Examples of Poor Group Process

Two additional case studies provide students with an opportunity to deepen their understanding about group process. The first case study involves two foundations, and the second case study involves AT&T.

A9.1 THE PACKARD FOUNDATION

The families who founded the firm Hewlett-Packard also created two foundations, the Hewlett Foundation and the Packard Foundation. Both foundations are institutional investors that fund charitable projects from their portfolios.

According to the capital asset pricing model (CAPM), investors are only rewarded for holding market risk, not firm-specific risk that they can diversify away. Yet for years more than 90 percent of the Packard Foundation's portfolio consisted of a single stock, the stock of Hewlett-Packard. In contrast, the Hewlett Foundation had made the decision to hold a more diversified portfolio.

One cost of failing to diversify is excess volatility. Exhibit A9.1 displays the market value of Hewlett-Packard together with Agilent Technologies, the firm Hewlett-Packard spun out in 1999. The Packard Foundation continued to hold the shares of Agilent Technologies it received from the spinoff. The fortunes of the Packard Foundation ebbed and flowed in accordance with Exhibit A9.1.

The Packard Foundation reported assets of about $2.4 billion in 1995 and $7.4 billion in 1996. By year-end 1999 its endowment was worth $13.1 billion, placing it among the 10 largest foundations in the United States. In mid-2000, its endowment was $18 billion and it was the second largest foundation in the United States.

However, the value of the Packard Foundation endowment fell to $9.8 billion in 2000, to $6.2 billion in 2001, and to $3.5 billion during the autumn of 2002, just after the merger of Hewlett-Packard and Compaq Computer Corporation. At year-end 2003, the foundation's endowment was worth $4.7 billion.

In contrast, the Hewlett Foundation held about 20 percent of its endowment in Hewlett-Packard stock. At year-end 2002, its endowment stood at $4.5 billion. Between 2000 and 2002 its endowment experienced far less volatility than did the Packard Foundation endowment.

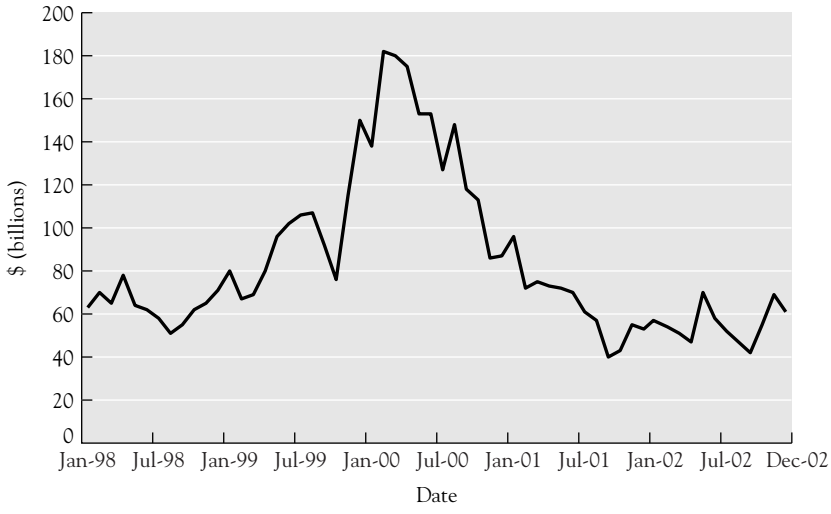
The cost of the volatility to the Packard Foundation endowment was borne by the recipients of its grants and the foundation itself. The foundation had been generous in its support of environmental conservation, science, children's issues, and reproductive health and population. As the value of its endowment plummeted, the foundation reduced its grants from $451 million in 2001 to a planned $200 million in 2003. It reduced its staff by 40 percent.

Governance and Groups

In 2002, the Packard Foundation board consisted of 12 directors. Of the 12, five were members of the Packard family. Nonfamily members included Lewis Platt, the

EXHIBIT A9.1
Market Capitalization, H-P & Agilent, Jan. 1998–Dec. 2002

Sources: Center for Research in Security Prices.



former CEO of Hewlett-Packard; William Reilly, the former head of the Environmental Protection Agency; and Richard Schlosberg, the president of the foundation.

Finance Committee

The Packard Foundation has no separate investment committee. Rather, it has a finance committee that makes decisions about both its portfolio and the grants it will provide. In 2000 the finance committee was composed of the following five members:

- Lewis Platt, who chaired the committee.
- Susan Packard Orr, daughter of David and Lucille Packard.
- William Reilly, mentioned earlier.
- Dean Morton, former chief operating officer of Hewlett-Packard.
- Colburn Wilbur, the former executive director of the Packard Foundation.

David Packard's Request

The proposal that the Packard Foundation maintain a portfolio heavily concentrated in the stock of Hewlett-Packard came not from a member of the committee, but from David Packard.

Before Packard died in 1996, he wrote an eight-page memo describing the manner in which he wished his heirs to oversee the foundation. In that memo he encouraged the foundation to continue its support for Hewlett-Packard, recommending but not requiring that the foundation concentrate its portfolio in Hewlett-Packard stock.

In July 1998, the foundation received the residual of David Packard's estate after the gifts he stipulated had been made. That residual was all in Hewlett-Packard

stock. Colburn Wilbur, one of the members of the finance committee mentioned earlier, was the executive director at the time the foundation received the residual of David Packard's estate.

Richard Schlosberg

As can be seen from Exhibit A9.1, the foundation's endowment soared between July 1998 and March 2000. Tax rules require that foundations spend 5 percent of their assets every year or else pay heavy taxes. The soaring endowment led to the foundation increasing the magnitude of its grants. As a result, the foundation decided it needed a new executive director to succeed Colburn Wilbur and hired Richard Schlosberg, the former CEO of Times-Mirror and publisher of the *Los Angeles Times.* He led the Packard Foundation for five years, retiring in December 2003.

When Schlosberg joined the foundation as CEO in May 1999, he proposed that the foundation diversify its portfolio. However, his proposal did not elicit a positive response. As it happened, family members' personal portfolios were also concentrated in H-P stock.

The proposal that the foundation might wish to sell some of its stock in H-P did not arise as a discussion item until September 2001 when H-P announced its intention to acquire Compaq. Before that time, the finance committee focused its attention exclusively on making grants. After the merger announcement, a move the foundation opposed, H-P's stock price plummeted, and the committee began to consider diversifying.

To Diversify or Not to Diversify?

In 2002, George Vera was the chief financial officer of the foundation and its only internal investment professional. Looking back, he explained the finance committee's quandary as follows: "When the stock is going up, it doesn't feel like the right time to sell. When the stock is falling, it doesn't feel like the right time to sell."[1]

There may be several psychological elements at work in Vera's perspective. However, the desire to avoid going against David Packard's guidelines loomed large. Packard's daughter Susan Packard Orr, who sat on both the board and the finance committee, gave a presentation to a conference in September 2002. One of her slides read: "Why didn't you sell your HP stock at the top of the market? Because Father asked us to hold on to it."[2]

Ultimately, the decline evident in the right portion of Exhibit A9.1 persuaded the members of the finance committee that Richard Schlosberg had a point when he encouraged the board to diversify the portfolio. In late 2002, they did decide to move in the direction of diversification, by gradually selling half their shares in H-P and Agilent stock over the subsequent five years.

After five years, the Packard Foundation still planned to have about half of its portfolio in a single stock, hardly a well-diversified portfolio. Yet the group appears to be content with the decision. George Vera, CFO of the Foundation, was quoted as saying: "This is a family foundation. The family makes these kinds of decisions, and the board is comfortable with this as a starting point."

A9.2 THE HEWLETT FOUNDATION

The Hewlett Foundation diversified when the Packard Foundation did not. What accounted for the difference? To begin with, William Hewlett left no memo detailing how he wished his money to be spent. That alone would have made it easier for those who followed to avoid the kinds of portfolio decisions made at the Packard Foundation.

However, long before his death in 2001, William Hewlett was persuaded of the need to diversify. In 1987 the treasurer of the Hewlett Foundation was Bill Nichols, a certified public accountant (CPA) and former accounting professor at San Jose State University. Nichols was willing to offer a recommendation that he suspected Hewlett might resist. He told Hewlett, who chaired the board: "I think we should diversify out of the stock of the company you built."

That message was reinforced from others in the academic community. Hewlett was friends with Arjay Miller, the former dean of the Stanford University business school. Miller told Hewlett that while H-P might always be a great company, it might not always be a great stock. Persuaded by the arguments of Nichols and Miller, Hewlett and the board made the decision to diversify the foundation's portfolio.

Another issue pertains to board composition. Walter Hewlett, the eldest son of William Hewlett, who became the chairman of the Hewlett foundation, stated: "My father once said he was indifferent as to whether there were Hewletts on the Hewlett Foundation board. He was making a point. We are not a family foundation."[3]

A9.3 GENERAL FINDINGS ABOUT INVESTMENT COMMITTEES

A study conducted by John Payne and Arnold Wood of investment committees who oversee the portfolios of institutional investors provides a good vehicle for examining the implications of group structure for corporate governance.[4] Consider their general findings.

Homogeneity

In theory, groups bring together people with different, but complementary, skills in order to improve on the decision making of a single individual. In practice, investment committees bring together people with similar skills. Investment committees comprise mostly white males over the age of 60, with few women and few members of minorities.

Size

The size of the group can be important. The Payne-Wood study found that the median investment committee had seven members. Yet 60 percent of investment committees that have at least six members indicated that their committee was larger than necessary. Those expressing this opinion contended that a committee consisting of three or four individuals would do just as well.

A group of three or four individuals with complementary skills and differing viewpoints can be as effective as a group of seven people with similar skills and

viewpoints. At the same time, investment committees are often concerned about sharing the blame when something goes wrong. Sharing the blame is more readily accomplished in larger groups than in smaller groups.

Confirmation Bias

A homogeneous group is vulnerable to collective confirmation bias, that is, groupthink. Investment committees tend to be composed of like-minded people because when evaluating candidates for membership, they do not assign a high priority to the characteristic "brings different values to the committee." Instead they assign high priorities to characteristics such as "overall level of investment knowledge" and "expressed interest in serving." To be sure, the latter characteristics are important. However, applying them uniformly to all candidates tends to generate a group that is excessively homogeneous.

Overconfidence

Recall the third of the three key issues mentioned in Section 9.2: Group discussion leads to greater acceptance of a decision. Greater acceptance also brings with it a sense of effectiveness.

At the same time, acceptance also brings with it a sense of overconfidence. For the overconfidence trivia quiz discussed in the additional resources for Chapter 1, most people predict that the average responses will achieve a higher hit rate than is warranted. In general, group members exhibit the illusion of effectiveness. When asked for the probability that their groups arrive at the correct decision, the range of responses for investment committee members is 55 to 90 percent.

A9.4 THE ENDOWMENT EFFECT

A phenomenon known as the endowment effect is closely related to prospect theory. Although the endowment effect can afflict the managers running endowments, it is much more pervasive. In order to understand the general phenomenon, consider the following question.

CONCEPT PREVIEW
Question A9.1

Suppose that you owned a lottery ticket that offered a 1 in 50 chance of winning $50,000. The drawing will occur within the next 24 hours.

a. If someone came to you and offered to buy the ticket, what is the least amount of money you would accept in exchange for the ticket?
b. Suppose that instead of owning the lottery ticket, you were thinking of buying the ticket. What is the maximum amount of money you would pay in order to purchase the ticket?

What is the expected value of a lottery ticket that promises $50,000 with a probability of 2 percent (1 in 50)? It is $1,000. When asked to state the minimum amount a person would accept to sell such a ticket, the median response is $4,750. This means that the median respondent attaches a negative risk premium when it comes to the amount they would be willing to accept (WTA) in exchange for the ticket.

However, when asked to state the maximum amount that he or she would be willing to pay (WTP) for the ticket, the median response is $500. This amount corresponds to a risk premium of $500 ($1,000 − $500), or 100 percent on a rate of return basis.

Notice that the WTA amount is almost an order of magnitude higher than the WTP amount. Paying money in exchange for a lottery ticket involves an out-of-pocket cost. However, deciding to refuse money in order to hold onto the ticket represents an opportunity cost, not an out-of-pocket cost. Psychologically, it appears that out-of-pocket costs loom larger than opportunity costs. This is akin to the asymmetric treatment of gains and losses of equal magnitude.

endowment effect
People attach a greater value to an object once they regard it as part of their endowment than before it becomes part of their endowment.

The inequality WTA > WTP gives rise to what is known as the **endowment effect,** whereby people attach a greater value to an object once they regard it as part of their endowment than before it becomes part of their endowment.

A9.5 MOTIVATION AND INCENTIVES: RESIDUAL INCOME

A major source of process loss is lack of motivation. To be sure, the traditional approach to corporate finance recognizes the importance of incentives. Yet, instituting appropriate incentive-based compensation has been a challenge for many firms. In 1997, the consulting firm Towers Perrin conducted a survey of the incentive plans of 177 large U.S. corporations. Only 10 of the firms in the survey tied management compensation to the extent to which the firm had earned its cost of its capital. Instead, the most common compensation plans were structured around negotiated budget standards or earnings, which only loosely reflect investors' required returns.[5]

A consulting industry has developed to assist managers in instituting value-maximizing systems. For example, Stern Stewart & Company and the Boston Consulting Group (BCG) are consulting firms well known for having developed compensation systems based on the notion of residual income.[6]

Residual income is a straightforward concept. Imagine that shareholders have invested $1,000 of their money in an all-equity financed firm, either buying its shares when first issued or when managers retained their earnings and plowed them back into the firm. Suppose that shareholders require a return r of 15 percent in order to be willing to hold the stock. In that case, shareholders require earnings to be 15 percent of $1,000, or $150, in order to feel adequately compensated. Call this $150 the charge to capital. Imagine that earnings over the next year turn out to be $200, which is $50 more than the charge to capital. Call this $50 residual income, or economic value added (EVA).[7] In respect to leveraged firms, the general definition of EVA is the difference between net operating profit after tax (NOPAT) and the charge to capital, that being the product of the cost of capital and the book value of the firm's capital.

One of the most important features about EVA is the role it plays in valuation. It turns out that the present value of the firm's cash flows to equity can be expressed as the sum of book equity (shareholders' equity) and the present value of the future

EVA stream, discounted at the required return *r*. That is,

$$PV = BV + PV(\text{future EVA stream, discounted at } r)$$

where

PV = intrinsic value of firm at end of the current year
BV = shareholders' equity at end of the current year
PV(EVA . . .) = present value of future expected EVA stream, discounted at the cost of capital

The main idea behind EVA-based incentives is that management compensation be based on the difference between the return that a firm generates for its shareholders and the return that its shareholders require. This approach is known as value based management (VBM).

The list of companies that have instituted VBM systems in the 1990s includes Armstrong Holdings, AT&T, Bausch & Lomb, Briggs & Stratton Corp., Coca-Cola Inc., R.R. Donnelley, Eli Lilly, Herman Miller Inc., and Scott Paper.

The degree of success among these firms has been mixed. Beginning in 1991, Stern Stewart began to argue that EVA better reflects equity values than the more traditional accounting variables, especially GAAP earnings computed in accordance with generally accepted accounting principles (GAAP).[8,9] However, careful studies in academia challenged this position. One study[10] found that accounting earnings are more closely related to market-adjusted stock returns than EVA. Another study suggested that there may be no special advantage to the specific EVA systems offered by consulting firms, in that these firms did no better than a matched sample of nonadopting firms.[11]

Illustrative Example: AT&T

With Stern Stewart's guidance, AT&T began to implement an EVA system in 1992. They extended an EVA bonus plan to their entire white-collar workforce of more than 100,000 people. In instituting its system, Jim Meenan, CFO of AT&T's communications services group, stated: "Every decision is now based on EVA. The motivation of our business units is no longer just to make a profit. The drive is to earn the cost of capital. When you drive your business units toward EVA, you're really driving the correlation with market value."

Notably, AT&T ultimately terminated their program in 1997, and in their bonus calculations replaced EVA with various expense-to-revenue ratios, along with earnings per share (EPS). What went wrong? Consider the following quotation from *CFO Magazine*[12]:

> At AT&T, the inability to adjust the program to reflect a drastically changing company seemed at the heart of the problem. But then Ma Bell "struggled to reset EVA targets after Lucent Technologies and NCR were spun off and AT&T Capital was sold" in 1996, according to Stephen F. O'Byrne, president of Shareholder Value Advisors, in Larchmont, New York, and a former Stern Stewart consultant.

> Behind the restructuring and associated problems, though, AT&T was looking at value-based metrics as a "panacea," he says. Company managers "came to EVA with tremendous enthusiasm, but no specific understanding of how EVA was going to help them." And O'Byrne, who co-authored the book *EVA and Value Based Management* with S. David Young last year, says AT&T also "suffered from a lack of commitment to EVA as the sole basis of their nonstock compensation," thus diluting the power of the model to deliver results. In the face of challenges, AT&T managers "found it easier to take alternative routes, like setting new goals or adopting new measures," he says.

AT&T's management failed to adhere to a disciplined compensation system that was established in advance. Instead, the compensation committee deviated from established policy when, in 1996, the market rose by 20 percent, the firm achieved its EVA target, and yet AT&T's stock price declined by 9 percent.

Questions

1. Are there factors that impeded the Packard Foundation from diversifying, but not the Hewlett Foundation?
2. With five family members and the former CEO of H-P comprising half the Packard Foundation board, was the Packard board largely a homogenous group or a heterogeneous group?
3. Did the composition of the Packard Foundation finance committee predispose it to groupthink?
4. George Vera, CFO of the Packard Foundation, was quoted as saying: "This is a family foundation. The family makes these kinds of decisions, and the board is comfortable with this as a starting point." Place his statement into the context of the general discussion.
5. Was there an endowment effect at work at the Packard Foundation?
6. Was there an endowment effect at work at the Hewlett Foundation?
7. What are the main lessons from AT&T's failed experience with EVA?

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[1] Interview provided by George Vera, November 15, 2002.
[2] See Adam Lashinsky, "The Other Divide at HP; This One's Not About Making Money, but Donating It. How the Hewletts and Packards Split," *Fortune,* March 3, 2003.
[3] Quoted in Adam Lashinky's article cited previously.
[4] See John Payne and Arnold Wood, "Individually Decision Making and Group Decision Processes," *Journal of Psychology and Financial Markets,* vol. 3, no. 2, 2002, pp. 94–101.
[5] See Kevin Murphy, "Executive Compensation." In Orley Ashenfelter and David Card (eds.), *Handbook of Labor Economics,* vol. 3, New York: North Holland, 1999.
[6] Both Stern Stewart and BCG have modified residual income in order to adjust for accounting manipulations. Stern Stewart calls their measure economic value added (EVA), and BCG calls their measure cash value added (CVA).
[7] EVA has been trademarked as a term by the consulting firm Stern Stewart.
[8] See James Wallace, "Adopting Residual Income-based Compensation Plans: Do you Get What You Pay for?" *Journal of Accounting and Economics,* vol. 24, no. 3, pp. 275–300, 1997.
[9] See Robert Kleiman, "Some New Evidence on EVA Companies," *Journal of Applied Corporate Finance,* vol. 12, 1999, pp. 80–91.

[10] See Biddle, G., R. Bowen, and J. Wallace, 1997. "Does EVA Beat Earnings? Evidence on Associations with Stock Returns and Firm Value," *Journal of Accounting and Economics,* vol. 24, no. 3, 275–300.
[11] See Chris Hogan and Craig Lewis, 2004. "The Long-Run Performance of Firms Adopting Compensation Plans on Economic Profits," Working paper, Owen Graduate School of Management, Vanderbilt University; John Martin and J. William Petty, 2000. *Value Based Management.* Boston: Harvard Business School Press; Gary Biddle, Robert Bowen, and James Wallace, 1997. "Does EVA Beat Earnings? Evidence on Associations with Stock Returns and Firm Value," *Journal of Accounting and Economics,* vol. 24, no. 3, 275–300.
[12] See Alix Nyberg Stuart and Bill Birchard, "On Further Reflection: Do EVA and Other Value Metrics Still Offer a Good Mirror of Company Performance?" *CFO Magazine,* March 1, 2000.