than explicit, as long as the optimism is within a range of accuracy that maintains the credibility of the analysts’ skills. Analysts who are optimistic are much less likely to be fired from a top brokerage house and much more likely to be promoted or hired by a better house. They also are given the better assignments. “Look at Henry Blodgett, the key guy at Merrill Lynch. Even after it was clear that all the dot-com stocks he recommended were busts, he was promoted to be the lead analyst on Microsoft,” Hong notes.

The study also finds that analysts are judged less on accuracy when it comes to stocks underwritten by their houses. “Among analysts who cover stocks underwritten by their brokerage houses, job separations depend less on forecast accuracy and more on forecast optimism,” Hong says. “This pattern was even more pronounced in the mid to late nineties than in the eighties and early nineties.”

If the relationship between the analyst’s brokerage house and the stock he or she is promoting can influence forecasting, how does the private investor track the relationship? “There are Internet sites starting up—Yahoo, E-Trade, etc.—that can help track information about analysts,” Hong says.

So what about regulating the analysts? Hong says that the post-Enron outcry to have securities analysts disclose which stocks they are buying for their personal portfolios is too narrow a regulation. His study shows that the real benefits to the analysts for their optimism are much subtler and that career concerns such as an analyst’s reputation, hiring and firing patterns, and the allocation of jobs would be very difficult to regulate.

Hong’s recommendation: “We may want to have some version of a public education warning, alerting the private investor to listen to forecasts, especially positive forecasts from an analyst covering firms that have investment banking relationships with their brokerage house, at their own risk.” —LISA EUNSON

Newsmakers

WHO’S IN THE NEWS | A Roundup of Media Mentions

Jyotiraditya Scindia, recently elected to Parliament, wants a more forward-looking India.

Youth Takes a Seat in Indian Parliament

“SEVENTY PERCENT of India’s population is younger than 35,” Jyotiraditya Scindia, MBA ’01, told Celebchat, a Web-based publication in India. “I think it’s time for us, i.e., the youth of India, to steer the nation into the next century.” Scindia, the youngest person in India to be elected to Parliament, is a member of the Congress party, which advocates a secular Indian government and is now in the minority. Scindia’s interest in politics developed when his father, who died in a plane crash last year, represented the same Gwalior-Guna region.

Who Can You Trust?

With the breakdown of the Oslo Accords in the Middle East and scandals in the U.S. Catholic Church and at Enron and Arthur Andersen, trust is eroding. Researchers told the newspaper that once trust is shattered between parties, it is extremely difficult to rebuild, even if they must continue in their relationships.

On the business fallout, the paper sought out Professor Roderick Kramer, who said that the Enron scandal was “a major assault on people’s trust in financial institutions but also, importantly, in the institutions that are supposed to hold financial institutions accountable, such as Arthur Andersen. So that is a double assault. Even if we know that institutions aren’t fully trustworthy, we believe that we have a system in place that makes trust reasonable and prudent. That’s our defense against misplaced trust; it’s our Maginot Line. And that has been breached.”

On the positive side, polls have found that since the Sept. 11 terrorist attacks, Americans profess more trust in a wide range of things from government and police to neighbors and people of other races.

KPMG’s O’Kelly in the Spotlight

KPMG’s 1,500 partners ratified the selection of Eugene O’Kelly, MBA ’77, as chairman and CEO in late April. O’Kelly, who joined the accounting firm in San Francisco before coming to the GSB, became managing partner of the Palo Alto office in 1998 and vice chairman of financial services in 1998. A spate of news stories appeared this spring about a meeting he held with Harvey Pitt, chairman of the Securities and Exchange Commission. Some Democratic lawmakers contend that Pitt, a Bush appointee, should not have met with O’Kelly, whose firm audits Xerox, which is undergoing an SEC investigation.

West Meets East

A “POWERFUL new princeling has arrived on China’s information-technology scene,” the Far Eastern Economic Review reported last February. The princeling is none other than Zeng “Jeffrey” Zhijie, Sloan ’01. He is in charge of investments in China’s semiconductor and telecom sectors for the San Francisco-based venture capital firm Walden International.

“Princeling” is the term used in China to describe the children of powerful people in government. According to the Review, Zeng, the son of State Development Planning Commission minister Zeng Peiya, is “in direct competition with the business interests of Jiang Mianheng,” who is the son of Chinese President Jiang Zemin.

In Sickness and Health

Dressed in white satin and displaying a thatch of chest hair, Microsoft CEO Steve Ballmer, Class of ’81, was portrayed as a jilted bride on the cover of Red Herring recently under the tabloid headline “Broadband Left Me at the Altar!” The computer-altered photo, along with a similar one of Scott McNealy, MBA ’80 (see following story), in Business 2.0 raises the question: Are political cartoonists who have long specialized in parodying public figures going the way of the horse and buggies?

CEO Talk Radio

Watch out, executives—a new addiction from Silicon Valley is spreading among you. Sun’s Scott McNealy, MBA ’80, is among those top executives who travel to a studio in San Francisco’s Marina district to host their own radio shows for employees. The typical format is for the CEO to interview guests, and McNealy recently landed the well-known retired GE executive Jack Welch for his show. In commenting on “Boss Radio,” the March issue of Business 2.0 featured a picture of McNealy with curly dark locks flowing over his shoulders—or was that Howard Stern?

The Meek Do Not Inherit the Earth

Getting a little huffy during negotiations can pay off for people who are perceived as powerful, according to a report in Business 2.0 on research by assistant professor of organizational behavior Larissa Tiedens. Her research also has revealed that employers have a bias toward promoting employees who get mad occasionally. “I don’t think we’re cognizant of this,” Tiedens said. “We make inferences about people all the time, and we don’t
always know where the information has come from.” For a more detailed report on Tiedens’ research on anger, see “There’s Power in Anger” in the May 2000 issue of Stanford Business.

God and Business
FOR YEARS WHEN HE WAS making good money in banking, Robert Richards, MBA ’64, says he “had this feeling that if I were really Christian, I’d abandon business and go be a missionary somewhere.” The former research economist for Weyerhaeuser, the Bank of Alaska, and two banks that he founded and then sold, decided in 1998 to enroll in a seminary, where he selected courses relating to his interest in capitalism. The result is a 500-page book published by Xulon Press called God and Business: Christianity’s Case for Capitalism. “People talk about a competitive free-market economy. Participation in that involves as much cooperation as it does competition,” Richards told the Mercer Island Reporter, a newspaper serving suburban Seattle, where he lives.

Steve Smith is beginning to feel as much at home in space as he does on Earth.

Veteran Spacewalker
AS ONE OF TWO CREW members on a NASA mission to expand the international space station, Steve Smith, MBA ’87, took his sixth spacewalk in April. During his three earlier space flights, Smith logged 700 hours in space, including 35 hours of spacewalks. For photos, see the NASA Web site: http://spaceflight.nasa.gov/shuttle/.

Are Good Grades a Health Hazard?
PUBLICLY AVAILABLE report cards for hospitals may not be a good idea, Business Week reported, because they may encourage hospitals to reject sick patients who are harder to treat and drag down performance scores.

The magazine cited research coauthored by associate professor Daniel Kessler that looked for changes in the practices of doctors and hospitals in New York and Pennsylvania after those states began to publish mortality rates for coronary bypass surgery.

They found that after reporting began, the hospitals were more likely to do bypass surgery on relatively healthy patients, and they saw some evidence that hospitals were less likely to accept sick patients for bypass surgery. The report cards also led to a rise in Medicare costs. One reason is that hospitals did bypass patients on patients who were candidates for cheaper angioplasty surgery, a switch that didn’t improve outcomes.

Silicon Valley Shop Talk
“SILICON VALLEY HAS A metaphorical life of its own,” the Financial Times said in reporting on research coauthored by John Jost, associate professor of organizational behavior. “Inventive types are known as ‘idea hamsters.’ Software code not fit for public consumption but good enough for internal use is called ‘dogfood.’ The grueling period before software is shipped is the ‘death march.’ And everyone in the business lives on the ‘bleeding edge,’” Silicon Valley’s melodramatic version of the cutting edge.” Why do the terms relate to the body, animals, and death? The researchers say it might be that this is mostly an aggressive male culture and an industry in which most companies fail.

Merger Portends New HP Way
THE CONTROVERSIAL MERGER of Hewlett-Packard and Compaq brought with it much discussion of the legendary “HP Way,” a management philosophy that emphasized innovation, respect for individuals, teamwork, and loyalty.

Cultural change was inevitable for the company, human resources professor Charles O’Reilly told the Palo Alto Weekly. “HP developed a culture for engineers at a time when life cycles of products were longer.

In the last decades, product life cycles became shorter and profits lower.” The consensus-oriented infrastructure was too slow for the current market, O’Reilly said.

Nevertheless, Joel Hyatt, lecturer in entrepreneurship, was quoted by Red Herring on the dangers of merging behemoth companies like HP and Compaq. “The larger the tech merger, the more it is bound to fail,” he said. “These deals can end up wrecking both companies.”

The Aloha Spirit
IF YOU ARE GOING to make a profit in a small community, you might try adopting management philosophies from the nonprofit sector, suggests Connie Lau, MBA ’79, the CEO of Hawaii’s third largest bank, American Savings. Noting that business can be “cutthroat,” Lau says that people in the nonprofit sector “don’t seem to have as much difficulty showing that they care about other people,” an important skill to have in an island community such as Hawaii.

Featured on the cover of Hawaii Business in February, Lau is the granddaughter of a houseboy to Hawaii’s first territorial governor. She earned a law degree from UC Hastings College of the Law, she says, because her father taught her that it was necessary for a Chinese American to “know your rights” in a Hawaii of limited opportunity.
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For additional information, please contact Laura Moore at moore_laura@gsb.stanford.edu or 650.723.2694
SEPTEMBER

september 8–13: Executive program “Leveraging Human Resources for Competitive Advantage,” Stanford campus

september 12–15: Executive program “Negotiation and Influence Strategies,” Stanford campus

september 18, 19: Stanford Executive Forums, Professor George Parker on “Profit and Loss Dilemma in a Post-Enron World,” Club de Industriales in Mexico City (Sept. 18), Club de Industriales in Monterrey, Mexico (Sept. 19)

september 26: First day of fall quarter classes

october

october 1–2: Alumni Conference in Hong Kong. Contact Laura Moore at sloanadmin@gsb.stanford.edu or 650.725.4094

october 6–11: Executive program “Electronic Business and Commerce,” Stanford campus

october 17–20: Alumni Weekend and Fall MBA Class Reunions for ’82, ’72, ’67, ’62, ’57, and ’52, Stanford campus. Contact Coral Hunt at hunt_coral@gsb.stanford.edu or 650.725.3454

october 20–25: Executive program “Negotiation and Influence Strategies,” Stanford campus

october 27–november 1: Executive program “Finance and Accounting for the Non-Financial Executive,” Stanford campus

November

november 1: Alumni Conference in Hong Kong. Contact Laura Moore at sloanadmin@gsb.stanford.edu or 650.725.4094

november 5–8: Executive program “Leading Change and Organizational Renewal,” (with Harvard Business School), Stanford campus

november 20: Women in Consulting Alumni-Student Dinner sponsored by the Consulting Club and Women in Management, off-campus location. Contact Molly McCabe at mccbyme@yahoo.com or Ann Bosche at bosche_ann@gsb.stanford.edu

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