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Recent Studies

On securities analysts, innovation, European happiness, Asian competitiveness, and other topics of interest.

Research Notes
by Des Dearlove and Stuart Crainer

Why Analysts Have Two Faces

Leslie Boni (boni@mgt.unm.edu) and Kent L. Womack (kent.womack@dartmouth.edu), "Wall Street's Credibility Problem: Misaligned Incentives and Dubious Fixes?" Forthcoming in *The Brookings–Wharton Papers in Financial Services, 2002*. http://mba.tuck.dartmouth.edu/pages/faculty/kent.womack/workpaper.htm

Investors, politicians, regulatory authorities, and the media have voiced growing concern that conflicts of interest undermine the quality of research and stock recommendations of Wall Street brokerage houses' sell-side analysts. These analysts have lost credibility, especially among small investors who feel they are victims of biased research.

According to two academics who have researched the issue, the disparate needs of investment banks' different clients are at the heart of the controversy. "While brokerage clients (investors) want *unbiased* research, most corporate finance clients (issuers) benefit from *optimistic* research," note Leslie Boni, assistant professor of finance at the

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Anderson Schools of Management at the University of New Mexico, and Kent L. Womack, associate professor of finance at the Amos Tuck School of Business Administration at Dartmouth College. This, they argue, creates "misaligned incentives" that undermine the objectivity of analyst research.

Professors Boni and Womack examined a number of pressures analysts may face. There are internal pressures from analysts' employers to increase brokerage commissions or investment banking business. And there are external pressures from the management of the firms the analyst covers (i.e., management can restrict access to privileged information if the analyst fails to toe the company line). Analysts must also answer to institutional investor clients who may not want a company's stock downgraded if they have a substantial holding. In addition, analysts' personal investments can cause conflicts of interest.

In their analysis, the authors emphasize three points. First, the main reason brokerage firms employ analysts to do investment research is to encourage client transactions in stocks and bonds, and to facilitate underwriting. In reality, analysts are marketers earning commissions and fees on the volume of transactions, rather than independent truth tellers.

Second, the management of the firms covered by Wall Street analysts decides which analysts will receive so-called nonmaterial information, such as information about strategy or long-term plans. Analysts who make recommendations unfavorable to those firms risk being cut out of the loop.

Third, the authors argue, professional fund managers understand the biases inherent in the system and are able to read between the lines. They filter and interpret the analysts' recommendations — and often employ their own analysts. Small investors, on the other hand, do not necessarily understand the pressures acting on analysts or the nuances of their signals. "Without adequate education," the authors conclude, "[small investors] will continue to be disadvantaged when they do not understand that 'buy' may not mean 'buy' and 'hold' definitely means 'sell.'"

Reforms currently proposed by regulators and brokerage firms include restricting analysts' personal investments, increasing disclosure requirements, reinforcing "Chinese firewalls" that separate investment banking from research, better investor education, and expanding independent research services. But unless reforms confront the issue of misaligned incentives, professors Boni and Womack argue, they are unlikely to restore Wall Street's research credibility.

Public Policy Impacts Innovation

Scott D. Anthony (santhony@hbs.edu), Erik A. Roth (eroth@hbs.edu), and Clayton M. Christensen (cchristensen@hbs.edu), "The Policymaker's Dilemma: The Impact of Government Intervention on Innovation in the Telecommunications Industry," Harvard Business School Working Paper Number 02-075, April 2002. www.hbs.edu/dor/abstracts/0102/02-075.html

Policymaking is fraught with difficulties. Even the best intentions can have unintended consequences. The problems are especially acute when it comes to crafting public policy to promote competition and innovation in highly regulated industries.

Applying his considerable expe-

rience to this issue is Clayton M. Christensen, the Robert and Jane Cizik Professor of Business Administration at Harvard Business School and author of *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail* (Harvard Business School Press, 1997). Professor Christensen and two Harvard research associates, Scott D. Anthony and Erik A. Roth, use the U.S. telecommunications industry to analyze the relationship between government intervention and innovation. Their conclusion is that although government action can have a large impact on the market for innovation, the relationship between policy and innovation is more complex than was previously understood.

The implications are significant. Innovation, defined by the authors as a "new product, service, or business model," is widely recognized as a key factor in U.S. economic success. Moreover, disruptive innovation — innovation that has the potential to change industry structure — has been instrumental in the spectacular economic growth in the U.S. over the past century.

Policymakers' general lack of understanding about the market for innovation has led to a paradox. In many cases, decades of policies aimed at stimulating economic welfare have "actually stifled the development of the most dynamic form of innovation — disruptive innovation." This is "the policymaker's dilemma," and it results from the fact that policymakers are bereft of a coherent theory of innovation that helps them understand how different policies promote or inhibit innovation. The shame of this is that, when one is armed with a theoretical framework, the effects of policy on the innovation process are largely predictable.

According to the authors, policy's impact on the natural market for innovation has two primary forces. These are *motivation*, defined as market incentives (or "a pot of gold"), and the *ability* of individuals and firms to access resources to innovate. Successful innovation requires both motivation and ability. To be effective, therefore, public policies must recognize and influence these two levers.

The U.S. telecommunications industry highlights the issues. Legislation and regulation have had a big impact on the evolution of the telecommunications sector, which accounts for 3 percent of total U.S. GDP. But the authors claim there has been no significant disruptive innovation in the telecommunications industry since the telephone replaced the telegram at the start of the 20th century.

They observe: "In their sometimes-overzealous attempts to protect voters, policymakers have at times done more harm than good through policies that kept prices down but denied the public the disruptive innovations that would have created lower-cost business models."

Almost a century of intervention in the telecommunications sector at the national, state, and local level has produced a "complex legal soup flavored by politicians, courtrooms, lawyers, and lobbyists." This, the researchers say, has distorted the natural market for innovation and created an environment in which policymakers try to make sense of this barrage of conflicting information and advice from firms, consumers, and lobbyists.

To help policymakers cut through the noise, Professor Christensen and Messrs. Anthony and Roth offer the "motibility" (optimal combinations of motivation and ability) framework. Policymakers can use this tool to craft policies that have a positive impact on both motivation and ability, driving the innovation market toward "the panacea … a hotbed of successful and profitable innovation."

Can Wealth Buy Happiness?

Alberto Alesina (aalesina@harvard.edu), Rafael Di Tella (rditella@hbs.edu), and Robert MacCulloch (r.j.macculloch@lse.ac.uk), "Inequality and Happiness: Are Europeans and Americans Different?" Harvard Business School Working Paper Number 02-084, Revised June 2002. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265293

On average, European countries redistribute more wealth and provide more generous welfare benefits than the United States. In 1996, for example, government spending as a percentage of GDP across Europe (excluding interest payments) was 44 percent. This compares to 30

percent in the U.S. Europe is known for its benevolent social welfare policies. But what is it about Europeans' attitudes toward social inequality that makes them more inclined than Americans to favor government largesse?

This question is usually studied from the perspectives of history, culture, politics, and society. In this case, however, three academics — Alberto Alesina, professor of economics and government at Harvard University; Rafael Di Tella, associate professor of business, government, and international economy at Harvard Business School; and Robert MacCulloch, a postdoctoral fellow at the London School of Economics — analyzed the effect of inequality on people's stated happiness in the U.S. and Europe. They did so by analyzing responses to the basic question: "Are you happy?" From this study they conclude that income inequality affects European and American sensibilities differently. Indeed, the researchers found that inequality — often associated with high poverty rates — had a significant negative effect on happiness in Europe, but was almost neutral in the United States.

Thousands of European and American responses to this simple question about personal well-being were correlated by the trio with measured levels of inequality. In all, 128,106 responses were analyzed from two well-established surveys. U.S. data came from the United States General Social Survey (1972 to 1997), and European data came from the Euro-Barometer Survey Series (1975 to 1992). Happiness levels over time were then correlated with the prevailing level of inequality (using inequality measures for whole countries in Europe and individual states in the U.S.).

The use of happiness data for rigorous statistical investigation raises some academic eyebrows. But a body of literature in psychology and economics supports this approach. Further, the results of this study are intriguing and could help explain differences in attitudes toward big government on the two continents.

Not only did the study find Europeans to be significantly more sensitive to social inequality than Americans, but it also found clear differences between ideological and income groups in each region. In Europe, people on the political left are more affected by inequality than those on the right. In the U.S., by contrast, the impact of inequality has no clear ideological divide. More interesting still are the variances in attitudes among the rich and poor. In Europe, feelings of inequality affect poorer people's happiness much more than rich people's. In the U.S., this pattern is reversed: It is the happiness of the rich that suffers as a result of inequality, while the U.S. poor seem indifferent to it.

The authors pose two potential explanations for their findings. One, Europeans prefer feeling that they live in a more equal society; or two, social mobility is (or is perceived to be) higher in the U.S. The researchers conclude that the latter explanation is the more plausible. Because Americans believe that their society is more mobile, the poor believe they can move up. However, the rich worry they may fall back.

Europeans, on the other hand, perceive themselves to be less mobile. Inequality has a negative impact on the happiness of Europe's poor because they believe they are stuck. (Other research has found that 71 percent of Americans believe the poor have a chance of escaping from poverty, compared to just 40 percent of Europeans.)

Asia's Competitive Hurdles

Bala Chakravarthy (chakravarthy@imd.ch), Peter Lorange (lorange@imd.ch), and Hee-Jae Cho, "The Growth Imperative for Asian Firms," *Nanyang Business Review*, January–June 2002. www.nbs.ntu.edu.sg/research/NBR/nanyang.asp

Healthy rates of growth are the expectation of large corporations.

Asian companies need to ignore calls for instant transformation and renewal and return to the basics of inspired evolution from within.

But their capacity to disappoint is larger than you may imagine.

Bala Chakravarthy, Peter Lorange, and Hee-Jae Cho, three academics at the Swiss business school IMD, examined the performance of 3,000 public companies throughout the world with annual revenues of more than $500 million between 1993 and 1999. A mere 24 percent recorded year-over-year growth and positive operating income throughout this period.

These global figures appear worrying enough, but for Asia (905 of the companies were Asian), the news is even worse. Only 2 percent of Asian companies in the survey demonstrated consistent profitable growth during this period. The companies that recorded sustained growth were largely (and predictably) drawn from the technology sector.

Although the performance of the Asian companies can, to a greater or lesser extent, be attributed to the region's economic travails in the 1990s, reasons for the more generally poor performance are less easily identified. Professors Chakravarthy, Lorange, and Cho (respectively, professor of strategy and international management, IMD president and Nestlé Professor of Strategy, and research associate) point out that commentators have a standard litany of reasons for disappointing growth. These are managerial complacency, lack of appetite for renewal and change, overly rigid strategy-making processes, and an emphasis on profits rather than growth that is deeply built into management cultures and systems.

The authors contend that growth is delivered by companies that have an appetite for self-renewal. This attitude emphasizes learning rather than planning and is guided by principles involving market strategy and business competence. The authors argue that seeking to capitalize on opportunities in the marketplace while developing new competencies is dangerous. Markets need to be sought, and competencies need to be developed. But to do the two simultaneously is asking for trouble.

The authors suggest that self-renewal requires that an organization employ people who can drive the capture of markets or the acquisition of new competencies. Their other ingredients for growth are familiar — for example, a willingness to experiment and then execute fast (or withdraw speedily if things go wrong).

This is largely conventional wisdom, but, especially for Asian firms, the authors' conclusion is not. If Asian companies are to seize the imperative for growth, they need to concentrate on organic growth (though occasional mergers and acquisitions can prove helpful) and judge their continuing success by year-over-year revenue growth and positive operating income. In short, Asian companies need to ignore the calls for instant organizational transformation and renewal and return to the basics of inspired evolution from within.

Knowledge Economy Realities
Paul A. David (paul.david@economics.ox.ac.uk) and Dominique Foray (dominique.foray@oecd.org), "Economic Fundamentals of the Knowledge Society," Stanford Institute for Economic Policy Research, Discussion Paper Number 01-14. www-econ.stanford.edu/faculty/workp/SWP02003.html

The reality behind the much-vaunted concept of knowledge economics

The knowledge economy does not look back. It moves forward vigorously and views history simply as defunct knowledge.

is often elusive. Paul A. David, of Oxford and Stanford Universities, and Dominique Foray, of Paris-Dauphiné University, manage to cut through the vagueness. They provide a pithy differentiation between knowledge — which "empowers its possessors with the capacity for intellectual or physical action" — and information — "structured and formatted data that remain passive and inert until used."

Charting the knowledge-fueled economic transformation and pausing to poke fun at the New Economy bubble, they examine four key issues: the accelerating speed of our production of knowledge, our capacity to innovate, the growing importance of intangible capital, and radical developments in the means by which knowledge and information are produced and distributed.

These issues are most active and observable in knowledge-based communities. In many ways, this is the standard argument in favor of the innovative and commercial power of small teams or groups. Professors David and Foray, however, go further by identifying the characteristics of those communities that are more fruitfully focused on "knowledge-driven production."

At the heart of these communities is a willingness to exchange and disseminate knowledge, often through the latest technology, but also through organizations structured around knowledge sharing. While mapping out the virtues of such communities, the professors refuse to declare an optimum size for such a community — it depends, they say, on why, how, and where the knowledge is exchanged.

If the knowledge economy is to develop to its full potential, the authors suggest that a number of challenges must be tackled. The first is the challenge of access to knowledge and information. Globally this remains highly uneven. This unevenness is also reflected in the fact that knowledge develops and is applied at different paces in different sectors of human activity and commercial endeavor.

Another unresolved issue is that of balancing intellectual property rights with public access to knowledge. The explosion of access to knowledge through technology has been matched by an expansion in patents. The two now exist unhappily together. Only the lawyers are truly happy. The authors suggest that a better balance between the two issues needs to be struck.

Perhaps the most interesting and daunting matter the authors identify is that of "a society bereft of memory." The transient nature of knowledge means that today's knowledge is quickly consigned to history. The knowledge economy does not look back. It moves forward vigorously and views history simply as defunct knowledge — usually written in another language. In the new knowledge economy, holding on to the past may be our greatest challenge.

Socializing the Virtual Team

Manju K. Ahuja (mahuja@indiana.edu) and John E. Galvin (jogalvin@iupui.edu), "Socialization in Virtual Groups," unpublished. www.bus.indiana.edu/ardennis/wp/tr120-1.doc

Starting work at a new organization is always stressful and fraught with complications. Socialization — defined as "the process of learning the behaviors and attitudes necessary for assuming a role in an organization" — is rarely easy. Knowledge of "how we do things around here" is

largely acquired over time through observation and face-to-face interaction. Eventually newcomers make sense of their environment, of how the organization and their colleagues work, and become more effective themselves.

Manju K. Ahuja and John E. Galvin, two assistant professors at Indiana University's Kelley School of Business, consider how socialization works differently in the case of a virtual group — "a group of people who interact through interdependent tasks, guided by common purpose … with links strengthened by webs of communication technologies." How does the process of socialization work when e-mail is the principle means of communication among group members?

Professors Ahuja and Galvin sought an answer by examining the e-mails exchanged by a particular group of academics over three months. For this widely dispersed group in 27 locations, e-mail was the primary form of communication, although there also was personal interaction. The messages were categorized by the identity of the sender, by whether information was being requested or provided, and by those who were actually exchanging information.

In total, 673 messages were analyzed (with the permission of all involved). The general pattern was that more established members sent many more e-mails (587 versus 86). They also sent much shorter messages — the average e-mail between two established members of the group was a mere 110 words — suggesting that established group members communicate more effectively. Established members usually provided information, whereas newcomers requested information.

The newcomers were inquisitive about "regulative information" (the rules, regulations, and processes of the group), and also engaged in cognitive task-centered activity. The authors suggest that the impersonal nature of electronic communication may have proved helpful in encouraging the newcomers to seek out such information.

But newcomers were notably reticent about seeking more information or guidance about normative behavior — the expectations and the values of the group. They remained silent and watchful rather than using the impersonal nature of e-mail to explore these more ambiguous issues.

It seems that socialization in a virtual group does not simply happen. It needs to be managed and requires many of the same supports given to conventional socialization. In particular, the authors suggest that using different electronic channels of communication (such as discussion groups and chat rooms) might prove helpful, and that pairing a newcomer with an established member may be a means of accelerating the acquisition of more subtle normative information. ✚