CAPITAL vs. TALENT

THE BATTLE RAGES ON

Capital is no longer the undisputed 'scarce resource' of the economy, and accordingly, its power over talent has dramatically waned. by **Roger Martin**

WHEN WARREN BUFFETT PURCHASED 15 per cent of **Salomon Inc.** in 1987, his goal was to work his investment magic from his Salomon board seat and help his investment grow and prosper. To his dismay, he found that the firm's investment bankers were eating up all the potential upside with bonus demands that continued to grow, even when profitability was modest or flat. Buffett's patience was depleted by 1991 when, as chairman, he engineered the removal of $110 million out of the investment bankers' bonus pool, apparently striking a blow for shareholders. But the victory was short-lived, as it led to a mass exodus of Salomon bankers who sold their services to more pliable firms elsewhere on Wall Street.

The incident was indicative of what has become a pervasive conflict between capital and talent. Buffett represented the capital of the shareholders of **Berkshire Hathaway**; the investment bankers of Salomon represented no one but themselves – their own God-given and personally-refined talent. On that day, as it would on many days to come, talent won out.

From giant pension funds to small retail investors, capital has increasingly lost its patience with talent, whether it be CEOs, fund managers, lawyers, investment bankers, athletes or actors. Capital is particularly upset because it really liked the previous world – which crested for it in the 1960-to-1980 period and has headed downhill ever since. The truth is, capital is no longer the undisputed 'scarce resource' of the economy, and accordingly, its bargaining power has dramatically waned.

The Origins of the Battle

From the beginning of the First Industrial Revolution to the early-to-mid 20th century, labour had two central attributes congenial to capital. First, it was not *the* key feature of the productive power of the enterprise in question. As the Industrial Revolution marched onward, large-scale physical assets epitomized by urban factories full of expensive machinery became significantly more critical to success than labour. Second, the labour required at the time tended to be generic: one worker was pretty much as good as the next. This was the world that **Karl Marx** observed when he predicted the increasing dominance of capital through the gradual reduction of the labourer's status to that of a slave, and the need for violent revolution by labour.

In a world of inalienable rights, the capitalist could not 'acquire' the upside of the expected value of its workers as it could with a real estate or equipment investment. However, that reality didn't prevent capitalists from trying their best to alienate the economic rights of their workers by developing techniques for turning labour markets into commodity markets wherein one worker could be substituted easily and costlessly for another, granting capital undisputed bargaining power.

The Hollywood studio system of the early 20th century provides an illustration. In order to get their faces on screen, actors had to tie themselves to studios permanently and work at fixed rates under highly-restrictive conditions. The situation had all the appearances of a capital-dominated system in which human assets were but a small cog: the movie business required big studios and broad distribution; massive amounts of capital – at least by early 20th century standards – had to be invested long before one could hope to see returns flowing in. So with their capital, a few key studios wielded enormous power over their actors.

However, it was in this very system that talent successfully reared its head in one of the earliest battles between capital and talent. The movie business began to grow recognizable stars, creating a direct line-of-sight to the consumer. And the stars began to see that even without capital, they had power. In 1919, three actors representing the pinnacle of talent at the time – **Charlie Chaplin**, **Mary Pickford** and **Douglas Fairbanks** – plus leading director **D.W. Griffith**, broke away from the studio system and created their own studio – **United Artists**, perhaps the first great 20th century talent-based organization. They had little capital, but plenty of talent, and with that talent, they charged capital – i.e. the studios – a premium price for their services, a trend that has ratcheted upward ever since.

The talent contagion has since spread far and wide. In the world of investing, managers have dramatically ramped up their take from the capitalists for whom they work. In the late-1970s, enterprising investment managers decided that they should share directly in the upside of the capitalists whose money they managed. The discovery by **Theodore Forstmann**, founder of **Forstmann Little**, that he could charge 20 per cent of the upside he earned for his clients in addition to his traditional fee of two per cent of assets-under-management for his buyout fund opened the way for hedge fund, venture fund and buy-out fund managers worldwide to earn equity-like returns without actually experiencing the inconvenience of having to invest their own equity. This new pay-off formula soon swept the industry, dramatically tilting the balance of power away from the capitalists.

Before long, CEOs figured out that stock-based compensation produced equity-like returns, again without capital investment and this time over-and-above their normal compensation. Even professional athletes got into the act of creating compensation formulae that produced virtually unlimited upside: football and basketball players' unions negotiated pacts that guaranteed their members a fixed portion of league revenues – a better deal by far than a share of the profits.

The traditional approach of labour to the contest with capital had been to band together to make sure that their weakest was protected by the scale and solidarity of their brethren. That approach produced unionized labour pools that afforded wage stability and better working conditions. It did not, however, produce capital-like returns for labour: a well-paid fixed wage labourer remained a labourer, a member of the working class. The new approach was to utilize the differentiated talent of the strongest – whether actor, athlete, CEO or fund manager – to create a compensation structure that turned labourers into members of the capital class.

Tactics for Talent

While capital is attempting to battle back against CEO-level talent, it has yet to feel the muscle-flexing by a much broader array of talent at all levels. The improved bargaining power of talent will continue to broaden as more and more classes of talent begin to flex their muscles, not by collectivizing to promote their equality, but by emphasizing their uniqueness. As talented bank employees, customer service representatives and product designers watch the talent in 'sexier' industries like sports, entertainment and finance migrate to huge differentials in remuneration based on talent level, they will begin to recognize that they, too, have bargaining power unique to themselves and not standardized across their cadre.

As a result, capital will increasingly find itself in a negotiation with a wide variety of its employees, with each dedicated to finding out exactly how much he or she can extract. Instead of feeling like it is getting a fabulous deal from its best customer service representative – who currently earns the standard compensation package for CSR's – capital will find itself paying top dollar to keep that fabulous CSR engaged. However, anyone from the talent side who has a desire to plum the depths of 'how much' rather than 'enough' needs to heed certain rules of value maximization.

1. Achieve and Maintain Distinctiveness

The lynchpin for talent is the achievement of distinctiveness. Quite simply, the more differentiation talent can achieve, the better. There is only one **Harrison Ford** or **Julia Roberts**; in baseball, by contrast, there are a number of ways to get 40 home runs and 100 runs batted in, and both management and fans may be indifferent between the 'ways' as long as the output is there. Of course, 'a number of ways' does not necessarily mean 'a large number of ways': the smaller that number is, the better things will turn out for talent at the bargaining table.

It is critical for the skills, knowledge and capability of talent to arise in mysterious, difficult-to-quantify ways. If there were a simple formula for creating an insightful investment manager, plenty of them would be produced and differentiation would disappear. Thus it is important for talent to thwart any attempts to simplify or codify the knowledge structures underlying the talent in question. The more the basis for talent development is *heuristic* in nature -- i.e. based on experience and judgment – and the less it is *algorithmic* – i.e. "I studied the manual" – the better for talent. Putting up barriers to the replication of its distinctiveness is critical to the maintenance of talent differentiation.

2. Establish Clear Line of Sight to End Customers

In the end, talent will only be able to extract value from capital to the extent that customers insist on the talent being present. One does not seek to have one's brain aneurysm treated by 'some neurosurgeon' but by *that particular neurosurgeon*, who often comes

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recommended by others in the profession. If customers are indifferent between alternative sources of talent, then capital has greater power and talent has little leverage. The key is for talent to make sure that the customer can see and appreciate its particular contribution to the value proposition, because then the customer will induce capital to acquire the requisite talent – often with little regard to the cost.

3. Attach to Deep Pools of Capital

When talent is not attached to a pool of capital, it can only 'eat what it kills'. For example, strategy consultants can earn substantial incomes, but they are constrained by the fact that strategy consulting is largely a capital-free enterprise. Consultants can only earn what they charge for their own time. Hence the highest paid strategy consultants in the world rarely earn more than $5 million per year.

This contrasts dramatically with investment banking, where the bank in question supports its talent with vast sums of capital in order to underwrite securities, bridge finance deals, arbitrage mergers, etc. Talent positions itself as absolutely critical to all aspects of the business, and in doing so, it attaches itself irreversibly to the pool of capital that leverages its activities.

4. Develop Creative Extraction Formulae

The richest elements of the talent class have gotten there by developing a formula for extracting value that is uncapped and 'equity-like', if not better. Capped-value extraction is based on a fixed fee, like a billing rate for a lawyer or consultant, or a fee for a physician's service. Even though these rates can appear impressively high – like $10,000 per day for a consultant or $20 million a movie for **Tom Cruise** – they don't have equity-like returns; they don't scale upwards with increases in the value of the final product or the enterprise as a whole.

U.S. trial lawyers, on the other hand, often charge a percentage – as high as 33 per cent – of the judgment awarded in the case in question. Negotiating a share of profit in a capital-backed venture without supplying any capital is an even more powerful value extraction tool. This is what talent figured out in the private equity business with its two-per-cent management fee plus 20 per cent of the upside.

Better still is the negotiation of a share of the *revenue* of a capital-backed venture, which leaves capital in a position of needing to figure out how to make a profit after the cost of talent extracting its share of the revenue. Movie stars and directors figured this out in the movie business with 'percentage deals' that earned them a share of box-office revenues.

When talent succeeds in these areas, it courts two dangers. First, it exposes itself to the public and political fallout associated with its greed. Trial lawyers, investment bankers and professional athletes are feeling this already. **Michael Milken** felt it early on in his relationship with his peers at **Drexel Burnham Lambert**, who began to scowl as soon as his $50,000-a-year fixed-salary plus 10 per cent cut-of-profits deal saw him achieve hundred million dollar annual compensation figures – 10 times those of his then-chairman. Second, as talent succeeds, it accumulates earnings and becomes – of all things – capital-like: upon cashing out, entrepreneurs often become angel investors or venture capitalists; directors become independent producers; star athletes become team owners. As it becomes capitalist, talent needs to find a way to make money on its accumulated capital – and presto, it needs advice from investment management talent, which is busily playing the talent game.

Defenses for Capital

It will not be a pleasant time for capital in the near term. It seems profoundly unfair to capital that it takes the risk and talent walks off with the rewards. However, capital will learn that fairness is not the issue in this battle: utility is. Increasingly, talent is content with any kind of capital, while capital increasingly needs a specific kind of talent. To defend itself, capital needs to do four things.

1. Maintain Closer Involvement

It will be the darkest of days for capital that is completely uninvolved in the enterprise. The opposite, 'involved capital' (epitomized by **Bill Gates** or Warren Buffett) are capitalists, but the majority of

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their capital is tied up in an enterprise in which they are intimately involved. In fact, they are themselves arguably the single most important talent input into the enterprise. As such, they are least likely to hold themselves up by extracting the maximum value they can from the capital providers to the enterprise; and as extremely knowledgeable talent – especially with respect to the kinds of talent necessary for their particular enterprise – they are in a strong position to discipline members of the talent class who might try to argue that they are more valuable than they really are.

At the opposite extreme is totally-uninvolved capital – the passive investor who simply dumps capital into an enterprise, whether as an individual or an institution such as a pension fund, and hopes to earn an attractive return on that investment. In this situation, talent small and large is perfectly positioned to have its way with capital. This situation is epitomized by boards of directors – talent hired by the shareholders – hiring compensation consultants – more talent – to opine on the compensation of the company's CEO – yet another layer of talent. Of course the compensation consultant will issue an opinion suggesting that the CEO is really valuable and needs to earn very high compensation.

Smart capital will push toward deeper involvement with the members of the talent class it is backing. In many ways, it will be 'back to the future': in the early 20th century, before the coming of managerial capitalism, talent and capital were more closely linked. The great early-20th-century capitalists – **Rockefeller**, **Morgan**, **Mellon**, etc. – were also the greatest talent their organizations possessed. They ran companies in which their own talent made the capitalists – primarily themselves – rich. And they were able to discipline and manage the lesser talent in their companies to keep its extraction power under control.

2. Commoditize Classes of Talent

Capital brilliantly commoditized a key class of talent – senior executives – in the 1950s and 60s by creating the concept of 'the organization man'. This generic corporate executive in a grey flannel suit, white shirt and trench coat worked his way up the ladder along with all the other, similar organization men, usually while married with two or three children, a suburban house and a dog. Distinctiveness was frowned upon, and the organization men converged into a generic army of interchangeable parts, which was perfect for capital because with undifferentiated talent, it maintained the power.

Capital should commoditize whatever categories of talent it can in similar ways to the commoditization of the organization man. The key tools are to suppress distinctiveness and obscure the line-of-sight to customers. In many respects, large product management companies and pharmaceutical companies have done this successfully with their brand managers and research scientists. At **Procter & Gamble**, the firm cannot be held hostage to the Tide brand manager attempting to extract excessive value for his or her talent because the firm has developed a capacity for developing brand managers. It could readily transfer-in another brand manager – say from Pampers – to take over Tide; and of course, knowing that fact, the Tide brand manager is not likely to overplay his or her hand.

Thus, it is in capital's best interest to invest in the codification of expertise and the simplification of the complicated knowledge structures that are in the interests of talent to maintain in a non-codified and mysterious state. Two aspects make the codification difficult. The first is that those necessary for the codification process are members of the talent class, so that over time they will extract ever-more value for the act of codification itself. The second is that some knowledge structures that are critical to the successful performance of the tasks of talent aren't susceptible to codification – a reality that does not escape the attention of the talent class. The 'Midas touch' of that star investment banker cannot be turned into a recipe, leaving such individuals beyond the reach of uniformizing strategies.

3. Build Talent-Independent Assets

The third defense for capital is to build assets that can be used by the company to earn profits for shareholders without intensive use of talent. For example, consider the contrast between investment banking and retail-branch banking.

To operate an investment bank such as **Goldman Sachs** requires thousands of investment bankers, each of whom spends their career positioning themselves as a unique, differentiated human asset. When the firm earns a dollar of investment banking business, numerous investment bankers are at the compensation window arguing that it wouldn't have been possible without them. If the firm refuses, they simply walk, as Warren Buffett found.

On the other hand, to operate a retail-branch network such as **Royal Bank of Canada**'s requires thousands of largely interchangeable branch personnel, real estate staff, computer programmers, product designers, etc. It certainly takes concentrated talent to create the strategy and make ongoing critical decisions, but the talent as a share of total personnel required to carry out business on an ongoing basis is fractional. Such talent can be paid handsomely while leaving plenty of profit on the table for capital.

The implication for capital is that it should build as many assets as possible that can be operated with human assets that are as generic as possible.

4.Collectivize to Fight Talent

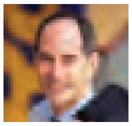
This is the tactic that labour used to fight capital in the great battle of the 20th century. After the *National Labour Relations Act* of 1935 and the coincident creation of the **National Labour Relations Board**, labour collectivized to a dramatic extent and used its collective power to extract great gains from capital. Though no single worker could threaten a company, the entire workforce could do so if it threatened to shut down the company.

Collectivization of capital has begun to take shape in the 21st century war against talent. In June of 2002, 19 pension and investment funds with CDN$350 billion in assets formed the **Canadian Coalition for Good Governance**, announcing that they would use their powers to keep executive compensation in corporate Canada at 'reasonable levels'. The Coalition continues to flex its muscles: since its inception, it has grown to 46 members, with total assets under management of $1.3 trillion.

In closing

In the 21st century economy, no matter who you are, it will benefit you to nurture and exploit your talent. Regardless of your current level of distinctiveness, it is in your interest to enhance and maintain it. This applies whether you are a customer service representative, software engineer or cook.

With talent continuing its ascendancy, the first responsibility lies with talent to show some sense of self-control, and then for capital to respond in kind. While there is little evidence of this to date and great challenges exist in coordinating an effort by something as amorphous as 'talent', the consequence of a lack of self-control will be the provocation of a war that could make the great 20th century economic wars look tame by comparison. ***R***



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