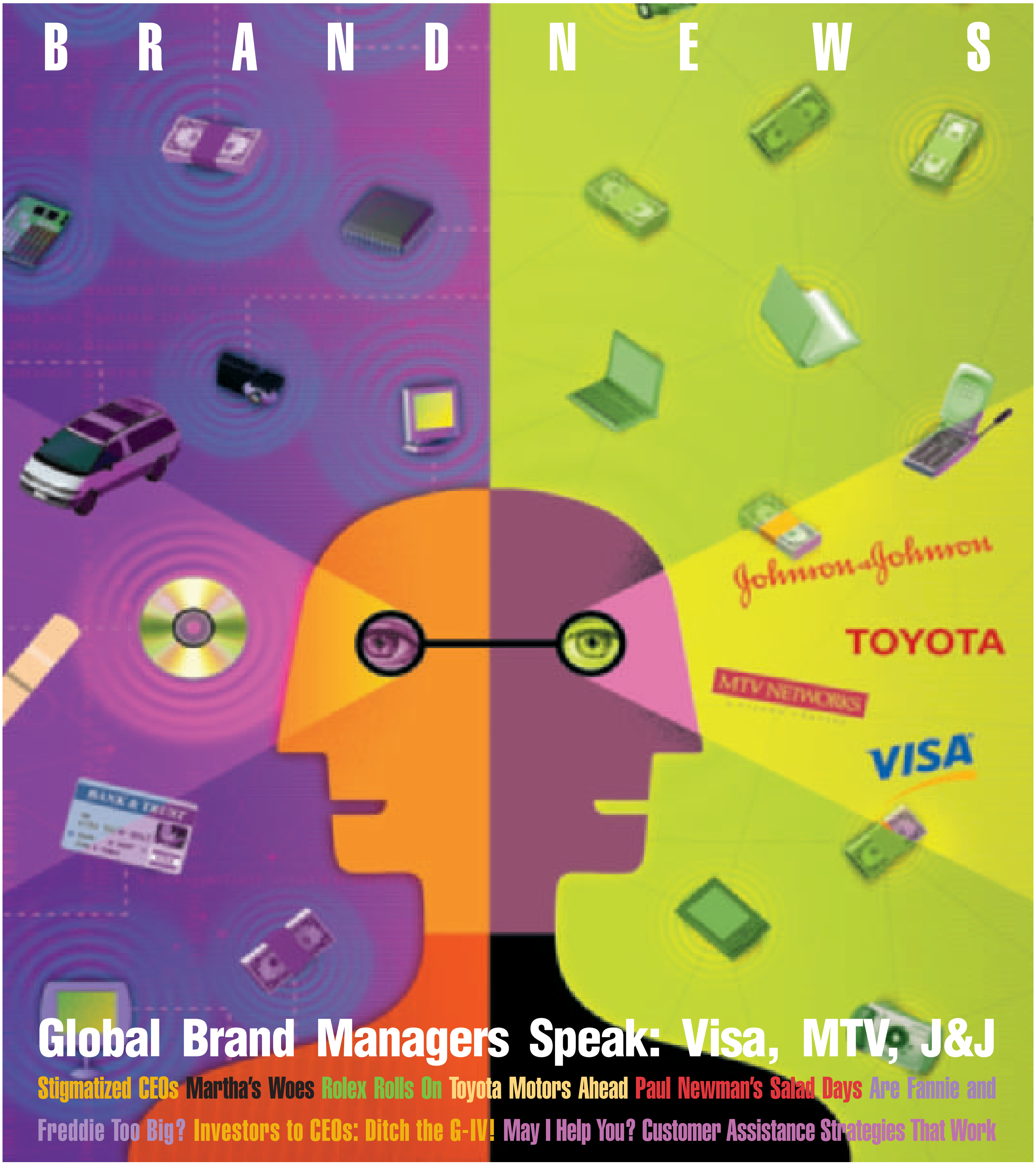
FALL/WINTER 2004

STERN*business*

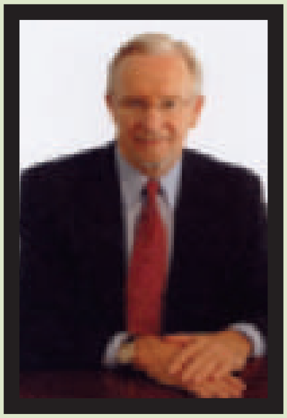
BRAND NEWS



Global Brand Managers Speak: Visa, MTV, J&J

Stigmatized CEOs Martha's Woes Rolex Rolls On Toyota Motors Ahead Paul Newman's Salad Days Are Fannie and Freddie Too Big? Investors to CEOs: Ditch the G-IV! May I Help You? Customer Assistance Strategies That Work

a letter from the **dean**



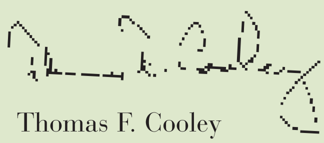
It's rare to discuss branding in the context of a university, or of a business school. After all, we don't have customers or products. We don't try to gain market share by rolling out periodic marketing campaigns. And yet, in one important way our efforts are inextricably linked to the process that companies go through when trying to build a brand. We have a strategy in place to ensure that NYU Stern signifies and embodies certain values and attributes in the minds of all our stakeholders – students, faculty, staff, colleagues, and our counterparts in the private sector. Beyond that, we strive to communicate our values consistently and frequently to our different constituencies.

What are the components of the NYU Stern brand? A spirit of rigorous interdisciplinary inquiry; an openness to the city that is our home, and to the global context in which we live and work; a commitment to excellence in teaching; and the ambition to grow, expand, and deepen our knowledge base through research.

The Stern brand has been built over a century of sustained effort. We have deep roots in finance and accounting. But over the decades, as we have grown, and as our human and financial resources have grown, we have expanded our horizons. Today, we are proud to offer strong programs in a range of disciplines: from economics to marketing, from management to information systems.

We strive constantly to invigorate Stern by recruiting new faculty, by bringing a broad range of guest scholars and executives to share their experiences with us, and by finding new ways to connect and re-connect with members of our far-flung community. This September, we are welcoming 11 new junior faculty to campus. We are also delighted that Steve Florio, the former president and chief executive officer of Condé Nast Publications, is coming to teach at NYU Stern this fall. Our long-running CEO Series and the popular Author Lecture Series both continue, with the appearance of business leaders such as Larry Bossidy and Robert Rubin, respectively. And in October, our Global Alumni Conference in Paris will feature presentations on topics ranging from the future of the European Union to the global luxury market.

SternBusiness is an integral part of these efforts to explore, raise questions, and establish connections in New York – and beyond. And this issue proves that members of our community have significant intellectual contributions to make on the important subject of branding. I hope you enjoy it.



Thomas F. Cooley
Dean

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FALL/WINTER 2004 **Brand News**

Illustrations by: Bryan Leister, Juliette Borda, Jud Guitteau, Ken Orvidas, Steven Salerno, Michael Caswell, Robert O'Hair

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Tom Freston

co-president and co-chief operating officer of Viacom

Tom Freston, co-president and co-chief operating officer of Viacom, received his MBA from NYU Stern in 1969. He has been with the pioneering music channel MTV since its founding in 1981 and served as CEO of MTV from 1987 until last spring. MTV Networks, a division of Viacom, operates cable networks MTV, VH1, Nickelodeon, Country Music Television, Spike TV, Comedy Central and TV Land. The company also controls MTV films in association with Paramount Pictures and licenses consumer products. MTV currently broadcasts to 314 million of the world's households in 136 countries and territories. MTV has branched out from its original fare of music videos to offer original programming, such as *Real World* and *Newlyweds*, and has engaged young audiences with its "Rock the Vote" and "Choose or Lose" campaigns. In June 2004, Freston was promoted to co-president and co-chief operating officer of Viacom, and is now responsible for the company's cable, publishing and theme park units.

RR: *What television moments influenced you growing up in Connecticut?*
TF: I grew up in the '50s and '60s, which must seem like ancient history now, and I saw those iconic moments: Elvis's first time on TV and the Beatles and the Kennedy assassination. But I spent more time listening to the radio, and I was really touched by the Beat movement of the late '50s, early '60s, and the rise of the counterculture. I wasn't a hippie, but I was right here in Washington Square Park. And the late '60s was a real interesting time to be going to business school in New York City. There are certain themes from those movements that resonated with me. One was the notion that you should experience as many different things as you can, that travel would be a very important journey to take in your life.

RR: *So what motivated you to go to business school in the first place?*
TF: I couldn't really see myself being a doctor or a lawyer or a dentist. If I went to business school I thought I could find something that I liked, although it was really hard for me to figure out what that would be. It was also helpful at the time to get a deferment and stay out of the war in Vietnam. But I was very pleased to get into NYU. I was lucky enough to have Peter Drucker as one of my professors.

RR: *Do you remember anything that he specifically taught you?*
TF: I always remember him talking about innovation. Invention is creating something totally new. But the real thing in life is innovation, which is taking two things that already exist and putting them together in a new way. That's where most businesses come from.

RR: *What did you do when you left here?*
TF: I took off a year and a half and sort of bummed around. I was a bartender in Aspen. Then I went to Mexico and worked around the Caribbean. Then I decided I better get a job. I wanted to do something really creative. So I got a job at an ad agency, Benton & Bowles. They put me on a Proctor & Gamble business. I was assigned to the Charmin toilet paper account. But I was very alienated at the time. So after a year and a half I quit, and I spent a year traveling around the world. I ended up in Asia, and I was just so enthralled with everything I saw there. So I made up my mind that I would like to live there and work, and figured out a way to support myself.

I came back to the States and found a friend who had some money. And in 1973, with the advent of air freight, it was possible to make some-

Mr. Freston was interviewed by **Randall Rothenberg**, editor-in-chief of the quarterly business magazine *Strategy+Business* and editor-at-large at *Advertising Age*.

thing in a country like India or Afghanistan, and sell it 24 hours later in New York City. We set up factories to design and make clothes in India and Afghanistan. I had a house in each place. We sold our clothes through a network of showrooms here and in Europe and Australia. We did that for seven or eight years. It was an excuse for me to live an adventurous life in Asia.

RR: *Why didn't you stay there?*
TF: Well, the U.S. put in place a system of quotas on textiles and garments. Then the Russians invaded Afghanistan. And I had this epiphany one day. I was on a motorcycle in New Delhi. It was 110 degrees, and some gas from a diesel bus was blowing in my face, and I said, "I'm out of here." We had made and then lost a lot of money, so I came back to New York with my tail between my legs.

RR: *So you get to Warner Amex Satellite Entertainment in 1980. That's a pivotal year for cable. USA Networks started, CNN debuts, Showtime and The Movie Channel merge. What did you think this industry was going to be?*
TF: I was really lucky to get in when I did. There was a vision of an alternative television universe other than the three broadcasters – based on cable rolling out across the country and the idea of narrowcasting. Almost all the incumbents said it would not work – the ad agencies, the broadcasting companies, producers. You had this melting pot of people, none of whom had any experience doing it. I was on the development team of MTV and we all had a passion for music and the belief that a network like this would work. We emerged at what became MTV Networks as a real brand-oriented powerhouse.

RR: *You went from new recruit, to a company that didn't exist, to CEO in about seven years. What were the touchstones along the way that led you to the point of leading this company?*
TF: One of the good things about being in a new company in an industry that didn't exist is that no one knew what they were doing. The people ahead of you often got fired because they usually did a few things wrong. So it was easy to rise, if you had your head up, if you were able to learn. In those days, you'd go from a secretary to vice president in six months. I was the marketing guy at MTV. Every time someone would get fired, they'd give me his job too. So then they put me in charge of affiliate sales, and I had never had a sales job in my life. But we did well, and then they moved me after a year of that to general manager of MTV. Then VH1 came along. And at this point, I'm only at the company four years. Then we were sold to Viacom and a lot of people left. They made me co-president, for no good reason. Then the guys who bought us got blown out in a takeover battle with Sumner Redstone, and he came in and they made me the CEO. That was in 1987 and I've just been there since. I have a distinct lack of ambition. When you have a good job, just keep it.

RR: *Reflecting back on the almost 17 years now of being in charge of MTV, is there a difference between running a company and leading a company?*
TF: If you were in a mature business, like you make the reflectors that go on stop signs, you could run the company, make it work more efficiently, and get everyone to do a slightly better job. If you're in a world that changes a lot like the media, the organization really has to mutate and move quickly, and it requires strong leadership. That doesn't just mean leadership from me, but a model where there is good leadership coming from a whole bunch of places.

"And I had this epiphany one day. I was on a motorcycle in New Delhi. It was 110 degrees, and some gas from a diesel bus was blowing in my face, and I said, 'I'm out of here'."

RR: *How do you do that?*
TF: There are five people who report to me, and there are maybe 15 people or so that report to them. And we talk a lot. I really believe we're a bottom-up company. You periodically will do a strategic plan that looks at how this world has changed, and to focus on, say, the Internet or on international or on digital services.

RR: *Can you give an example of an idea that bubbled up from below? Is Spike TV an example of that?*
TF: When Viacom merged with CBS, they had two channels: TNN and CMT. TNN was the Nashville Network and the average age of those viewers was 66. They wanted to make it a general entertainment network like USA Network. That's not what we do. So we decided, look, there's Lifetime and Oxygen for women. It's understandable to advertisers and cable operators. And there is no channel for men. We thought maybe we could make this a channel for men that would include everything from men's health and finance to documentaries on sports figures. It's off to a good start.

RR: *Would you call that primarily a research-based process?*
TF: It was based on research and then looking at product availability. But at the end of the day it's about gut. There were one or two people standing up, pounding the table, saying this is a fabulous idea. You need people working for you who are passionate about the audience and have great instincts.

RR: *Where do you find those kinds of people and how do you nurture them so they stay around and don't move off and start their own companies?*
TF: There is a sort of self-selecting process. You either find someone who is very obvious, who is banging down your door. Or sometimes you just find somebody you take a chance on and you nurture them; you allow them a certain amount of freedom. We have 94 channels we run around the world, so it's very decentralized. Each is run by somebody who has a team under them, and they make most of their decisions.

RR: *I think a lot of people here are interested in how you manage a global company. What's the trick of globalization in a cultural industry?*
TF: Coca-Cola can basically make the same bottle of soda and sell it everywhere. But in

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stern Chief Executive series

Carl Pascarella
ceo of Visa USA

Carl Pascarella has been president and CEO of Visa USA since 1993. Mr. Pascarella attended the University of Buffalo and received a MS in Management from Stanford University. He worked at Bankers Trust and Crocker National Bank before joining Visa International in 1983, where he served as president of the Asia-Pacific region for a decade before being named CEO of Visa USA. With more than one billion Visa, Visa Electron Interlinked Plus, and Visa cash cards in the market today, Visa cards are the world's most widely used form of plastic payment. In the past 10 years, Visa USA, owned by 14,000 U.S. financial institutions, and based in San Francisco, has seen its payments volume grow at a 17 percent annual rate, from $277 billion in 1993 to more than one trillion dollars today.

MCC: *Visa is very different from most financial companies. Can you explain the Visa business model?*

CP: One of the things that we never ever utter at Visa is the word "association." We drive to a bottom line; we drive to make sure that our customers, whether they're the banks or the merchants or the consumers, are receiving value. We are a for-profit. We're responsible for, and are owned by, approximately 14,000 banks, and we're all about delivering value to everyone who is touching a Visa card, wherever they are. But the banks that govern us are also regulated by us. If you use our brand or you use our systems, you've got to abide by the rules that we put in place. I report to a board of directors that is composed of 14 members, representing 10 of the major banks throughout the United States. At the same time, our customers are these same banks, and we regulate them as well. It sometimes is a very, very complex arena to operate in.

One of the things that has made us successful is making sure that we understand that the needs of a bank like Chase are much different than the needs of a smaller bank. And that the dynamics a merchant goes through are much different from those of a bank. They're interested in getting paid, and we're guaranteeing that payment for them, and making sure that Visa is available 24 hours a day, seven days a week, and that it never, ever fails. For consumers, it's making sure we're there any time they want to buy anything, wherever they are, any way they want to buy it. And making sure they have zero liability, so they don't have to worry about fraud.

MCC: *How do you divide up the profits?*

CP: We take a majority of our top-line income and reinvest it. That's why we're able to bring new products into the market; that's why we're able to look over the horizon and perhaps take a much more strategic look at the payments environment than other companies, like American Express or First Data. Those companies have to return funds to investors, in the form of higher share price or dividends.

MCC: *Who is your biggest competitor? Is it American Express? MasterCard?*

CP: At the risk of being immodest, I don't think so. We've moved market share for the last five quarters against all competitors, against all product lines. But since about 1994 or 1995, we've really transcended being a credit card company. We're going after cash and checks. And when you stop and look at the way the pie is divvied up today, we're 54 percent of the payment systems market.

Mr. Pascarella was interviewed by **Michelle Caruso-Cabrera**, co-anchor of CNBC's *Morning Call*.

We're 14 percent of the $12 trillion that American consumers use to pay in cash and checks every year. And that's the real market. We want to displace cash and checks. Seven or eight years ago, the debit check card arena – debit cards that access your checking account – was about 6 percent of our volume. Today they're over 41 percent of our total volume. So we've made significant inroads to make people aware that you can access your checking account or your savings account through a Visa card, and get that same level of service without having to write checks.

MCC: *How do you teach a consumer to want something that didn't exist before?*
CP: The first thing we did was use the power of the Visa brand. There are two things that are sacrosanct at Visa – our systems and our brand. We had the capability to expand our systems, to be able to offer a debit or a check card product. Then the question was: How to get folks to change behavior? We started with educational advertising, and it was two old men up on a porch in 1993, or '94. One says, "You know, I use this card to access my checking account." And we walked through it. We wanted to make sure that everybody understood that this was going to be a universal product, that it was safe and secure. Then there was a lot of collateral material that went out to the branches of the banks, and they did a lot of training at the branch level.

And then it got to be all about the facility of the product, and that's when we started doing the ads with Yao-Ming, Derek Jeter, and Senator Bob Dole, who say, "Hey, you know, they may not know who I am, but I can use this card because they don't take checks." So it migrated from the educational side to a message of: "Look how easy this is."

MCC: *I want to take a step forward. When you talk about the revolution in the electronic payments that you initiated and created, 10 years down the road what does the landscape look like?*
CP: If you go back 30 or 40 years ago, credit cards were non-existent. Today you can't rent a car, go into a hotel, or buy an airline ticket without one. So it really is important for us to look at this $12 trillion and how it's spent today, and how we can change the behavior to help the consumers and the merchants address this. We look at things today like automated payments and recurring payments, we look at quick-service restaurants. Those are the markets that we're really going after very strongly right now. And in 2003, the growth rates were 100 percent plus in terms of entry into that market.

MCC: *You're talking about quick-service restaurants being willing to take the debit cards?*
CP: Yes, that's right. And credit cards, for that matter. And people being able to pay their utility bills, their mortgages, their health club and cable bills. It's a great benefit for the consumer, because they don't have to sit and write checks all the time. But the important thing from the standpoint of the merchant and the bank is that it makes it a stickier relationship. And today in the financial services industry, the cost of acquisition is so high, that you've got to do everything to retain every customer that you have. We introduced a product in 2003 that allows companies – instead of issuing paychecks – to issue Visa cards to their employees and then just automatically update them whenever they're paid. So many of the people in the United States that work don't have a banking relationship. These people have to stand in line, pay user's fees to get their checks cashed, and then have the lack of security of walking around with cash. Now they get a card, the money is put onto their card, it's safe, secure, and they can use it everywhere Visa is accepted, or they can go to an ATM and get cash, so they've got total flexibility.

"But since about 1994 or 1995, we've really transcended being a credit card company. We're going after cash and checks."

MCC: *How about the technology?*
CP: About two years ago we employed Oracle and Sun Microsystems to put in an IP front end into our legacy systems. And so today, whether it's a PDA or a cellphone, or whatever the latest technology that Michael Dell wants to put out, you can use that device and access your Visa account and exchange value. But we are totally device-independent, and we are able to route messages and information anywhere the parties want it to go. And that's a significant breakthrough, because now we're only limited by our creativity. We keep looking at this tag line all the time, "It's everywhere you want to be." We're about ubiquity. People are more demanding today, they're smarter, they know much more about technology.

MCC: *You have a lot of experience in Asia. What are the particular issues that you face in Asia in terms of Visa?*
CP: The first time I went to China in 1983, the Bank of China picked me up in what they called the red flag car – a black car with a red flag on it. And there was one Chinese hotel where I could stay. None of the Chinese could socialize with you individually. You always had to be in a group. And from the airport to downtown Beijing, we never passed a car. Now today, it's gridlock. Then, everything was done at the provincial level. We signed an agreement with the Bank of China. Then we found out, well, that's good for Beijing, but if you want to do any business in Guangzhou, you'd better sign the provincial leader, because he runs the province. There were no telephones from province to province, so we had to put up a satellite to do authorizations. The way we broke into China was to say "We can bring you a lot of foreign income in terms of accepting Visa." And they got that right off the bat. The Chinese are the most entrepreneurial people in the world, and I think we're going to see that as soon as the infrastructure is built. But you have to be careful not to get too far ahead of the curve.

MCC: *How does it feel as a company to have essentially changed the way monetary policy works around the world? I mean, have you thought about that?*

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William Weldon

chairman and ceo of Johnson & Johnson

William Weldon is chairman and CEO of Johnson & Johnson. Johnson & Johnson, founded in 1886 and based in New Brunswick, N.J., manufactures health care products, pharmaceuticals, and medical devices. J&J, which has annual revenues of $42 billion, comprises more than 200 operating companies that employ more than 100,000 people and sell products in more than 175 countries. Born in Brooklyn, Bill Weldon graduated from Quinnipiac University, where he serves as a member of the Board of Trustees. He joined J&J as a sales representative in 1972 and, after a 30-year career at the company in the U.S., Asia, and Europe, rose to become the sixth chairman in the company's history in 2002.

MCC: *This is a wonderfully timed opportunity. Johnson & Johnson was the lead story all day on CNBC, because it signed a big deal with Guidant. Tell us about the stent wars and about your deal with Guidant today.*

WW: A stent is a small device that is inserted into the aorta to keep it open. It was a huge medical breakthrough about six or seven years ago, and J&J actually developed the technology. It's a huge and growing market, because stents really help eliminate a lot of heart attacks. Recently drugs have been put on the stents, which keep the aorta open longer. For about the last nine or 10 months, J&J had the first drug-alluding stent, with a drug named Sirolimus on it. Boston Scientific has another drug-alluding stent, which may get approved shortly. Today the deal we signed was with another maker of stents, Guidant, which has excellent delivery systems. Putting these two top companies together will be an advance for patients.

MCC: *All day long we've talked about how Johnson & Johnson was moving higher. What's it like to be at work on a day like that?*

WW: It's fun. Innovation is what it's all about. Whether it's in devices, or drugs, or consumer products. We were the first company that came out with stents, but very quickly other companies came out with better stents, and we lost a lot of the market. Then we came out with the drug-alluding stent, which has really taken the world by storm. And it's continuing with this acquisition.

MCC: *Your entire industry has really been under siege. People ask why we can't get cheaper drugs from Canada. Do you feel drug companies are being treated fairly?*

WW: I don't think there is a really good understanding of the drug industry. At J&J, about 50 percent of our volume is in drugs, about 35 percent is in devices, and the rest is in consumer products and diagnostics. I don't think people appreciate the amount of time and energy and cost that goes into bringing a drug to market. There are literally thousands of products you have to synthesize in the lab to do so, and only one out of every three products that comes to market pays for the investment made in it. You could argue it costs $800 million to a billion dollars to bring a drug to market in 10 years. And the actual time in which you can recoup your investment is shortening every year. I think the investment is really to help patients and to bring these significant breakthroughs into the marketplace.

You have to put it into perspective – namely that these drugs are having huge impacts. If you take cholesterol-lowering drugs, and you look forward, you're going to eliminate a lot of open heart surgery. With stents, you're

Mr. Weldon was interviewed by **Michelle Caruso-Cabrera**, co-anchor of CNBC's *Morning Call*.

going to eliminate open heart surgery, which is tens of thousands of dollars of cost that will be taken out of the system.

MCC: *What do you do as a CEO to try to deal with that?*
WW: We try to talk to people and try to explain the investments that are necessary. We work with the government and we work with payers to help them understand. And of course we work with patient groups. If someone is a diabetic, she doesn't want us to stop spending in research and development on new medicines.

MCC: *You started as a sales rep at McNeil Pharmaceuticals more than 30 years ago, and now you're the CEO of Johnson & Johnson. Essentially, you've been at the same company for 30 years. Why do you think you got to where you are now?*
WW: In every opportunity you're given, you do the best job you possibly can. I think too many people have their sights focused on what's the next job, and they forget to do the best job where they are. It's doing a little bit extra, it's trying to look at new programs, new opportunities and capitalize on them, and to take advantage of everything that's put before you.

MCC: *Do you think being at the same company for three decades is a good idea for Stern students?*
WW: I think it's a great idea, and obviously I'm biased. To be able to go into a company and build your career within a company is really extraordinary. You build a network, you understand the workings of the organization. At J&J, there are lots of opportunities to move from company to company. Few companies have such a broad breadth of businesses and such global opportunities. I started as a sales rep, then worked in New York City, then went into the home office and worked through various jobs. I then went overseas, and I spent time in Asia for about four years working for groups of companies. I went to Europe, then came back to the U.S., worked in a device business and ended up back in pharmaceuticals. Then I moved into the office of the chairman. I think I've moved 13 times, and I've had I don't know how many jobs. You can do everything within a company like J&J, or a company like General Electric.

"I don't think people appreciate the amount of time and energy and cost that goes into bringing a drug to market. There are literally thousands of products you have to synthesize in the lab to do so, and only one out of every three products that comes to market pays for the investment made in it."

MCC: *In the last 10 years J&J has bought 52 businesses. How do you determine whether or not you're going to buy a company?*
WW: We have about 12 criteria. We're in health care, and we're going to be in health care. We look at the products the company has; are they compatible with our products? And is it going to take us into areas of new technology, new product opportunities? We ask if it will accelerate our growth, both short and long term. We look at the management and ask if it is compatible with the values embodied in the J&J Credo. We've walked away from very good companies, with very good people, where we just didn't feel the cultures were compatible. You never get all 12 of them, but we go through them and then assess the returns we expect to see over time on a financial basis.

We don't go in with the attitude that we'll buy a company and throw everybody out on the street. We bought a company called DePuy in 1998 that was a leading orthopedic company. We took our orthopedic company and merged it with DePuy. The reason you want to acquire companies is because they're great companies. So why would you want to gut them and get rid of them, other than to get cost synergies?

MCC: *About half your profits come from pharmaceuticals, compared with consumer products and devices. Is the mix going to stay this way?*
WW: Ten years ago, consumer was the biggest piece and pharmaceuticals were the smallest. Because of the technological advances and the growth of the market, pharmaceuticals have grown to become the biggest part. The pharmaceutical industry is growing at 15 percent and the consumer industry is growing at 3 percent. Right now I think devices are the fastest growing segment of the health care industry, not just at J&J. I think we will probably have a mix that will be somewhat similar to what we have today, as far into the future as you can see.

MCC: *A lot of companies got rid of their consumer products divisions because they wanted to be pure-play pharmaceuticals or device companies. Johnson & Johnson didn't. Why not?*
WW: We see real value in being broadly based. If you look back, there have been periods of time where consumer products are more highly valued and pharmaceuticals are down, and then devices come up. So having a mix of businesses provides some stability. And if you fast forward and look into the future, you'll see a convergence of skills and technologies. We've got a stent called Cypher that really came as a result of an engineer working in our device business and a scientist working in our pharmaceutical business. Even our consumer business is becoming so much more dependent upon science and technology. We've moved scientists from our pharmaceutical business into our consumer businesses. We have a company called Aveeno, which is based upon natural ingredients. The scientific work on natural ingredients has been able to expand that business.

MCC: *There are three CEOs on trial this week in New York City: Martha Stewart, John Rigas and Dennis Kozlowski. Any thoughts on that?*
WW: It's unfortunate that a few people try to take advantage of situations and then it gets extrapolated out into the broader industry. I think it's our responsibility to build the reputation of business executives up again. People who tried to abuse the system should be punished, and I really feel for

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the entertainment world you really can't do that because most culture is local. When we went into Europe in 1987 we had a pan-regional signal. We didn't have the amount of homes to develop the scale to have specialized services in each country. The VJs were people who spoke English as a second language. That worked pretty well for a while because it was a novelty. But the local competitors really said we had to change our model. So we decided to regionalize and now we have 45 different feeds of MTV around the world.

RR: *Do you have programming and leadership flowing between or among these units? Do you find great executives in France?*
TF: Every general manager can pick and choose for MTV or Nickelodeon or VH1 whatever they want on the worldwide feed. In doing so, they get to know each other. On the management side, outside the United States, there is a great interchange of people moving from region to region. I've been disappointed continually in the States by the number of people who are here who don't have any interest to leave. I always think, God, I'd be banging on the door. Send me to Singapore or somewhere. What I do find is you're probably better off having locals run your business than bringing in some expatriates, except in the early days when you want to do what I call the DNA transfer.

"We have 94 channels we run around the world, so it's very decentralized. Each is run by somebody who has a team under them and they make most of their decisions."

Audience Questions

Q: *I'm a part-time MBA student and a full-time employee of your sister network, Showtime Networks. When we look at the consolidation in both programming and distribution, what advice would you give to your 26-or 30-year-old MBA student who would like to start their own MTV one day?*
TF: Most of the good ideas are taken for television networks where the economics are such that you could actually make money from advertisers and distribution. If you have great ideas for a real niche, there are a lot of great online applications where you have more control over your destiny and you can get started with a lower base of capital.

Q: *I am employed at MTV Networks and have been there for five years now and am a part-time student. I'm curious to hear your thoughts on some of the threats that we currently face with the emergence of digital cable?*
TF: On digital cable, we're trying to be at the forefront. I look to the U.K., which is the testing ground. There are 28 music channels in the U.K., if you can imagine that, and we have about 11 of them. What we've done is basically do brand extensions or bring in new brands. And they capture about 65 percent of the viewership and the lion's share of the money. Despite all this competition, we've been able to increase our market share, increase our overall ratings, and increase our business. That's a strategy we're set to put in place in a bunch of other countries. Having a strong brand in a world of endless choices becomes even more valuable.

Q: *How about another technology trend: music downloading and Napster?*
TF: We believe that that business is about to rationalize and become a viable pay business. The turning point was with iPod. We didn't want to be the first one in there because for the last several years there have been so many failed technologies. I didn't want to attach our brands to one of them early. In the next few months, we are probably going to announce a music subscription/downloading service.

Q: *It seems the record industry is not really signing and willing to promote new artists. Where do you see the music industry and MTV headed in breaking in and promoting new artists?*
TF: There is all this talk that

"In those days you'd go from a secretary to vice president in six months. I was the marketing guy at MTV. Every time someone would get fired, they'd give me his job too."

the music industry is down because of downloading and file sharing. I think it's fair to say one of the reasons the music industry is down is because the willingness of labels to take chances and nurture artists isn't what it should be. Bob Dylan had six albums out before he had a hit single. That wouldn't happen today. You'd be dropped after two albums if you don't have a hit single, and that's unfortunate. I see the record industry as mutating, surviving, and actually I see good days ahead for it. It's going to be easier in many ways for independent labels to get started online and to market and merchandise and promote their artists to consumers.

Q: *You went from exploring the world to 17 years in the same position at the same company. What makes you want to stay at the same place for so long?*

TF: I guess I traveled around for a long time because I never really – and this sounds like a real cliché – found myself. I came into this company and all the things I love are here. Just when it's getting boring, there is a new thing that keeps your interest – new services or going international or starting a huge online operation. I just think I'm still in the middle of the things I love. I work with a great team of people. And I get all these free CDs all the time. ■

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CP: I have. And you know, I joined Visa for all the wrong reasons. I had been with banks, and I wanted to get a couple of chevrons on my sleeve in the overseas environment, and come back and run a bank. I went over there for Visa, and it was in disarray. We had markets where Diners Card had more market share than we did. When I look back, I have got to be one of the most fortunate individuals in the world, because you are able to change the way people live. With that comes such a huge responsibility, not just personal, but also corporate as well. Because if you misstep, and if you just try to get numbers, and if you get egotistical about this thing, it can blow up in your face at any time.

"Today in the financial services industry the cost of acquisition is so high, that you've got to do everything to retain every customer that you have."

MCC: *How about one piece of advice for these folks to close?*

CP: I think the most important thing is to be passionate, and to really and truly love what you do. And if you don't really want to get up every day and win in the market, or win at what you're doing, or enjoy the people that you're working with, I think you're missing the boat, because life isn't a dress rehearsal. That's very, very important.

When I was at Stanford a professor of organizational behavior told a bunch of us, "You folks kill me. You've spent all your time on economics, on statistics, on policy, on accounting. Those of you that are going to end up running businesses, you're going to hire economists and CFOs and IT people and statisticians. But what it's all about is motivating people; it's getting to know people." That was one of the best pieces of advice that I ever got. Don't lose the human side of business, don't lose the organizational side. Because if you do, you're only going to get so far.

"And if you don't really want to get up every day and win in the market or win at what you're doing, or enjoy the people that you're working with, I think you're missing the boat, because life isn't a dress rehearsal."

Audience Questions

Q: *I would assume that credit cards are a terrific target for counterfeiters and criminals, given the high value associated with them. What's Visa doing to stay ahead of the curve in security?*

CP: We've spent hundreds of millions of dollars in terms of what we call "neural networking." Today, we can recognize aberrant behavior at the point of transaction. So if you have never come to New York or you've never gone to a jewelry store, we'll at least stop that transaction and ask the merchant to do a little bit more checking. And the consumer response to that is very, very positive. We're launching, as we speak, the advanced authorization system, which is going to let banks put further information into the authorization. In terms of hacking, we've got very, very strict rules in terms of who has our data and whether or not it's encrypted. And we always make sure, above anything else, that the fire walls are up and that we're always ahead of the curve in terms of fraud risk and credit risk.

Q: *What kind of threat do you see from companies like Pay-Pal, which are doing electronic payments?*

CP: Pay-Pal and other aggregators are certainly interesting to us. In a lot of cases, the people that load their Pay-Pal account load it with a Visa card, and so that's volume that we get on the front end. With our relationship with Yahoo! and Amazon and all of the leaders in the Net, we certainly are aware of what's going on. Is it essential that we look at the $2 or the 20 cent transaction? It isn't. But what is essential is that the consumer is protected, and that we work with these aggregators to make sure that they are protecting the consumers.

Q: *You talked a lot about business, but you didn't mention what kind of person you are. What were the personality traits that made you what you are now?*

CP: You know, you look back on your childhood and early jobs, but I think the most important thing is to have confidence. To be sure you know who you are and what you want. You've got to be able to make that tough call. You know, it was a tough call going to Asia in 1983. I had been to Asia three times in my life. And I had enough confidence at that point in time to say "That's an opportunity, I want to do that, and I will succeed."

Q: *Can you talk about how securitization has affected the credit card industry? And how does Visa assist its member banks with securitization efforts?*

CP: With securitization, you're selling the risk. And it's done a great deal in order to grow the business. But there are a lot of contingencies that go along with this. The quality of the portfolio has got to be maintained at a certain level. If you have a downturn in your credit quality in your portfolio, you've got to replace those accounts, or you're going to have a capital call. So we help in terms of making sure that a portfolio is up to speed.

Q: *In terms of emerging markets, how do you balance the decision to go into these markets when you know that risk exists?*

CP: You make sure that the systems infrastructure is there before you do anything. Because if you can't handle an authorization, and you can't clear and settle the account to get the payment, it's not going to work. And then you've got to work with the regulatory agencies that are there. You might go in with a debit card, or a secured card first. You don't go in and give lines of credit to people that don't understand how to use them. ■

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the people who were secretaries and janitors – people whose whole lives were dependent upon these organizations. I think that we have a moral and ethical responsibility to try to do what's right. I'm not saying J&J's perfect, because as our general counsel says to me all the time: "We've got 112,000 people. It's the size of a city, and there's crime in the city." At J&J it really does tie back to our Credo and the values embodied in that.

MCC: *One of the results of the scandals has been the Sarbanes-Oxley law, which creates more regulations and mandates that CEOs sign off on corporate earnings reports. Does it make you nervous?*

WW: No. We go through half a day with internal auditors and our legal people to make sure that what we're signing is as accurate as it can be. You have to have confidence in the people that work for you. I keep going back to the Credo. It's been around for 60 years. It's an extraordinary document. And we do practice it. J&J holds that the ante to play in the game is the value system that we have. We have to deliver results, but never at the cost of the values.

Audience Questions

Q: *I have a small Internet company called E-Health-Care Solutions. How do you think the Internet is going to impact marketing and advertising going forward? And how many hours a week do you personally spend on the Internet?*

WW: Consumers are using the Internet to learn things about our products, and I think they need to be informed. We don't want to usurp the professional's responsibilities but we want consumers to be able to have an intelligent dialogue. My own personal use is very minimal. I have a 26-year-old son, who spends an extraordi-

people came to J&J because of the values. Our reputation is the most important thing that we have.

Q: *I'm an employee of J&J and a first-year student. In our first class on ethics, I find that a lot of what I add to the discussion is the Credo-based decision-making. I wonder if you can articulate or discuss some examples where you resolved that conflict between fiduciary responsibility to the shareholders and making Credo-based decisions.*

WW: I think the best example is Tylenol. The Credo of J&J says first and foremost, patients, people use your products. That's who you take care of. Second are the employees and making sure that employees are treated with dignity and respect. Third is the environment we work in. The fourth thing is, if you do those three things, then

nary amount of time on the Internet. When I want to find something, I just either ask him or my secretary. But I have to admit, I'm Internet illiterate by and large.

Q: *I'm a first-year student at Stern, and I'm going to be interning in your personal products company. What are some of the main challenges you see in the consumer products business?*

"I think I've moved 13 times, and I've had I don't know how many jobs. You can do everything within a company like J&J."

WW: There's a lot of consolidation. Companies like Wal-Mart are pushing, looking to get the best deals. As every company does, we've got a whole organization down in Bentonville, Arkansas working with Wal-Mart. In 2003, our consumer business had its best year in the past decade. And I think a lot of it has been this movement away from consumer oriented products that don't differentiate themselves in the marketplace. Neutrogena, one of our companies, is making huge advances in the area of healthy skin and healthy hair. I think Neutrogena is the most highly recommended product by dermatologists, and that's because we have a professional group going to dermatologists who are recommending these products and are creating value in the market place.

Q: *How do you motivate all of your employees across the different divisions and companies?*

WW: Motivation is personal. I think it comes down to treating people fairly. And you need to have a sense of urgency. It's not the old management style of beating people over the head. You have to support them. You've got to give them the tools to be able to do their job. You've got to make sure that there is fair recognition. I think the other thing that is critical, and it is embodied in our Credo, is treating people with respect and dignity. I recently asked our public relations people to get together people under the age of 30 who have been with the company for less than five years. I was impressed at their commitment to the Credo and how many

"I keep going back to the Credo. It's been around for 60 years. It's an extraordinary document. And we do practice it."

there's a fair payback to the shareholder. When we had the Tylenol poisonings, we pulled all the Tylenol off the market. We'd never even discussed the financial implications. The Credo actually allowed us to make that decision very clearly, to see that this was in the best interests of the people that consumed our products. Obviously, Tylenol has come back, and it's a huge brand, probably one of the biggest brands out there today. ■

B R A N D

There are comparatively few global brands, words that in a syllable or two can evoke a symbol, a product, or a feeling for billions of consumers. One of those is Visa. Plastic may have symbolized something artificial and even boring to a prior generation. (Remember the scene from The Graduate in which Mr. Robinson advises the young Benjamin to go into plastics? He recoiled in horror.) But today, when money is as likely to change hands in the form of bits and bytes as it is in bills and coins, plastic means real business, and growth. And Visa, whose logo is recognizable the world over (it helps that it's seen on stickers on pretty much every retail outlet from Bangkok to Bangor, Maine) has played a significant role in this evolution. "We want to displace cash and checks," declared Visa USA CEO Carl Pascarella (p. 4). "There are two sacrosanct things at Visa – our systems and our brand."

MTV is another one of those brands that functions as a sort of global shorthand. And even in a universe of hundreds of channels, Tom Freston, co-president and co-chief operating officer of Viacom (p. 2), sees opportunities. "There are 28 music channels in the U.K., if you can imagine that, and we have about 11 of them," said the Stern alumnus, who had been with MTV since its inception. "What we've done is basically do brand extensions or bring in new brands."

Brands can get hurt by a range of external factors – vigorous competitors and technological breakthroughs, malevolent vandals or unfortunate accidents. But no blow is so damaging as a self-inflicted one. Exhibit A: Martha Stewart. The domestic doyenne hurt her reputation – and that of her eponymous company – by getting caught up in an insider-trading investigation. Convicted in March of lying to investigators, both Stewart and her company face an uncertain future. But it didn't have to be that way, says Peter N. Golder, in "A Very Bad Thing" (p. 14). By seeking to become more than the sum of Martha's many parts, the company could have "developed an impersonal brand that was synonymous with a certain lifestyle – stylish, aspirational, and up-scale." Instead, the name is synonymous with an altogether different lifestyle: prison inmate. And, no, there's no truth to the matter that her next magazine will be entitled, *This Old Big House*.

A felony conviction stands as a black mark on any executive's resume. But you don't have to be a criminal to get branded negatively. Serving as an executive or a director at a failed public company can stigmatize a mature professional for life. But not all are branded equally, say Batia M. Wiesenfeld, Kurt Wurthmann, and Donald C. Hambrick in "The Scarlet F" (p. 18). The comeuppance bosses suffer after being involved in business debacles is a function of many factors – ranging from the severity of the mishap to the number of friends and connections an executive possesses. "The greater the social capital of an elite associated with a failed firm, the less the stigmatization he or she will experience," they conclude.

For investors, it would be great to know which executives are going to fail and be stigmatized in advance. It would have been great to know that Enron's top brass would be indicted. But how are shareholders to know? Analysts haven't yet developed stock-picking tools that screen for possible fiascos. However, David Yermack has identified one aspect of CEO behavior that points to potential underperformance of their stocks. In his article, "Flights of Fancy" (p. 30), Yermack examined the frequent flying habits of CEOs over a 10-year period. He found that "shareholders react negatively to the news that CEOs are using corporate jets." And with good reason, it turns out. "The shares of companies whose CEOs use private aircraft underperform the market by more than 400 basis points a year."

One of the sectors where brands matter most –

E Q U I T Y

where people pay the highest premium for goods that have a positive image in the consumers' mind – is in luxury goods. What makes one pair of shoes worth $500 while another, with many of the same components, costs $39.99? Brands help explain a lot of the difference. In "What Makes Rolex Tick?" (p. 24), David Liebeskind tells the story of how one Swiss watchmaker manages to hold onto its position with the regularity of, well, a finely made timepiece. The "largest single luxury watch brand" has pursued a strategy of continuity, limiting production, and zealously keeping watch not just on how the watches are made, but on how they are sold. "The crystal prism that indicates a store is an 'Official Rolex Dealer' is highly prized," Liebeskind notes.

Rolex has been careful not to dilute its brand by branching out into unrelated areas. (You won't find Rolex shoes and socks in Bloomingdale's.) And for many brands, a singular focus on a single product or group of products is the key to success. But Johnson & Johnson – which houses as many great brands as the Yankees' dugout houses all-stars – has followed a different tack. Over the years, J&J has built up three broad lines of business: consumer products, pharmaceuticals, and medical devices. William Weldon, the CEO of Johnson & Johnson, argues that the diversification provides ballast for a giant ship. "We see real value in being broadly based," said Weldon, who has spent his entire 30-year career at J&J. "Having a mix of businesses provides some stability." (p. 6).

One of the components of a brand, especially for retailers, is service. After all, why spend your money in a place that isn't going to treat you right, especially when there are so many options – online and offline. But there's a trick. There are different ways retailers can offer help to shoppers, and the relative effectiveness of "different" has to do with psychology, expectations, and feelings. Eric A. Greenleaf, Vicki G. Morwitz, and Russell S. Winer investigated the varieties of help online and offline and conclude which are most effective in their article, "Helping Hands" (p. 42). Their conclusion: Customers don't always want to hear the words: "Can I Help You?" Like Greta Garbo, some prefer to be left alone. And online and bricks-and-mortar shopping are two different worlds. "Since web shopping involves consumer experiences that are very different from store shopping, it is not clear that help strategies that work well in face-to-face retail encounters will work well on the web."

For most brands, success means avoiding controversy. Nobody wishes to offend a potential customer, after all. But two of the biggest brand names in financial services – Fannie Mae and Freddie Mac – are quite controversial. The two companies, which occupy the not-so-neutral ground between the government and private sector, have grown into massive forces in the housing markets – and in the House and Senate in Washington. But they have faced questions about their accounting, influence, and relationship to the government. Lawrence J. White, in "The Trouble With Fannie and Freddie" (p. 36), thinks some reform is necessary, and that the companies would thrive as purely private entities. "Given their substantial brand names and their impressive collection of human and intellectual capital, they would likely continue to innovate and prosper," he writes.

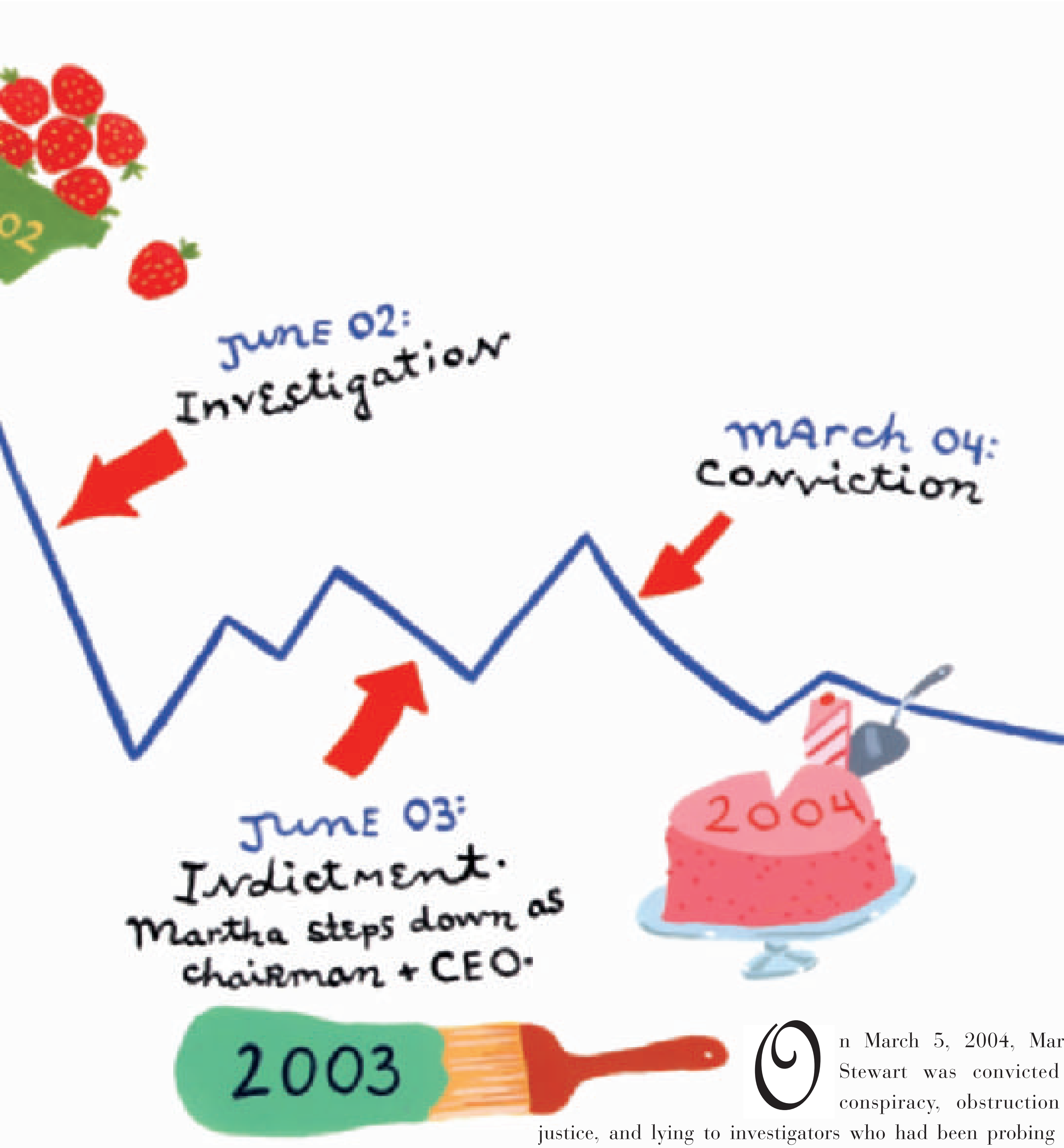
One of the great things about a magazine is that it offers readers the opportunity to dip into the content at their own leisure, and on their own terms. And this issue of Stern*business* is full of unconventional wisdom about the use and misuse of brands. All readers will find plenty to sample.

DANIEL GROSS *is editor of* STERN*business*.

A Very Bad Thing

By **Peter N. Golder**

After Martha Stewart's conviction, the prospects of the company she founded and built, Martha Stewart Living Omnimedia, looked bleak. By tying her personality so closely to that of the company's many lines of business, Stewart and her management team left the whole enterprise vulnerable. There's plenty we can learn from the rise and potentially avoidable fall of this brand icon.



On March 5, 2004, Martha Stewart was convicted of conspiracy, obstruction of justice, and lying to investigators who had been probing her stock sales in biotechnology company Imclone. Earlier that day, amid speculation she would be acquitted, stock in Martha Stewart Living Omnimedia (MSO) traded as high as $17. Soon after her conviction, the stock sank as low as $9.25. The damage to the Martha Stewart brand cost her company 46 percent of its total value – or $433 million.

Martha's legal travails have been thoroughly dissected. But their impact on the company's brand has received less attention. Did the company have to lose 46 percent of its peak value that day based on a single conviction? No. Did the company have a sound branding strategy in place at the time? No. Was there something the company could have – and should have – done differently to avoid suffering such a huge impact as a result of Martha's guilty verdicts? Yes.

In the Beginning

Martha Stewart's ascent to lifestyle impresario began with the publication of her 1982 book *Entertaining*. In 1991, she launched *Martha Stewart Living* with the support of Time Publishing Ventures. Throughout the 1990s, the indefatigable lifestyle expert expanded into several other businesses as she became a television star and syndicated columnist. In 1997, she bought her freedom and the rights to all of her businesses from Time Publishing Ventures for $53 million. In short order, she launched a website, a radio program, and more television programming. Most important, she began selling licensed merchandise through K-Mart. When her company went public in 1999, its assets were impressive: two magazines, *Martha Stewart Living* and *Martha Stewart Weddings*; two television programs, the syndicated "Martha Stewart Living" television show, available in 90 percent of U.S. homes, and "From Martha's Kitchen" on the Food Network; Martha Stewart's 27 books; the *askMartha* radio program, reaching 1.5 million listeners each weekday; the *askMartha* syndicated newspaper column, reaching 43 million readers each week; a website, MarthaStewart.com; and licensed merchandise, including bed and bath products, paint, furniture, and garden tools.

From the beginning, MSO was always about Martha Stewart. All of the key assets of the company depend on her persona and her brand name. Early on, the company recognized this singular focus as a potential liability. The prospectus for its 1999 initial public offering filing noted that the "business would be adversely affected if Martha Stewart's public image or reputation were to be tarnished." As a result, management felt there was a need to "evolve our brands – and reduce dependence on our founder."

Unfortunately, there was never a serious attempt to implement such a strategy. The company continued to practice the easy strategy of "All Martha, All the Time." And so when the guilty verdicts came in, the company was seriously wounded. And in the wake of the verdict, many openly wondered about its long-term survival.

"The company continued to practice the easy strategy of 'All Martha, All the Time.' And so when the guilty verdicts came in, the company was seriously wounded."

Developing Long-term Brands

Branding is primarily about owning a distinctive and valuable spot in your customer's thought. One simple approach to achieve such distinctiveness is to develop a personal brand. Essentially, a unique individual imbues the brand with all of her personal characteristics. Yet, as MSO acknowledged back in 1999, this easy strategy risks sudden demise if that person's reputation is damaged. By contrast, the harder yet more enduring way to develop a distinctive brand is to start by identifying the attributes that your customers value. Then, if the company can perform on those attributes and communicate that performance, customers begin to associate your brand with those attributes.

Differentiating Martha Stewart as a personal brand was relatively easy. But it would have been much better if the company had developed an impersonal brand that was synonymous with a certain lifestyle – stylish, aspirational, and up-scale. The Disney brand thrives today, nearly 40 years after its founder's death, because it came to mean so much more than the person Walt Disney.

Martha Stewart should have had her company develop brands and distinctive values that transcended her alone. It's likely that the astonishing success of MSO's personal-brand approach blinded the company to the longer-term potential of the impersonal-brand approach, in which the company is tied more closely to key attributes than a single person. The value of these key attributes would likely have stood the test of time much better than the value of one individual. Even if Martha Stewart had not committed crimes, it's likely that her personal appeal would have fallen out of fashion eventually.

So, what prevented MSO from implementing an impersonal branding strategy, when the company acknowledged that it was important to do so? Perhaps the early success of the company fed the hubris of its founder and fostered a cult of personality within the company. Or perhaps Stewart and her management team simply didn't know how to shift towards a less personal branding strategy.

Missed Opportunities

There are a series of integrated steps that MSO – or any other company – could take to build an impersonal brand portfolio.

First, determine the attributes that deliver value to your customers. Then, based on the company's current strengths and strategy, decide which attributes you want to own, and devote resources to capture them. Just as FedEx is tied to reliable overnight delivery, and Disney is tied to family entertainment, MSO could have tied itself primarily to stylish, aspirational, up-scale living – much as Ralph Lauren has done. Then, its efforts could have been directed toward reinforcing associations with these attributes, rather than associations with Martha Stewart. This approach creates value in a company, rather than value in a personal brand.

Second, adapt brand names over time. As one example, the magazine *Martha Stewart Living* could have been re-titled *Living by Martha Stewart*, and eventually just *Living*. Over time, *Living* could have been tied to those attributes the company wanted to own. Then, should Martha Stewart "the person" encounter problems, *Living* "the brand" could live on. Advertisers wouldn't have run from a magazine called *Living* as quickly as they ran from a magazine named for a convicted felon.

Third, introduce sub-brands (part 1). In MSO's magazines and television shows, it would have been very easy to introduce guest experts in a variety of areas – gardening, cooking, decorating, etc. The best guest experts could then have been turned into regular features. In the best-case scenario, some could have even been spun off into their own television shows and magazines. And MSO could have owned the rights to these new properties. Of course, such a strategy would have been a big divergence from "All Martha, All the Time." In contrast, Oprah Winfrey's success in launching the Dr. Phil television show demonstrates how such a strategy could have been implemented.

Fourth, introduce sub-brands (part 2). Licensed merchandise presented another opportunity for developing sub-brands. With such a wide variety of licensed merchandise, different attributes are relevant for different products. Therefore, the company could have developed brands for different groups of products: one brand for kitchen products and a second brand for bed and bath products. Over time, these sub-brands could have been converted to primary brands.

"The best future opportunities to diversify are likely to be with licensed merchandise, because the appeal of these products has relatively more to do with the products themselves than with Martha Stewart the person."

Now What?

From the time it went public in 1999, MSO realized the importance of moving away from Martha Stewart the person. Unfortunately, it now faces the task of doing so, out of necessity, and with a dramatically weakened brand. The best future opportunities to diversify are likely to be with licensed merchandise, because the appeal of these products has relatively more to do with the products themselves than with Martha Stewart the person. In contrast, the media properties, especially television, are much more closely tied to Martha Stewart herself. After the verdict, stations dropped her television shows and newspapers dropped her columns. The flagship television program went from reaching 90 percent of U.S. households to only 50 percent. More recently, the company announced that her main syndicated television program would take a hiatus for the 2004-2005 season.

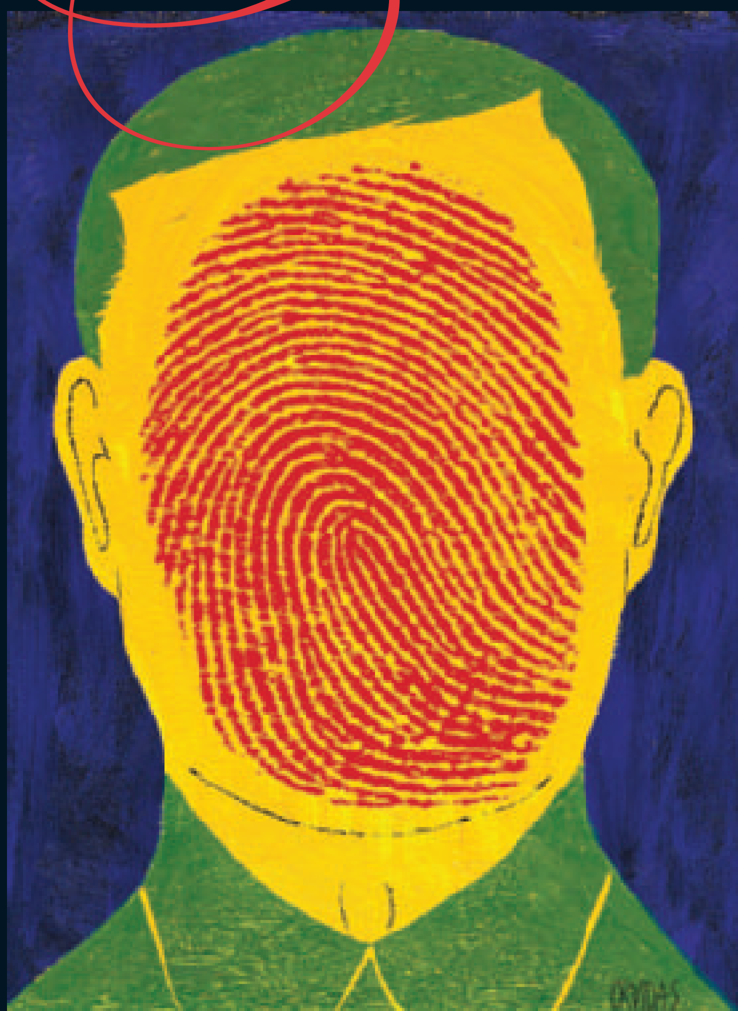
The impact on magazines is substantial, but not quite as bad as television. Earlier this year, *Martha Stewart Living* reduced its guaranteed circulation from 2.3 million to 1.8 million. Even more important, advertisers fled. Total ad pages dropped from 1,887 in 2002 to 1,234 in 2003. While the impact on merchandise has been minimal thus far, it's likely that a reduced media presence will eventually lead to lower revenue here too.

MSO has to hope that eventually its branding strategy can take precedence over Martha's legal strategy. Even now, the Martha Stewart brand is likely the most valuable asset of the company. Thus, it has to hope that Martha Stewart the person can help to revive Martha Stewart the brand. Whether or not her convictions are upheld, Martha Stewart must find a way to re-connect with her customers in a way that incorporates and subsumes these legal events into the public's broader perception of her.

For Martha Stewart herself, the optimal strategy is to continue to fight the legal battle. Yet, this personal strategy is at odds with the best brand strategy. The right brand strategy will likely incorporate acknowledgment of her conviction, contrition, and an appeal for forgiveness. The sooner this strategy is implemented the better. Then MSO can begin to diversify its brand portfolio from the strongest possible base. People may be willing to wait to forgive the person, but they won't wait to forgive the brand.

PETER N. GOLDER *is associate professor of marketing at NYU Stern.* *He wishes to thank Alina Dijur, MBA '04 and Cecilia Dones '04, for their research assistance in preparing this article.*

THE SCARLET F



Executives and directors associated with corporate failures can get branded for life. But the stigmatization process is not always rational or efficient. Why are some executives tarred with failure while others seem to be Teflon-coated?

By **Batia M. Wiesenfeld, Kurt Wurthmann** and **Donald C. Hambrick**

When companies fail – because of misjudgment, misdeeds, or even bad luck – leaders' names and reputations stand to be indelibly smeared. They get fired and have a hard time finding work elsewhere. Those who do get rehired tend to do so in lesser capacities or at smaller firms. It is difficult to imagine Dennis Kozlowski of Tyco or Jeffrey Skilling of Enron ever working again. Even executives who have been labeled as simply bad managers, such as Jill Barad of Mattel, become marginalized.

For CEOs who get branded with the Scarlet F – for failure – it's all part of the "settling-up" process. Settling-up is an essential, but often overlooked, premise of agency theory developed by University of Chicago finance professor Eugene Fama. Corporate owners (principals) can rely on the fact that managers and directors (agents) will be motivated to do their very best by the prospect of future adjustments to their compensation – adjustments, or settling-up, that will be based on prior performance. Executives who perform well build good reputations and get better jobs and higher pay in the future. Meanwhile, the markets disseminate word about the failings of those who perform poorly, and their prospects are accordingly diminished.

But the settling-up process for corporate elites can be exceedingly imprecise. Peter Lynch, the investment guru and vice-chairman of Fidelity Management and Research Company, was a director of two of the most visible corporate collapses of the 1990s – Morrison Knudsen and W.R. Grace. Yet his name was rarely invoked in conjunction with these failures, and he went on to enjoy great acclaim after their occurrence. And sometimes corporate leaders are penalized far out of proportion to their culpability. Lloyd Ward served as CEO of Maytag for only 15 months. He was replaced in November 2000, after being blamed for the 59 percent drop in Maytag's share value; he lost prestigious corporate directorships and has not found a comparable position. But Ward served at Maytag during very difficult times for the appliance industry. And Maytag's performance was worse under some other CEOs who somehow avoided stigmatization.

ILLUSTRATIONS BY KEN ORVIDAS

How is it that some elites who are associated with failures avoid paying much professional price, while others – who, on the surface, seem no more or less blameworthy – face the end of their career?

It turns out there are many factors – economic, social, and psychological – that influence the amount of professional devaluation that a corporate director or executive will face. We have constructed a model to describe the process. In this model, failure evokes a stigmatization process, whereby opinion-shapers discredit the professional identities of corporate elites. The discrediting, in turn, triggers tangible economic loss. The greater the stigmatization of corporate elites, the more unwilling companies will be to associate with them and the greater the professional devaluation they will encounter. But the amount of stigmatization the person encounters is shaped by a host of factors. These include indicators of a person's responsibility for failure, cognitive biases that amplify or diminish the assignment of blame, emotional biases, and the amount of social capital the person possesses.

"When a company fails, those whose professional identities are closely tied to the organization are affected – particularly its officers and directors."

How Stigma Starts

The process starts after a precipitating event, a major corporate failure. This loss may be abrupt or gradual. It may be attributed to business misjudgment or to ethical misdeeds that impair the firm's legitimacy. It may be large enough to send the firm into bankruptcy or simply enough to wipe out a significant percentage of its value.

When a company fails, those whose professional identities are closely tied to the organization are affected – particularly its officers and directors. Professional identities are achieved through a social negotiation process whereby the person and audience (or interaction partners) interactively claim and grant identity through words and actions both symbolic and substantive. Ultimately, however an elite's claim to an identity may be either supported or rejected by others, including the press, employees, business peers, and others.

When a firm experiences failure, a social negotiation process is mobilized through which elites' professional identities are revised. The elites leading the firm are often themselves branded as failures. This process bears the hallmarks of stigmatization, whereby an individual is discredited and denigrated because a negative attribute is associated with his or her social identity.

The media plays a particularly substantial role in the stigmatization process. The business press frequently glorifies leaders whose companies are performing well, but then disparages the same leaders if their companies stumble. It is common for press accounts of company failures to emphasize the role of the firm's leaders in corporate fiascos. The stigmatization of leaders can be driven by other voices: investor advisory services and newsletters; watchdog groups, such as the Council of Institutional Investors; and academics, who often focus their attention on a company's leaders when performance declines.

The business community may join in the stigmatization process as well. Peers and business acquaintances may withdraw their contact because of the negative portrayals from other quarters. Company employees may speak vigorously to the press about the deficiencies of the firm's leaders in order to deflect blame and to reassure outsiders that the source of the firm's problems is gone.

Professional Devaluation

Stigmatization is emotionally painful, but it can be financially painful as well. And the greater the stigmatization of a corporate elite, the greater will be his or her subsequent professional devaluation. Stigmatization leads to substantive devaluation through three interrelated conduits. First, the presence of a stigma is a signal of a person's inferior abilities. Since labor markets consider all available information about candidates in arriving at appropriate wages, public information about inadequacy would have a negative effect on the elite's employability and compensation. Second, firms tend to feel social pressure not to hire the stigmatized – especially for leadership positions. Third, stigmatized individuals are likely to anticipate the reluctance of companies to make them favorable offers, and so they may be unwilling to present themselves as candidates for future leadership positions.

Stigmatization will be tempered by referent comparisons that shape observers' expectations. Failures in healthy industries are unexpected. As a result, they provide strong signals of leader ineffectiveness and contribute to greater stigmatization. In contrast, failures that occur in hostile contexts can be largely assigned to environmental factors and therefore result in less leader blame.

Social psychological research suggests that stigmatization is greater to the extent that observers perceive that the individual was able to control or prevent the offending attribute. And so individual-level factors such as an elite member's position, tenure, and actions will influence attributions of control and blameworthiness.

For example, executives at failed firms experience greater stigmatization than do outside directors. Outside directors' professional identities are not strongly invested in the company on whose board they serve. Because their contact with the organization and their access to information is limited, outside directors are not held to the same standard of in-depth understanding about company affairs as executives.

Among executives, the higher you are, the harder you fall. Senior-most executives (CEOs, COOs, and CFOs) who are associated with failed firms experience greater stigmatization than do lower-level executives of the firms. Increasing hierarchical position in an organization brings increasing access to information, formal decision-making authority, and individual power. Leaders with greater access to information are better able to foresee the consequences of their decisions and actions. And those with greater authority and individual power have greater control and ability to overcome resistance by less powerful opponents within the organization.

Tenure matters, too. The longer an elite's tenure at a failed firm, the greater the stigmatization he or she will experience. When executives and directors are relatively new to a firm, the degree of control they are able to exert over organizational outcomes is constrained. With time, executives and directors accumulate the information they need to empower them to make important decisions. Greater tenure also puts them at the helm over an extended decision-making period, giving them more influence over both strategy and performance.

And it's better to be incompetent than corrupt. Elites accused of ethical misdeeds that lead to firm failure will experience greater stigmatization than will those accused of business misjudgment. Ethical misdeeds – insider trading, fraud, misleading and dishonest actions, sexual misconduct, and abuse of power – will be even more stigmatizing than simple lack of ability, because a willful misdirection of effort is far more controllable than is a mere lack of skill.

Cognitive Biases

Observers are not fully rational in how they view the influence of leaders on organizational outcomes. Observers frequently engage in a "romance of leadership." Even though corporate failures may stem from any number of factors – including environmental jolts, long-institutionalized structures and systems, even accidents – observers tend to blame leaders.

The assignment of blame is an interpretive process rather than a black-and-white calculation. And like other stigmatizing stereotypes, the act of blaming leaders is subject to bias. We anticipate that there are two prevalent mental short-cuts, or heuristics, that shape observers' stigmatization of elites.

The first is the availability heuristic. People tend to view information that comes most easily to mind, such as vivid and recent information, as the most reliable and relevant. As a result, it will be more available in the sensemaking process. Social psychologists, for instance, have observed that people may be stigmatized merely by their proximity to a negatively evaluated object or person – even if there is no apparent relationship between them.

And so elites who are present at the firm during the visible phase of a failure will experience greater stigmatization than those who departed earlier. Since these leaders have to explain the failure event in speeches, on television, in newspaper articles and formal announcements, and sometimes even in formal testimony, they will be perceived to be much more closely associated with the failing firm than leaders who have already departed. By contrast, leaders who depart prior to a perceived failure do not serve as the human face of the firm in public forums in which the failure is examined, making them less available in observers' minds. For example, Gerald Levin, the CEO of Time Warner, engineered the eventually discredited merger with AOL. But he announced his resignation seven months before a 59 percent collapse of the combined company's market value, and thus received far less criticism and stigmatization than did the other top executives who were present at the collapse, notably former AOL CEO Steven Case.

"Elites who are present at the firm during the visible phase of a failure will experience greater stigmatization than those who departed earlier."

In addition to timing, size matters. Failures of large firms affect many people – employees, customers, and suppliers. Large corporate failures are vivid because they are relatively rare and surprising. When big companies fail, observers are likely to conclude that serious errors in leadership must have occurred. And that increases observers' tendency to attribute blame to corporate elites. For example, both Xerox and its much smaller competitor, Global Imaging Systems, Inc., lost 52 percent of their market value between May of 1999 and May of 2000. The losses at Global Imaging received relatively little attention. But Xerox CEO Richard Thoman was widely and vehemently criticized in the press and forced to resign after only a year in office.

Representativeness Bias

Another heuristic associated with stereotypes is representativeness. Observers make judgments, in part, by taking into account the degree to which a specific event corresponds to a broader category of occurrences in their minds. Instances that are representative of a broader category of events will lead observers to perceive that all of the features of the broad category apply to the new instance, far out of proportion to the actual degree of correspondence.

As a result, elites who have been previously associated with other failed firms will experience greater stigmatization upon a firm failure than will those without such prior associations. Observers will perceive leaders who have been associated with past failures to be representative of the category of causes for firm failure. If a failed company is accused of using dubious accounting stratagems that resemble (even somewhat) the accounting stratagems of already notoriously failed firms – like Enron – then the focal company and its leaders are readily placed in the same category as the earlier offenders.

In addition to the cognitive biases, there are critical emotional processes that cause stigmatization of elites to deviate from what might rationally be expected. For corporate leaders, we can expect that *schadenfreude* – or pleasure in others' misfortune – will exert an emotional influence on stigmatization. After all, *schadenfreude* is motivated by observers' desires to feel better about themselves by comparing themselves to less fortunate others. And observers may obtain a feeling of justice in seeing the lofty brought down to earth.

The more that an elite's previous success and status is viewed as undeserved, the more likely his or her pain will trigger *schadenfreude*. And so the more an elite leader has been portrayed as ruthless or arrogant, the greater the stigmatization he or she will experience upon firm failure. For example, Al Dunlap openly acknowledged his take-no-prisoners style of leadership, including drastic layoffs at Scott Paper and at Sunbeam; he wrote a book about his experiences entitled *Mean Business*. Once Sunbeam's performance began to decline, those who observed the indifference he seemed to have about firing people were eager to help speed his fall from grace.

Additionally, corporate elites who are seen as selfish and greedy are likely to inspire resentment. The greater an elite's compensation, relative to peers and to others in the focal firm, the greater the stigmatization he or she will experience upon firm failure. Observers may grudgingly tolerate high executive compensation when firm performance is good. However, once performance falters, the appearance of unfairness will inspire anger and indignation. Observers will take great pleasure in seeing such elites cut down to size.

Elites who are associated with failed firms during periods of macroeconomic malaise will experience greater stigmatization than those associated with failed firms during periods of macroeconomic vitality. In periods of widespread economic trouble, many social actors will be dissatisfied with their own lot, and comparing themselves to less fortunate others may be among the few available ways for people to derive a (perverse) form of happiness. As the old adage goes, "misery loves company."

Social Capital

Some corporate executives and directors possess much more social capital than do others. They may sit on multiple, influential boards, or maintain close personal friendships with lots of influential people, or have prestigious educational and military credentials. These aspects of social capital can also function as a stigma buffer. The greater the social capital of an elite associated with a failed firm, the less the stigmatization he or she will experience.

Executives and directors who have high levels of prestige tend to be perceived as competent, credible, and trustworthy. Observers are reluctant to view such individuals as inept, careless, or self-serving. Furthermore, high-status leaders will be more likely to be excused for having many important things on their minds that might justifiably absorb their attention. What's more, fellow elite members often make the decisions through which tangible devaluation occurs. When they feel bound by the bonds of loyalty and friendship, these elites will be motivated not to ostracize failed elites; and they may be unwilling to impose the devaluation that otherwise seems warranted.

> **"High-status leaders will be more likely to be excused for having many important things on their minds that might justifiably absorb their attention."**

Individuals who possess social capital are also able to grant favors to those upon whom they depend. These favors create a diffuse, generalized commitment among individuals through norms of reciprocity. Such obligations may be "called in" when an individual with social capital requires them, such as when his or her career is at risk – thus providing another countervailing force against the effects of stigmatization.

Our elaborated model of settling-up has widespread practical implications. People need to be aware that they are likely to face considerable career loss if associated with a company failure. And they will seek either compensation or insurance for this risk. Thus, some portion of the high pay that executives and directors receive can be thought of as compensation for bearing extreme career risk. Similarly, the fact that elites may seek some form of insurance for the event of their stigmatization helps to explain the large severance agreements that executives have been seeking in recent years.

Beyond building social capital, there are things an executive can do to mitigate his or her eventual risk of stigmatization and devaluation. A person may intentionally adopt a style of humility, and even carry this philosophy over to his or her pay package.

Ultimately, however, the fact that cognitive and affective biases play such an important role in the stigmatization and devaluations process throws into question the market efficiency of settling up. If some elites are not sanctioned to the full extent they should be – say, simply because they are associated with relatively obscure companies, or because they have a lot of social capital – other elites in similar situations will implicitly be allowed to engage in unsound behaviors. On the other hand, if some elites are punished more harshly than their behaviors warrant, then some talented individuals may be unwilling to become executives and directors of companies. If leaders are unduly timid and risk-averse because they fear failure and the stigmatization it brings, then investors and society will ultimately pay the price.

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What Makes Rolex Tick?

By **David Liebeskind**

The market for luxury goods is booming – locally and globally. In the U.S. alone, 2.2 million individuals have liquid portfolios of over $1 million. And tens of millions of less well-heeled consumers routinely splurge on high-end products. But the market relies more on psychology than sheer consumer utility. In order for luxury goods makers to crack the market and maintain a hold on finicky consumers, they have to convince people to pay far more for something – a pair of shoes, a bottle of wine, or a watch – than they need to. After all, why would otherwise economically rational people spend thousands on a watch when one that costs only $10 tells time just as accurately?

Rolex, the Swiss watch company that will celebrate its 100th anniversary next year, knows the answer. Over the past century, Rolex has built and defended a strong position in the high-end watch market. And it has remained independent even as many competitors have sought the shelter of conglomerates. Today, Rolex is the largest single luxury watch brand, with revenues of about $3 billion and annual production of between 650,000 and 800,000 watches. The secret to its success: a strategy that eschewed fashion and emphasized performance, brand purity, and continuity.

By the standards of the timekeeping industry, Rolex is a relative newcomer. The pocket watch first emerged in the early 1600s. In the 18th century, innovators incorporated jewels into the design to reduce the friction of turning points and thus improve accuracy and reduce wear. According to Frank Edwards' *Wristwatches: A Connoisseur's Guide*, Berguet in 1810 made a watch for the Queen of Naples to be worn on the wrist. At London's 1861 Crystal Palace Exhibition, Patek Philippe featured a watch with a diameter of only 8.46 millimeters.

In the 19th century, England, Germany, and France became early centers for wristwatch manufacture. The United States also played a vital role in the evolution of the industry. The Waterbury Clock Co., founded in 1857, brought mass production to the industry, and drove the price of pocket watches down sharply. Switzerland, however, was the source of the highest quality watches. French Huguenots, who settled in Switzerland in the late 16th century, formed the nucleus of the Swiss industry. The Swiss concentrated their efforts on watches rather than clocks. And by the early 20th century, the label "Swiss Made" began to indicate quality, and Swiss firms began to dominate the middle and high-end of the market.

Luxury brands can rise and fall quickly. But by following a strategy of brand purity, continuity, and performance, the leading Swiss high-end watch maker has withstood the test of time.

"Today, Rolex is the largest single luxury watch brand, with revenues of about $3 billion and annual production of between 650,000 and 800,000 watches."

High Performance

The company that would eventually become Rolex was founded in London in 1905 by a 24-year old Bavarian who was orphaned at age 12. Hans Wilsdorf founded the company with his brother-in-law, William Davis, and coined the brand name Rolex. He felt the name sounded like the noise a watch made when it was being wound. It was also easily pronounceable in different languages and short enough to fit on the face of his watches. Wilsdorf ultimately moved his company to Geneva in 1919.

The period between the two World Wars was a difficult one for Swiss watchmakers, as they had to contend with successive economic and political crises. But in this period, Rolex began to build its reputation for performance. In 1914, a Rolex watch was awarded a Class A precision certificate from the British Kew Observatory, an honor previously reserved exclusively for marine chronometers. In 1926, Wilsdorf developed and patented the first truly water-resistant watch, the Oyster. The watch was strapped to the wrist of Mercedes Gleitze as she made her pioneering 15-hour swim across the English Channel. Rolex capitalized on the event by using it in advertisements, and by building displays in jewelers' windows that featured a watch submerged in a small tank of water.

By World War II, the Rolex brand had gained such prestige that British Royal Air Force pilots bought them to replace the inferior watches that were issued to them. Pilots captured as prisoners of war frequently had their Rolexes confiscated, but when pilots wrote to the company describing their experiences, Rolex replaced the watches free of charge. American servicemen learned of Rolex while stationed in Europe, thus helping to open the lucrative U.S. market to the company.

In the post-war era, as the company set its sights on expansion, Rolex continued to build its high-performance reputation. In 1945, Rolex introduced the Datejust model, the first chronometer with an automatic date changing mechanism. Eight years later came the Submariner, which was both water-resistant and pressure-resistant to a depth of 330 feet. And Rolex continued to find even more dramatic opportunities to demonstrate its unique performance characteristics. Sir Edmund Hillary wore a Rolex when he climbed Mt. Everest in 1953. The watch became the key instrument to measure time at sporting events.

Continuity Amid Change

Before his death in 1960, Hans Wilsdorf placed ownership of Rolex in the hands of the Wilsdorf Foundation, which would assure the company's independence. In 1962, Rolex's board appointed 41-year-old André Heiniger, who had worked for Wilsdorf for 12 years, as managing director. In 1992, Patrick Heiniger, a 32-year-old lawyer, who had served the company for six years as marketing director, succeeded his father. André stayed on as chairman until 1997, when he became chairman emeritus. In Rolex history, there have been only three managing directors.

In the post-war years, watches became both cheaper and more reliable. In 1950, a Norwegian born engineer, Joakim Lehmkuhl devised a more dependable inexpensive watch by making significant improvements to pin-lever technology. It was marketed under the brand name Timex. In 1968, prototype quartz crystal watches were introduced. These time pieces were extremely accurate and eventually would be inexpensive to produce. The new quartz technology allowed for both analog and digital readouts, and opened the door to new functions like calculators. By the end of the 1970s, about half of the watches sold worldwide were based on quartz technology, and Hong Kong had emerged as a major center for watch production.

Rolex was reluctant to join the quartz wave, but did come out with a limited number of models. In spite of threatening new technologies, a proliferation of low-cost producers in the Far East, and economic ups and downs, most of the luxury brands survived in one way or another. But Rolex thrived in the face of disruptive technologies. In an era when accuracy and dependability were no longer the exclusive province of premium products, Rolex developed a series of attitudes toward defending and building its position in the high-end market.

Even as watches became mass-produced commodities, Rolex continued to emphasize craftsmanship and quality. It used materials such as gold, platinum, and jewels. And it continually improved its movements and added new functions to its watches: the ability to tell the date, the day of the week, and the time in different time zones. As a result of this greater complexity, Rolex's watches were made with a greater sense of old-fashioned craft. An inexpensive quartz watch produced with a great deal of automation has between 50 and 100 parts; a Rolex Oyster chronometer has 220 parts.

Maintaining Demand

Rolex also maintained its brand image by limiting production, even as demand rose. For luxury goods, scarcity in the marketplace can influence value, spur demand, and contribute to collectibility and long-term appreciation. And a company that can pitch its product as an investment can frequently charge a premium. Finely-made luxury watches tend to appreciate in value over time. The *Complete Price Guide* *to Watches* (2004 edition) lists the value of a 1936 Patek Philippe Calatrava in 18-karat gold at $700,000. Rolex watches have held their value well, too. Price guides for collectors indicate that almost all older Rolex models are valued above their initial selling price. Most collectible Rolexes sell in a range of between $1,500 and $20,000.

Rolex has also taken pains to ensure that its watches are sold only in appropriate venues. The crystal prism that indicates a store is an "Official Rolex Dealer" is highly prized. Rolex looks for dealers with high-end images, relatively large stores, and attractive locations that can provide outstanding service – such as Tourneau. At one point, Rolex got into a dispute with Tiffany because the venerable retailer was imprinting its name on the Rolex watches it was selling. When Tiffany refused to stop, Rolex dropped Tiffany as an official jeweler. In the 1990s, as part of an effort to control sales of their goods in the so-called gray market, Rolex cancelled agreements with about 100 dealers.

Rolex has also focused on maintaining the purity of its brand. Many luxury-goods makers have used their original product as a springboard. Cartier and Mont Blanc, for example, have bet that the equity of their brand built on a single product will pull sales for a variety of luxury goods. And some brands have licensed their brand to other manufacturers, thus ceding some control over the products appearing under their name. But Rolex makes only watches, and it has never licensed its name.

What's more, many watch brands have responded to competition by merging into conglomerates over the last few decades. LVMH Moët Hennessy Louis Vuitton, the world's largest luxury goods company, with annual sales of more than $15 billion, includes venerable watch brands such as Tag Heuer, Zenith, and Dior Watches. Compagnie Financière Richemont, the world's third largest luxury goods maker, owns watch brands such as Cartier, Baume & Mercier, Piaget, Jaeger-LeCoultre, and Officine Panerai. Well-known brands Movado, Patek Philippe, and Breitling remain essentially independent. By placing control of the company in the hands of a foundation, Wilsdorf guaranteed that Rolex would have the means to withstand the pressure to affiliate with a larger company that has a range of interests and markets.

Rolex also maintains its brand purity by combating counterfeiters. Today, many copies are so good that only an expert can tell the difference. And while connoisseurs will certainly note the difference between a $5,000 Rolex and a $25 knock-off, the existence of large number of counterfeits inevitably affects demand at some level. Rolex likely spends more money policing fakes than any other brand.

In the future Rolex will no doubt face stiffer competition as innovative entrepreneurs search for new ways to attack its markets. And the large luxury goods conglomerates enjoy certain advantages over an independent firm like Rolex. They have restructured operations to take advantage of size and significantly reduce cost, enjoy synergies in advertising and marketing, and are more willing to engage in open discussions in trade associations to learn from the competition. The conglomerates may also be more willing to source from Asia, where labor costs are considerably lower than Switzerland.

But as it approaches its 100th anniversary, Rolex is sticking to its core strategy of independence, continuity, and brand purity. The company's attitude has allowed it not just to survive decades of technological and economic upheavals, but to thrive amid them. Even in today's massive, global luxury-goods market, an independent company that clearly defines its market niche and relentlessly sticks to its strategy can rise to the top.

DAVID LIEBESKIND *is an adjunct professor of management at NYU Stern.*

ROLEX TIMELINE

1905 – Hans Wilsdorf and his brother-in-law, William Davis, found watchmaking firm in London

1908 – Rolex brand created

1910 – Rolex obtains first official chronometer certification in Switzerland for a wristwatch

1919 – Wilsdorf forms Montres Rolex SA in Geneva, Switzerland to be close to Bienne, where his precision movements are crafted

1926 – Rolex patents Oyster design for a waterproof watch

1931 – Rolex introduces the Oyster Perpetual, the first waterproof & self-winding watch

1945 – Rolex introduces their first Datejust model, the first chronometer with an automatic date changing mechanism

1950 – Rolex creates the "Turn-O-Graph"

1953 – Rolex introduces the Submariner, the first automatic diving watch that is water resistant to 100 meters

1956 – Rolex launches the Day-Date model

1960 – Rolex founder Hans Wilsdorf dies

1963 – André J. Heiniger succeeds Hans Wilsdorf as head of Rolex

1978 – The Oyster Perpetual Date Sea Dweller is introduced, waterproof to a depth of 1,220 meters

1992 – Patrick Heininger becomes managing director

CAR TALK

Tatsuro Toyoda, a 1958 alumnus of NYU Stern, knows what it takes to build a global auto brand. He has worked in the family business — Toyota Motor Corporation — for more than a half century, and served as president from 1992 to 1995. Throughout his long, eventful career, Mr. Toyoda carried with him lessons learned at NYU Stern from Professor W. Edwards Deming. As an apostle of quality control, Professor Deming worked with many Japanese companies in the 1950s and 1960s, including Toyota. By following his statistical quality control techniques, Japanese manufacturers like Toyota built up a reputation for quality that enabled them to penetrate distant markets.

At NYU's Commencement Ceremony on May 13, 2004, Mr. Toyoda received an honorary Doctor of Commercial Science degree. At a dinner with NYU Trustees on the evening of May 12, Mr. Toyoda reflected on his career, and on his experience at NYU Stern.

Dean Thomas Cooley hosted a celebratory luncheon at NYU Stern in honor of Tatsuro Toyoda, a 1958 Stern alumnus who received an honorary Doctor of Commercial Science degree at NYU's Commencement Ceremony on May 13, 2004.

Pictured from left to right are Professor Eitan Zemel, W. Edwards Deming Professor of Quality & Productivity and chairman, Department of Information, Operations & Management Sciences; William R. Berkley, NYU Trustee, chairman of the Stern Board of Overseers and chairman and CEO, W.R. Berkley Corporation; Mr. Toyoda; Dean Cooley; Mrs. Toyoda; Diana Deming Cahill, founding trustee of the W. Edwards Deming Institute and daughter of W. Edwards Deming; Professor Ernest Kurnow, Mr. Toyoda's former Statistics teacher at Stern and a former colleague of W. Edwards Deming; and Yi Lu, a doctoral candidate in Statistics who currently holds the W. Edwards Deming Fellowship.

Tatsuro Toyoda

1928	Born in Nogoya, Japan, the son of Kiichiro Toyoda, founder, Toyota Motor Corporation
1953	Joins Toyota after earning a degree in mechanical engineering from the University of Tokyo
1956-1958	Attends NYU Stern, studying statistical inference with Professor Ernest Kurnow and statistical analysis with Prof W. Edwards Deming
1958-1974	Works in domestic and international marketing at Toyota Motor Corporation
1974	Named director of Toyota Motor Corporation
1984-1986	Heads joint venture with General Motors in California
1992	Succeeds brother Shoichiro as company president
1995	Named vice chairman of Toyota Motor Corporation
1998-present	Senior advisor to the board of Toyota Motor Corporation

Thank you, President Sexton, and good evening.

I am honored to be here tonight with NYU Board Chair Martin Lipton, the NYU Trustees, fellow honorary degree recipients, and other distinguished guests.

It is a great honor to receive the honorary degree of Doctor of Commercial Science.

When I came to the United States for the first time in 1955, we didn't sell any vehicles here. It was two years later, in 1957, when our first vehicle – the Crown – was shipped to the United States.

Unfortunately, at that time, Toyota vehicles were not comparable to the "Big Three" in terms of quality and driving performance. Since then, we worked hard to produce a better car for this great country.

I had the fortune to attend a class taught by Dr. W. Edwards Deming during my days at the NYU Stern School of Business. Many Japanese companies followed Professor Deming's advice, and substantially improved their quality control in manufacturing and other areas. His landmark work is widely acknowledged among Japanese companies – and one of the most prestigious awards in Japan is the Deming Prize.

When I was a student at NYU, our annual new car sales were less than 300 units. Last year, thanks to American customers, we sold over two million cars and trucks in the North American market, and our four assembly plants in North America built more than 60 percent of those vehicles.

From the beginning of our operations, we have sought to contribute to society through our investment, employment, and corporate citizenship activities. In recent years, we have focused on safety and environmental initiatives. For example, our advanced technology hybrid gas-electric vehicles achieve high mileage and reduce emissions.

I, and my colleagues at Toyota, owe a debt of gratitude to America. And we will work hard to repay it by continuing to provide jobs and investments here, and by building safer and more environmentally friendly vehicles.

My time at NYU taught me about American consumers and their tastes. This knowledge came in handy 20 years ago when I was asked to head Toyota's first vehicle assembly plant in the United States, New United Motor Manufacturing, Inc., or NUMMI as we call it. Located in Fremont, California, this joint venture plant with General Motors is still a thriving success some two decades later.

When I returned to Japan after NUMMI, I was named president of Toyota Motor Corporation – and I continued to pursue my dream of making a positive contribution to society.

I want to thank NYU for giving me a good foundation in business and in my personal life – that served me well in my career with Toyota.

It is a sincere privilege to have been chosen to receive the honorary degree of Doctor of Commercial Science from this great university.

I am deeply touched.

Thank you.

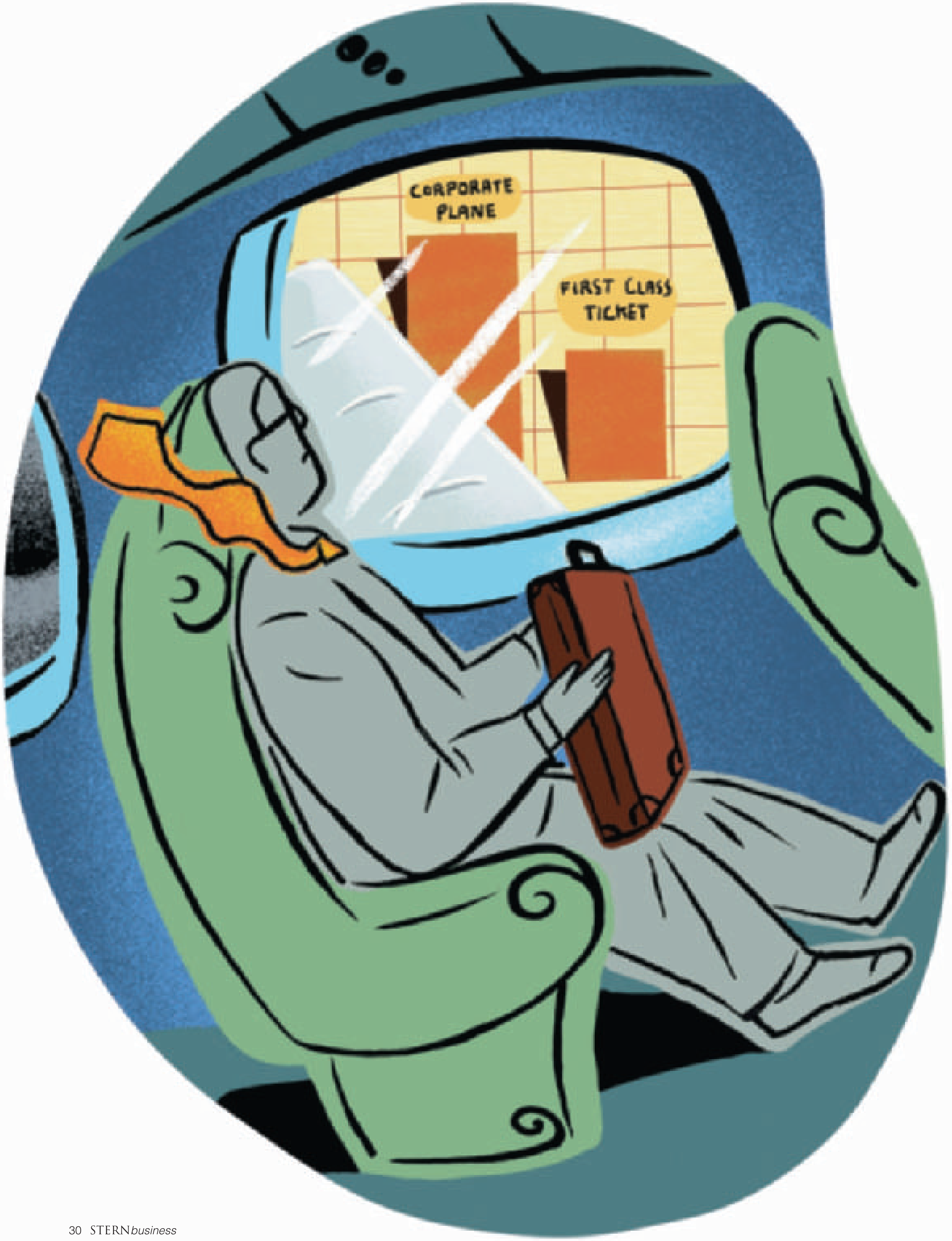
W. Edwards Deming

Born in Iowa, and educated at the University of Wyoming in Cheyenne, W. Edwards Deming received graduate degrees in physics and mathematics from the University of Colorado and Yale University.

But the scientist would make his mark in a different field: Statistics. In the 1940s, Deming was an adviser to the Bureau of the Census, which was starting to use sampling techniques to count the U.S. population. In 1946, Deming joined the faculty of what is now the NYU Stern School of Business as a professor of Statistics, and started a consulting practice to advise companies and institutions on the use of statistical quality control. While he didn't find many clients among American businesses, Deming quickly learned that Japanese companies were eager for his expertise.

He was convinced that the use of statistical methods could help Japanese companies rebuild, improve quality, and compete in global markets. In 1950, he delivered a series of eight day-long lectures, which were attended by many top Japanese business and industry leaders. He told them that "Japanese quality could be the best in the world, instead of the worst." Deming returned to Japan several times in the 1950s, ultimately helping to train some 20,000 engineers in statistical methods and directly influencing Japan's remarkable postwar recovery. Almost instantly, Deming became something of a folk hero in Japan. And in 1960, Emperor Hirohito bestowed on Deming the Second Order Medal of the Sacred Treasure.

Even as Japan continued to rise as a global manufacturing power, Deming's teachings on the need for worker cooperation and continuous quality improvement were largely ignored in the U.S. It wasn't until the 1980s, when U.S. industry aimed to recapture ground lost to Japanese firms, that Deming's ideas were discovered in his home country. The author of several books and more than 150 papers, Deming died in 1993 at the age of 93.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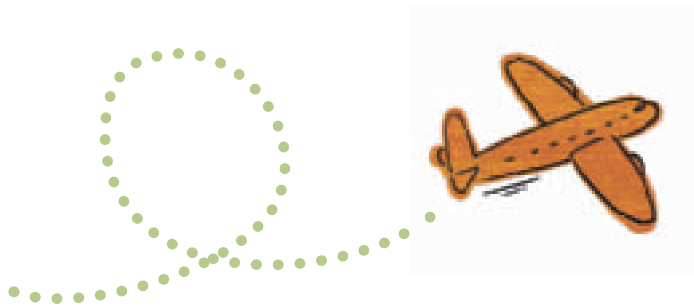
FIRST CLASS TICKET



FLIGHTS OF FANCY

A top of the line corporate jet can cost a company up to $35 million. But a new study shows that when chief executive officers trade in first-class commercial tickets for private planes, the cost to shareholders can be far greater.

By **David Yermack**

Personal aircraft use represents by far the most costly and fastest growing fringe benefit enjoyed by chief executive officers of major corporations. In 2002, more than 30 percent of *Fortune 500* CEOs were permitted to use company planes for personal travel, up from less than 10 percent a decade earlier.

Several factors have contributed to this growth. The rise of fractional aircraft ownership has dramatically reduced the up-front costs of access to corporate jets. And in the wake of the September 11, 2001 terrorist attacks, many executives have chosen to escape the hassles and perceived danger of flying on major airlines by using private jets.

Corporate jets regularly inspire criticisms of managerial excess by journalists and shareholder activists, and they frequently seem to symbolize corporate cultures of excess. At Adelphia Communications, the bankrupt cable company whose top executives have been convicted of fraud, prosecutors charged that the company jet was used to ferry corporate founder John Rigas to Kenya on a safari and to deliver a Christmas tree to one of Rigas' daughters. At Enron, according to Bethany McLean and Peter Elkind, authors of *The Smartest Guys in the Room*, members of CEO Kenneth Lay's family were known to use the company's jet fleet as a sort of personal taxi service.

"Corporate jets regularly inspire criticisms of managerial excess by journalists and shareholder activists, and they frequently seem to symbolize corporate cultures of excess."

But Adelphia and Enron provide only anecdotal connections between the use of jets and potential damage to shareholders. I set out to determine if there was, in fact, an empirical link between CEOs' use of corporate jets and corporate performance. The results were striking. In the short-term, shareholders react negatively to the news that CEOs are using corporate jets. While CEOs who fly on such aircraft may arrive at their destination quickly, their stocks lag. The shares of companies whose CEOs use private aircraft underperform the market by more than 400 basis points per year.

Perks and Compensation

In a sense, this effort was a matter of putting two theories of executive behavior and compensation to the test. In their classic 1976 study, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, Michael C. Jensen and William Meckling, of the University of Rochester, used perquisite consumption by man-

ILLUSTRATIONS BY JUD GUITTEAU

agers as the basis for their formal model of the agency costs of outside equity in a public corporation. When an owner-manager sells stock to the public and reduces his ownership below 100 percent, incentives increase for the manager to expend corporate resources for personal benefit. Jensen and Meckling's model seems to predict that perk consumption by a CEO should vary inversely with his fractional ownership of the company (that it would rise as a CEO's stake in the publicly-held company he runs falls). They also suggest a manager's personal tastes and the difficulty of monitoring the manager's actions would influence perk consumption.

In his 1980 paper, *Agency Problems and the Theory of the Firm*, University of Chicago Finance Professor Eugene Fama took a more benign view of perquisites. "Consumption on the job" by managers amounts to a form of compensation that can be offset through adjustments in salary or other forms of pay. Fama described the interaction between managers and their boards of directors in terms of a dynamic of "ex post settling up," in which the manager's wage is regularly revised to account for his performance and his personal consumption of company resources. Fama's model implies that perk consumption represents an agency cost only to the extent that its value exceeds the subsequent consequences to the manager from ex-post settling up wage revisions. Fama's theory, then, appears to predict an inverse association between perk consumption and compensation, controlling for other attributes that affect compensation such as industry, performance, and experience. In other words, perk consumption would fall as compensation rises.

"...aircraft use is by far the largest disclosed CEO perk, appearing more than twice as often as the next most popular item, financial counseling..."

Table 1

CEO Variables	Mean
Age	57.4
Years as CEO	6.9
Ownership fraction	1.48%
Founding family member	15%
Salary	$870,000
Annual bonus	$1.24 million
Stock option award	$4.48 million
Restricted stock award	$710,000

Political Affiliation	Percentage
Donor to Republicans	55
Donor to Democrats	19
Donor to both parties	19

Education Level	Percentage
No college degree	6
College only	37
MBA graduate degree	38
JD or LLB	10
Ph.D.	5
Other graduate degree	10

I tested both theories by investigating the prevalence of a major perk – the use of corporate jets – and then measuring its relationship to other factors such as overall compensation, CEO characteristics, and shareholder return. Data for this study was drawn from a panel of 237 *Fortune 500* companies between 1993 and 2002. The final sample had 2,340 observations, with most firms appearing in the sample for 10 full years. Those observations covered 485 individual CEOs, a small handful of whom served more than one term with the same company. The sample firms had median annual sales of close to $7 billion, median total assets above $10 billion, and a median market capitalization close to $8 billion.

Table 1 contains data on the characteristics of the CEOs in the study. The typical CEO was about 58 years old, with a mean ownership of about 1.5 percent of the firm's shares. CEOs received mean cash salary and bonus compensation of about $2.1 million, and additional annual income from stock option and restricted stock awards. Stock options delivered a large, skewed distribution of compensation, with a mean of $4.5 million and a median of $1.6 million.

It is impossible to measure the tastes and performance of CEOs directly. However, I was able to collect two variables about the backgrounds of my sample's 485 CEOs that one might expect to exhibit correlations with their perk preferences: political affiliation and education. First, I chose CEOs' political affiliations, which can be observed from databases of donations maintained by the Federal Election Commission. I classified CEOs as either

Republicans or Democrats if a clear majority of their donations were directed to one party's candidates or organizations. Fifty-five percent of the CEOs appeared to be Republicans and 19 percent, Democrats. An additional 19 percent donated fairly evenly to both parties, and the rest had no record of political donations. Second, I chose CEOs' educational backgrounds, which were provided by *Forbes* magazine's annual executive compensation surveys and supplemented when necessary by online news searches. Six percent of the sample CEOs had no college degree, but a majority had attained a graduate degree of some type.

Table 2
Perquisites Required for CEOs

Category	Observations	Frequency
Personal use of company aircraft	346	14.6%
Financial counseling	161	6.8%
Company car and local transportation	94	4.0%
Relocation and housing expenses	54	2.3%
Country club dues	46	1.9%
Medical care exceeding company plans	20	0.8%
Personal or home security	6	0.3%

Measuring Perk Consumption

Next, I measured CEO perk consumption – a complex and occasionally difficult task. The primary source of information was the companies' annual proxy statements. Data on perks usually appear in proxies as a footnote to column (a) of the Summary Compensation Table, headed "Other Annual Compensation." The total value of perks must be disclosed based upon their "aggregate incremental cost" to the company, but only if the total exceeds the lesser of $50,000 or 10 percent of the executive's salary plus bonus. Companies must itemize the cost of any individual perk, such as personal aircraft use, if it exceeds 25 percent of the overall perk total, assuming that the total exceeds the $50,000 threshold. The structure of the Securities and Exchange Commission's disclosure rules causes data for CEOs' personal aircraft use to be censored. For example, assuming the CEO earns at least $500,000 salary plus bonus, firms never have to disclose aircraft use if its cost lies below $12,500 (equal to 25 percent of the $50,000 overall threshold). From reading a large number of proxy statements, it is evident that several disclosure loopholes limit the transparency of perk consumption data.

Even so, I was able to amass a large amount of data on CEO perks, which is described in **Table 2**. Perks are rank-ordered according to the frequency of their disclosure. Companies use certain euphemisms to describe personal aircraft use, such as "travel expense" and "corporate transportation." I generally assumed that such language refers to airplane or helicopter travel rather than limousines, trains, or boats, unless disclosures indicate otherwise. As **Table 2** indicates, aircraft use is by far the largest disclosed CEO perk, appearing more than twice as often as the next most popular item, financial counseling, which includes tax preparation, estate planning, and the cost of representation in contract negotiations.

The median cost to the company of CEO's personal aircraft use, when disclosed, is a little more than $50,000. While costs of operating different aircraft vary greatly, *The New York Times*, using data from Executive Jet Inc., the leading timeshare company, in 2001 estimated the hourly cost of leasing an eight-person Cessna Citation V aircraft was $10,000 – or $2,500 per person if the CEO on average travels with three other passengers. A CEO with $50,000 in reportable aircraft use would therefore spend about 20 hours per year in the sky, enough for perhaps three round-trips between New York and Florida, for example.

What determines whether a CEO has a higher propensity to use corporate aircraft? I used a Tobit regression model to analyze how the cost of CEO aircraft use in each firm-year is related to a range of explanatory variables. Among the variables I chose were CEO stock ownership, compensation, the age of the CEO, whether or not he was a member of the firm's founding family, education level, and political affiliation. The regression model includes control variables for size and capital structure.

When I ran the models, the estimates for the excess compensation residual were negative. That provided some support for Fama's theory about perk consumption, since it implies that a CEO's compensation is adjusted downward when his perk consumption increases. But the effect was very small. The result implied that an additional $1,000 in perks consumed by the CEO leads to a reduction in compensation of 10 cents, an economically negligible amount.

The Jensen-Meckling theory of perks predicts that CEOs trade off the value of perk consumption against the reduction in personal ownership value entailed by that same consumption. When I estimated the model, the CEO ownership variable provided evidence of the predicted negative association with perk consumption. The estimates imply that increases in ownership act as a curb against perk consumption at both low and high ownership levels, but that greater ownership provides protective cover that CEOs use to extract greater perks over a middle ownership range. The overwhelming majority of CEOs in this sample lay

"While CEOs who fly on such aircraft may arrive at their destination quickly, their stocks lag. The shares of companies whose CEOs use private aircraft under-perform the market by more than 400 basis points per year."

in the low ownership range. Again, the effect was very small. The marginal effect implies that a 1 percent rise in CEO ownership leads to a $5,030 reduction in perk consumption, which seems quite small compared to the cost of the additional equity investment – $201 million in the mean sample firm.

Older Frequent Fliers

Variables associated with CEO tastes and preferences have clear impacts upon patterns of corporate aircraft use. Older CEOs are more likely than younger ones to make personal use of company aircraft. This pattern may arise due to increasing frailty of CEOs as they age, or it may represent opportunism by CEOs who consume perks heavily near the end of their careers with reduced fears that ex post settling up wage revisions will permanently impact their compensation.

CEOs from founding families also use corporate aircraft with abnormally high frequency, perhaps indicating that founders do not recognize boundaries between personal and corporate property as clearly as non-founders. Political affiliation has some impact upon perk consumption, but in a non-partisan way. CEOs who make no political donations are the heaviest users of corporate jets, while CEOs who make donations to both parties are the lightest users. CEOs who clearly are Democrats or Republicans fall somewhere in the middle.

Finally, the education variable results were striking. CEOs with the least education (no college degree) are the heaviest aircraft users, while those with the highest advanced degrees (Ph.D.s) are the lightest.

CEOs who hold MBAs or other masters degrees are somewhere in between, and CEO-lawyers have significantly higher aircraft use than normal, though not as high as non-college graduates.

Shareholder Returns

How does aircraft use affect stock prices? In my 1993-2002 sample of 237 firms, 63 companies disclosed no CEO aircraft use for either of the first two years and then began disclosing it for some future year or years. I calculated the mean cumulative abnormal stock returns (CAR) for these 63 firms beginning two weeks – or 10 trading days – prior to the statement date of the proxy in which corporate aircraft use was first disclosed. I extended the event window until one day after the filing day because some firms may post their documents after the market closes. The results: stock prices exhibit essentially zero change until one week before the event day, at which point they begin to trend downward, with the mean showing a CAR of -1.99 percent.

A loss of 2 percent in market capitalization was worth about $150 million for the median firm in the sample, far in excess of the disclosed incremental cost to the company of a CEO's personal aircraft use. If shareholders view the entire corporate aviation activity of a firm as a deadweight cost that yields no compensating benefits, and if one factors in additional costs for storage, maintenance, fuel, and operation of the plane, then the dollar loss in shareholder wealth could approximate the true present value cost to the firm of acquiring an aircraft and making it available to the CEO for both business and personal travel.

The CAR results indicate that shareholders do not welcome the news that firms permit CEOs to use corporate aircraft for personal travel. When I ran regressions that took into account compensation and ownership levels, I found that shareholder reactions to CEOs' corporate jet use are mitigated if the CEO earns lower compensation. This pattern is consistent with Fama's perspective, that perks are benign if offset by reductions in other forms of compensation.

"CEOs from founding families also use corporate aircraft with abnormally high frequency, perhaps indicating that founders do not recognize boundaries between personal and corporate property as clearly as non-founders."

Long Term Losses

Short-term, stockholders plainly view the use of a corporate jet as a negative. Next, I assessed the ongoing market performance of firms that permit their CEOs to have personal use of corporate aircraft. Again, the results were negative. The results indicate that firms with CEO aircraft use under-perform the market by more than 400 basis points per year, equal to a shortfall of about $300 million in market capitalization each year for the median sample firm.

Given that these performance shortfalls equal hundreds of millions of dollars per company per year, it would be difficult to argue that the direct costs of perk consumption alone could explain the gap. Even the most expensive jets don't cost several hundred million dollars. One clear possibility is that these managers who use jets frequently also run their firms inefficiently, tolerating waste, excess overhead, or uncompetitive cost structures. When I ran regressions of firms' return on assets against the aircraft use dummy variable, as well as dummy variables for industries and years, I found a negative association between profitability and the aircraft use variable, and a strong, significant negative association between the aircraft variable and sales per employee. These regressions indicate that firms with high CEO perk consumption also tend to be overstaffed relative to the competition, as they achieve $30,000 to $40,000 less in sales per employee.

The inverse relationship between CEO aircraft use and company performance appears surprisingly strong and much larger than could be explained by the direct cost of the resources consumed. It could be that CEOs who consume excessive perks may be less likely to work hard, less protective of the company's assets, or more likely to tolerate bloated or inefficient cost structures. High executive perks might also occur due to weak corporate governance.

For many in the world of business, the corporate jet is the ultimate sign of arrival. When they're able to fly in a Gulfstream IV out of Teterboro Airport in New Jersey instead of having to wait in line to board a Boeing 737 at La Guardia, many executives feel as if they have finally made it. For shareholders, ironically, this moment frequently signals it's time to head for the exits.

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The Trouble with Fannie and Freddie

Fannie Mae and Freddie Mac have parlayed the advantages they enjoy as government-sponsored enterprises to grow into massive financial powerhouses in the market for residential mortgages in the U.S. Have they grown too big? And do the benefits that they deliver to the public fall short of the potential costs they hold for taxpayers?

ORVIDAS

By **Lawrence J. White**

In the past year, there has been a great deal of debate about the special status, accounting policies, and the influence of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The two entities, which enjoy federal government charters and an array of implicit and explicit privileges, have grown into gigantic, publicly traded firms that wield enormous influence on the U.S. capital markets and housing market – and hence on the American economy and the political system.

Many national leaders, from Federal Reserve Chairman Alan Greenspan to the heads of large commercial banks, have raised questions about Fannie and Freddie. Have they grown too large and unwieldy? Are they disrupting housing and capital markets? Might they be a future source of systemic risk? And if so, what can be done about them? Answering these questions requires a careful consideration of the companies' roles and net effects, and some speculation as to what the world would look like if the two were to lose their special status.

Fannie Mae, created in 1938, and Freddie Mac, created in 1970, are federally chartered corporations, or government-sponsored enterprises (GSEs). They share narrow federal mandates: to provide finance for single- and multi-family housing. And while they are both publicly traded companies, at each company, five of the 18 directors have been chosen by the President, and the two companies enjoy an array of special privileges. Fannie and Freddie are the only two enterprises that have received this special housing finance charter from the federal government.

Both companies have grown rapidly in the past two decades, as the data in **Table 1** indicate. As of year-end 2003, Fannie and Freddie had $1,010 billion and $803 billion in assets, respectively. Ranked by assets, they were the second-

Table 1:

Balance Sheet and MBS Data, Fannie Mae and Freddie Mac, 1980-2003

(in billions of dollars)

Fannie Mae

	Total assets	Retained mortgage portfolio[a]	MBSs outstanding portfolio[b]
1980	$57.9	$55.6	$0.0
1985	99.1	94.1	54.6
1990	133.1	114.1	288.1
1995	316.6	252.9	513.2
2000	675.2	607.7	706.7
2003	1,009.6	901.9	1,300.2

Freddie Mac

	Total assets	Retained mortgage portfolio[a]	MBSs outstanding portfolio[b]
1980	$5.5	$5.0	$17.0
1985	16.6	13.5	99.9
1990	40.6	21.5	316.4
1995	137.2	107.7	459.0
2000	459.3	385.5	576.1
2003	803.4	660.4	768.9

[a] *Includes repurchased MBSs.* [b] *Excludes MBSs that are held in portfolio.*
Source: OFHEO.

and third-largest "private" enterprises in the U.S. In addition, there are about $1,300 billion outstanding pass-through mortgage-backed securities (MBSs) that carry Fannie's guarantee, and $769 billion guaranteed by Freddie. With market capitalizations of $75 billion and $43 billion, respectively, as of early 2004, Fannie and Freddie ranked among the 60 largest publicly traded companies.

The companies have been able to grow so rapidly in part due to their status as GSEs, which confers several advantages that rivals don't enjoy. Although their prospectuses explicitly note that the government does not guarantee the securities they issue, the securities markets act as if the firms' directly issued debt and MBSs may well carry a federal guarantee. Fannie and Freddie thereby enjoy lower financing costs than do AAA-rated corporations – but not quite as low as the U.S. government itself. The two firms are subject to lower capital (net worth) requirements for holding residential mortgages in their portfolios than are banks and thrifts, and are exempt from state and local taxes. Their securities are exempt from the Securities and Exchange Commission's registration requirements and fees. They can borrow from the U.S. Treasury and use the Federal Reserve as their fiscal agent. Their MBSs, when held by U.S. banks and thrifts, carry a capital (net worth) requirement of only 1.6 percent, rather than the capital requirement of 4 percent that the underlying mortgages themselves would require if held by a bank or thrift.

Fannie and Freddie are also subject to major limitations. They are restricted to the business of providing residential mortgage finance; they cannot originate mortgages. They can only finance mortgages that are at or below a specified maximum ("conforming") loan size that adjusts annually with an index of housing prices (in 2004 that limit is $333,700 for a single-family home), and the mortgages must have a 20 percent down payment or have a third-party credit enhancement, such as mortgage insurance. The U.S. Department of Housing and Urban Development (HUD), as well as HUD's Office of Federal Housing Enterprise Oversight (OFHEO), regulates the companies.

The GSE status of Fannie and Freddie gives them clear advantages over non-GSEs. Because of their "agency" status, Fannie and Freddie can issue debt at interest rates that are about 35-40 basis points less than could an otherwise similar non-GSE. Their MBSs similarly carry a yield that is about 30 basis points lower than non-GSE MBSs. On the other side of the ledger, Freddie and Fannie's mortgage purchase activities appear to have reduced conforming mortgage interest rates by about 25 basis points.

Pioneering New Markets

The companies' participation in the residential mortgage markets takes two forms. First, they buy and hold residential mortgage assets in their own portfolios; they fund these purchases overwhelmingly with debt. Of Fannie's $1,010 billion in assets at year-end 2003, $902 billion (89 percent) was invested in mortgage assets; of Freddie's $803 billion in assets, $660 billion (82 percent) was in mortgage assets. Their liabilities were composed of 96-97 percent debt and only 3-4 percent equity.

Second, they purchase residential mortgages from originators, create securities (MBSs) from bundles of the mortgages, and swap the securities back to the originators or sell the securities to investors, with guarantees on the MBSs as to the timely payment of interest and principal. By doing so, Fannie and Freddie have created a large national secondary market in residential mortgages and revolutionized the mortgage market.

A few decades ago, mortgage finance was largely a vertically integrated process. Banks and thrifts originated residential mortgages, which were financed almost entirely by deposits, and kept the mortgages in their portfolios. Federal deposit insurance, provided by the Federal Deposit Insurance Corporation (FDIC) to banks and the Federal Savings and Loan Insurance Corporation (FSLIC) to thrifts, provided guarantees to the depositor/liability holders.

The activities of Fannie and Freddie have created a second, vertically disintegrated process. Banks still make mortgages, but they frequently sell them to Fannie and Freddie. Banks and thrifts also purchase MBSs and hold them in their portfolios, thereby gaining a more liquid mortgage asset with a credit guarantee and lower capital requirements, and the potential for greater geographical diversification than could be achieved from local mortgage originations.

As of year-end 2000, Fannie and Freddie's mortgages-in-portfolio plus MBSs outstanding together accounted for the following percentages of the various categories of residential mortgages: 39 percent of the $5.6 billion total of all residential mortgages; 40 percent of the $5.2 billion total of all single-family (one-to-four units) mortgages; 48 percent of the $4.4 billion total of all single-family "conventional" mortgages (that were not insured by the Federal Housing Authority or the Veterans Administration); 60 percent of the $3.5 billion total of all single-family conforming mortgages; 71 percent of the $2.8 billion total of all fixed-rate single-family conforming mortgages.

"Although their prospectuses explicitly note that the government does not guarantee the securities they issue, the securities markets act as if the firms' directly issued debt and MBSs may well carry a federal guarantee."

The special status that Fannie and Freddie enjoy is part of a much larger mosaic of long-standing public policies to encourage residential housing. Owner-occupied housing is largely exempt from capital gains taxes. Owner-occupiers can deduct mortgage interest and real estate taxes on their income tax returns. Rental housing enjoys accelerated depreciation. A host of federal, state, and local subsidies and tax advantages exist that are intended to spur construction of rental housing. The government also directly provides rental ("public") housing. Thrifts and other depositories that focus on residential lending receive favorable funding through the Federal Home Loan Bank System. It is perhaps only a slight exaggeration to claim that when it comes to housing and especially home ownership, the ethos of public policy has been (and continues to be) "too much is never enough."

A Contingent Liability

Fannie and Freddie are exposed to at least three types of risks. First is credit risk. On all of the mortgages that they hold in their portfolios and on all of their MBSs, Fannie and Freddie are exposed to the risks of default by the mortgage borrower. Second is interest rate risk. On all of the fixed interest rate mortgages that they hold in their portfolios, Fannie and Freddie are exposed to the risk that interest rates will rise, which will decrease the value of their assets. Further, the risks are asymmetric: Since all mortgage holders have the option to pre-pay, interest rate decreases are often accompanied by waves of pre-pays and refinancings at lower interest rates. As a result, Freddie and Fannie do not experience comparable capital gains. Third is operational risk. This is the risk of poor management, bad judgments, and employee fraud.

As would be true for any well-managed company, Fannie and Freddie take extensive measures to contain these risks. But if the capital markets are correct in their belief that the federal government would stand behind Fannie and Freddie's obligations in the event that either were in financial difficulties, then creditors need not worry about suffering huge losses. Instead, the federal government is at risk. In essence, then, the implicit guarantees that Fannie and Freddie enjoy comprise a contingent liability, or implicit cost, for the federal government – for 2003 the annualized figure was around $13 billion.

The size of this contingent liability depends on external factors, such as the volatility of interest rates and homeowner defaults, and partially on internal factors, such as the size of the companies' securities issuance and the quality of their hedging. But the government only recognized the need to limit its exposure through heightened regulation of the companies in 1992, when Congress established core capital requirements for Fannie and Freddie and created OFHEO within HUD to set capital requirements and conduct formal examinations of Fannie and Freddie.

The Larger Context

The evaluation of the net or balance of Fannie's and Freddie's roles must be made in the larger context of housing policy in the U.S. The government puts great store in boosting the percentage of households that own their own home. That figure is seen as an important social indicator. In the fourth quarter of 2003, it stood at a record 68.8 percent. In the 1990s, the goal of extending home ownership deeper into the ranks of "low- and moderate-income" households became more important. And so in 1992, Congress gave HUD the power to set goals for Fannie and Freddie to extend their mortgage purchase efforts to encompass more low-and moderate-income households.

There are serious theoretical arguments to support the claim that home ownership provides positive externalities (spillover effects) for society and thus to support the encouragement of home ownership, and a recent body of empirical research has begun to validate those arguments. Owners tend to maintain their homes better than do renters, and are more likely to become more involved in their communities. Also, home ownership has traditionally been an important vehicle for household saving and asset accumulation. But there clearly are limits. Because of the substantial transactions costs in buying and selling a home, as well as the inherent riskiness of a home as an investment, home ownership may well be inappropriate for households with high mobility, unstable employment, and irregular incomes.

"Freddie and Fannie's mortgage purchase activities appear to have reduced conforming mortgage interest rates by about 25 basis points."

As a result, it would seem that the best program would be a focused one that encourages those households who would not otherwise buy (but for whom it is a close call) to purchase a home. This focus should be on would-be first-time low- and moderate-income household buyers. But virtually all of the policy tools used to encourage home ownership, including the basic Fannie/Freddie program, are quite broad and blunt. So our society effectively spends a great deal of time and resources subsidizing home ownership for households – especially middle-and high-income households – who would buy and own anyway but who are thereby encouraged to buy larger and better appointed homes and to buy second homes.

That the panoply of encouragements causes the stock of housing to be inefficiently larger than would otherwise be the case is evident. Northwestern University professor Edwin S. Mills in 1987 estimated that the U.S. housing stock was about 30 percent larger than if the encouragements were not present. With an excessively large housing stock (and insufficiently large stock of other productive capital), he found that U.S. aggregate income was substantially lower – about 10 percent – than it otherwise could be. More recent studies have supported that finding.

Reforming Housing Finance

Fannie and Freddie borrow for less than would otherwise be the case. They cause conforming mortgages to cost/yield less than would otherwise be the case, thereby increasing the demand for residential housing. And they create a contingent liability for the federal government.

Is it worth the price? We should start by assuming a zero-sum world and then look for positive externalities that would justify the special government treatment that Fannie and Freddie receive. While GSEs do lower the cost of home ownership modestly, most of the encouragement they provide must be to induce households who would be owner-occupiers anyway to buy a bigger/better appointed house and/or to buy a second house. In 2002, when the Fannie/Freddie conforming mortgage limit was $300,700, the median sales price for a new home was $187,600 and the median sales price for an existing home was $158,100. The median 80 percent mortgages would have been $150,080 and $126,400. Thus, Fannie and Freddie are financing many homes that are far above median levels.

As a result of legislation passed in 1992, HUD was instructed to set specific goals for Fannie and Freddie to help create more affordable housing. The GSEs were to focus on low-and moderate-income borrowers, households with less-than-median incomes, and to focus geographically on underserved areas such as low-income and high-minority census tracts.

Over the course of the 1990s, Fannie and Freddie met these goals. But the extent to which these efforts have induced Fannie and Freddie to expand home ownership, beyond what otherwise would have occurred, is unclear. Detailed studies indicate that the targets may be sufficiently broad so that meeting them is not a strain, and that these GSEs' efforts with respect to low-income households and areas tended to lag behind those of local portfolio lenders. What's more, such efforts to lean on Fannie and Freddie to make loans involve placing pressure on an organization to take actions that are believed to be unprofitable, and that thereby rasp against the grain of a profit-seeking enterprise.

Observers have noticed two other potential advantages from the government chartering of Fannie and Freddie. First, Susan E. Woodward of Sand Hill Econometrics has argued that the (implicit) government guarantee permits Fannie and Freddie to issue a blanket guarantee on all their MBSs that removes issues of credit risk from the minds of MBS investors. And that eliminates the transactions costs of credit/information research in which MBS investors would otherwise engage. While this argument is surely correct, the gains are likely offset by the contingent liability of the federal government, as well as the monitoring costs of OFHEO.

The other potential positive advantage arises in the context of Robert Van Order's model of "dueling charters." Van Order, the former chief economist at Freddie Mac, reminds us that depositories that fund residential mortgages and hold them in portfolio also have a government guarantee, in the form of federal deposit insurance. If the depositories are inherently a less (socially) efficient means of financing mortgages than are the GSEs, then the expansion of the GSEs at the depositories' expense reduces social inefficiency. However, though the innovation of mortgage securitization has clearly revolutionized mortgage finance and would persist even without the favored status of the GSEs, the assumed inherent superior efficiency of Fannie and Freddie may not be valid. Thrifts are likely holding more MBSs today because the MBSs enjoy regulatory advantages when it comes to meeting capital requirements.

Modest Benefits

In sum, the positive externalities and thus true social benefits provided by Fannie and Freddie are surely positive but modest. If the status of Fannie and Freddie could be considered in isolation, the policy recommendation to privatize them – i.e., remove all explicit/formal and implicit government support – would be an easy one. Given their substantial brand-names and their impressive collection of human and intellectual capital, they would likely continue to innovate and prosper, with their relative funding costs a bit higher than is currently the case, their MBSs yielding a bit more, and the costs for home buyers of obtaining a residential mortgage rising a bit. Freed of the restrictions that accompany their current status, Fannie and Freddie would likely vertically integrate into related areas, such as mortgage and title insurance, and expand horizontally into related areas of finance, such as auto loans and jumbo mortgage loans. And in turn, the government's contingent liability would disappear.

"The special status that Fannie and Freddie enjoy is part of a much larger mosaic of long-standing public policies to encourage residential housing."

In their place, the federal government should institute a targeted program to encourage home ownership for first-time buyers among low-and moderate-income households. This would be a far more direct way of addressing the positive externality of home ownership. The encouragement should apply both to reducing down payments and interest costs. The costs of the program would, and should, be explicit. Further, as a way of reducing the costs of housing more generally, governments at all levels ought to focus on supply-side considerations such as modifying restrictive land zoning (which reduces housing supply by limiting the ability to build single-family houses on small lots and limits the building of multi-family units), modifying building codes that unnecessarily raise housing costs without adding to housing safety, and avoiding restrictive international trade policies that raise the prices of important inputs into housing, such as lumber.

A general rationalization of U.S. housing policy may well be a quixotic goal, however. Public and political sentiment shows few signs of turning away from the notion that more housing is always a good thing, even if middle-and high-income households are the primary beneficiaries. If privatization of Fannie and Freddie is not a realistic political option, then rigorous and vigorous safety-and-soundness regulation must be pursued, so as to minimize the federal government's contingent liability. But so long as the GSEs exist in their current form, the goal of expanding home ownership will be pursued only indirectly as part of a larger mosaic of programs, subsidies, and tax breaks. Disentangling Fannie and Freddie from that larger framework will not be easy. But it is a task that is worth attempting.

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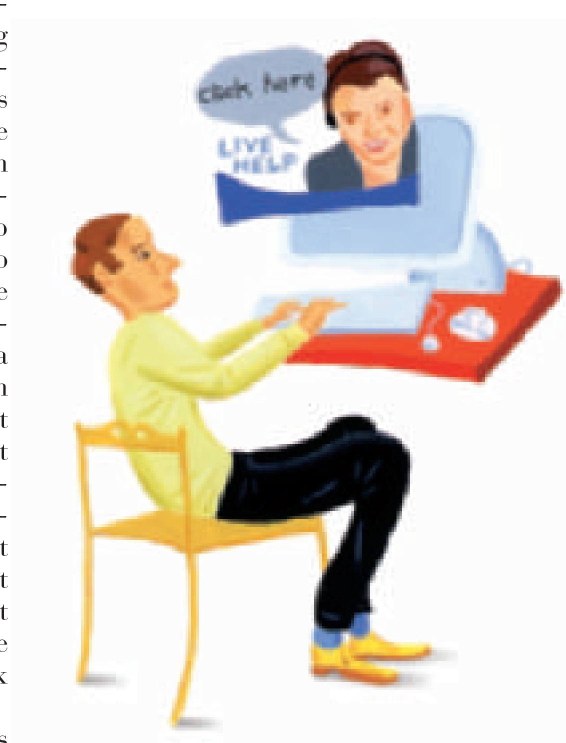
Helping Hands

Whether they are selling clothes in a mall or books on a website, retailers have to walk a fine line. They must offer help to customers who want assistance, while taking pains not to intrude on their privacy.

By **Eric A. Greenleaf**, **Vicki G. Morwitz** and **Russell S. Winer**

Retailers face a challenge in developing the appropriate approach to offering customers help. Salespeople can wait until approached by customers. Or, upon spotting a customer browsing at a bookshelf, a salesperson can approach and ask if the customer needs help. Or, the salesperson can grab a book and suggest the customer might like it. There are pitfalls to each approach. And of course, offering help does not always benefit retailers. When Safeway, the supermarket chain, encouraged employees to offer help to indecisive consumers without waiting to be asked, the program backfired. Many consumers viewed it as an invasion of their privacy, while many Safeway employees felt uneasy about observing customers.

Online retailers face a similar challenge. They have to make sure that customer help efforts increase sales and satisfy consumers rather than alienate them. Many websites feature icons that consumers can click to request help by starting an instant messaging chat with an Internet salesperson. Companies such as LivePerson and LiveOffice provide web retailers with software that allows customers to initiate help requests. This software also allows web retailers to use more aggressive help strategies, such as popping open a "May I help you?" window in the consumer's browser. But Internet help is a fairly recent innovation. Since web shopping involves consumer experiences that are very different from store shopping it is not clear that help strategies that work well in face-to-face retail encounters will work well on the web.



Marketing researchers have found that making recommendations that are consistent with consumers' prior preferences can increase consumer satisfaction. Marketers have also suggested that Internet retailers can use computerized "smart" agents to estimate consumers' preferences based on their characteristics and past behavior, and recommend products. But consumer help differs from consumer recommendations.

ILLUSTRATIONS BY JULIETTE BORDA

Recommendations often involve providing information impersonally, and do not necessarily involve personal or Internet contact. By contrast, we define consumer help as an encounter where a retailer representative explicitly provides aid to a consumer regarding a consumer need, product attribute or attribute importance, or a purchase decision. And while help-seeking and help-giving have been investigated extensively in the fields of psychology, education, child development, foreign aid policy, and organizational performance, the existing marketing literature has given relatively little attention to the question of consumer help.

Consequently, we set out to investigate which types of consumer help affect consumer satisfaction – in stores and online – how these strategies affect actual sales, and whether the best online strategies differ from the best in-store strategies. Researchers have generally distinguished three types of help: help requested by the person being helped; help offered by the helper, while allowing the recipient to accept or decline the help; and help imposed by the helper without first asking for permission.

Help Strategies

It is fairly simple to create strategies for each of the three help types, both online and offline. Consumers can request help in a store from salespeople, while Internet consumers can request help by sending an e-mail or clicking a help icon to start a help "chat." Store salespeople can offer help by asking consumers whether they would like to be helped, while online retail personnel can pop open a window in the consumer's browser and offer help. Store salespeople can impose help by giving consumers help without first asking for permission, while web retailers can impose help using an instant message window.

People have both positive and negative reactions to receiving help. And consumers' decisions on whether or not to seek help, and their reaction to help, can be viewed as the result of the relative weight given to the perceived costs and benefits. Requested help has a potential advantage over offered or imposed help since it allows the helped person to maintain autonomy and control. But past help research has shown that in face-to-face help encounters, people are more likely to have a more positive reaction when help is offered than when it is requested, because other factors outweigh the potential positive aspects of requested help. Requesting help may increase feeling of indebtedness to the help provider, and it can reduce self-esteem. People are also less likely to request help if their request is observed by other people.

These factors, which have been identified in contexts outside of the consumer realm, are also likely to increase consumers' perceived "cost" of requested help in face-to-face encounters. And so our first hypothesis holds that in stores, a help encounter that uses imposed or offered help will lead to higher consumer satisfaction than an encounter that uses requested help.

Our second hypothesis holds that customers will have more satisfaction with a retailer when they request help during Internet shopping than during shopping in a store. Computer contact omits many of the visual elements that can form an important part of interactions in face-to-face encounters and makes requested help less attractive to consumers. Other consumers cannot observe consumers who make help requests over the Internet, and people are more likely to request help if they remain anonymous to the helper. The lower level of personal contact in Internet help also increases the psychological and social distance between the consumer and the help provider. At the same time, consumers are likely to still appreciate the greater autonomy, freedom, and control that requested help gives them.

Our third hypothesis holds that imposed help will generate greater satisfaction in stores than on the web. Imposed help generally requires the greatest level of monitoring of consumers by retailers. Retailers of either kind cannot make a reasonable attempt to impose help without first observing customers. This need for monitoring may signal to consumers that they are being observed. If consumers believe that this monitoring invades their privacy, this can lower their satisfaction – particularly in online settings. While consumers have long accepted that employees in most kinds of stores, which are public spaces, may observe their actions as a prelude to offering or imposing help, people usually use the web in the privacy of their home or office. Many consumers are concerned that web monitoring invades their privacy. And so our fourth hypothesis holds that the impact of imposed help on satisfaction will depend on the extent to which the imposed help leads consumers to be concerned about their privacy.

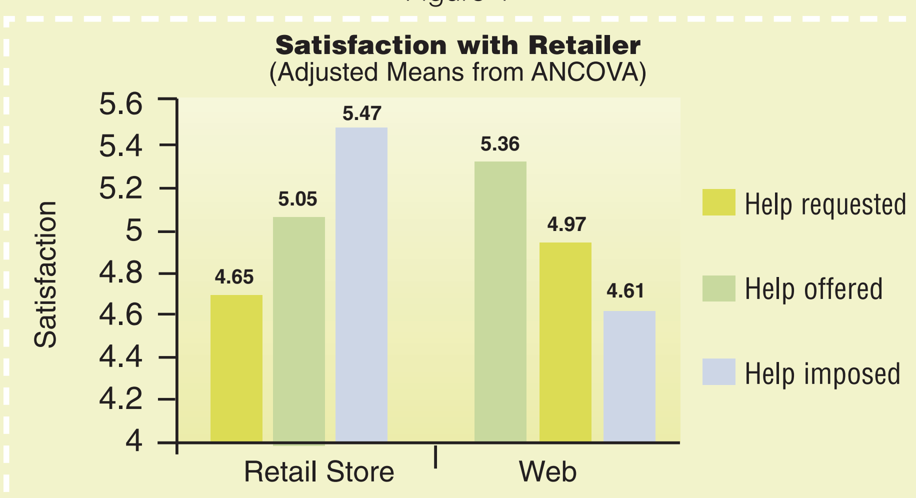
We tested these hypotheses with a study involving 135 undergraduates at a university in the northeastern U.S. Participants read one version of a help encounter with a salesperson in a bookstore or bookseller website. They were asked to "imagine that you are actually in this shopping situation" and then asked how they would react. In all scenarios, the participant was shopping for a friend's birthday present and was trying to choose between books by two of the friend's favorite authors. Participants were either told they were shopping in a store operated by Barnes & Noble, one of the largest retail booksellers, or on Barnes & Noble.com. The description of the help encounter with the salesperson involved either requested, offered, or imposed help. The scenarios for all three types of help contained the same help from the Barnes & Noble employee.

Participants were asked to report their satisfaction, on a numerical rating scale. Participants also reported how many books they had purchased for themselves or others during the past month. They were also asked whether during the shopping experience they were "worried about your privacy" and whether they "thought your privacy was being invaded."

The Results

Comparisons among participants showed that when shopping in a store, satisfaction with the retailer was higher when help was imposed than when it was requested (see **Figure 1**). The comparison between requested and imposed help is statistically significant, while the comparison between imposed and offered help is not significant, although in the correct direction.

Figure 1



"Requesting help may increase feeling of indebtedness to the help provider, and it can reduce self-esteem. People are also less likely to request help if their request is observed by other people."

Thus, our first hypothesis was partially supported. We also found that satisfaction in the requested help condition was higher for the website than the store, supporting our second hypothesis. By comparison, satisfaction with imposed help was higher for store than for web shopping, supporting our third hypothesis. It is interesting to note that the rank order of satisfaction for the three types of help in web shopping was precisely the reverse of their rank order in store shopping. For in-store, the rank was: imposed, offered, and requested. For online, the order was requested, offered, and imposed.

When we tested the hypothesis that privacy concerns affect the relationship between shopping context and satisfaction for imposed help, we found, as expected, that the average satisfaction for web shoppers was significantly lower than the average for in-store shoppers. The concern score when imposed help was received in web shopping was significantly greater than when this help was received in store shopping. These results suggest that, in general, web help generates higher privacy concerns than in-store help, and that imposed help on the web generated the highest privacy concerns of all.

Advance Notification

Why is that the case? Consumers' expectations for retail shopping may include help, but their expectations for web shopping may not. If consumers are offered help during web shopping, this creates a discrepancy with their expectations that leads to surprise. Unpleasant surprises can lower consumer satisfaction. As a result, we set out to examine whether providing web shoppers with advance notice that help may be provided would reduce privacy concerns, and in turn increase customer satisfaction. Doing so might tend to reduce feelings of unpleasant surprise and invasion of privacy at the time the consumer is helped.

However, we expect that the impact of advance notification on satisfaction will vary across the three types of help. If consumers perceive a type of help as unusual, novel, and opposite to their expectations, advance notification can be expected to have greater impact. Specifically, we hypothesized that consumers will perceive imposed help as the least normative, and most unusual type of retailer help on the web; offered help as more normative; and requested help as the most normative. Thus, we expect that advance notification will have the greatest impact on satisfaction for imposed help and the least impact for requested help.

To test these hypotheses, we designed a second study, with 132 undergraduates at a university in the northeastern U.S. who had not participated in the first study. This study used the same book-shopping scenario, but included the following advance notice condition as a variable: "The Barnes & Noble home page mentions that their sales agents might flash a message on your screen to help you with your purchase decision," while the conditions without advance notice did not contain this sentence.

An examination of comparisons between satisfaction with and without notification, for each type of help showed that, as predicted, advance notification had the greatest positive impact on satisfaction for imposed help, and a lesser, but still marginally significant, impact for offered help. But contrary to our expectations, advance notification actually decreased satisfaction in the requested help condition, although not significantly. One possible explanation: notifying consumers that they might receive help creates an expectation that they definitely will receive help. When they need help, but have to request it, this expectation is not met, resulting in lower satisfaction.

Influencing Sales

Marketers must also consider whether providing help has a direct influence on sales. In a third study we analyzed actual data from a well-known, general merchandise retailer with both store and web operations. The retailer's website includes an online help facility that lets consumers request help by initiating a live, instant messaging conversation with a retailer representative, by clicking on a live "chat" icon. This falls under our classification of requested, online help. So we hypothesized that the higher satisfaction associated with requested online help would make consumers who requested help using the online chat facility more likely to purchase from the web retailer than consumers who did not.

The data were provided by a market research firm that recorded the web usage of a large panel of consumers from August 2002 to June 2003. During this time, panelists made 60,057 site visits to the retailer's website, and purchased during 815 of these visits. We determined that panelists had requested help during 363 site visits. And we found there was a significant connection between help and sales. The proportion of consumers who purchased during a site visit if they requested help during the same visit was 38.3 percent. That was significantly higher than the proportion that purchased when not requesting help during the site visit – only 1.13 percent. We note that we can't infer causality from this test. It is possible that consumers who request help are already more likely to purchase. The mean number of the retail site's web pages viewed by panelists who requested help (46.8) was also significantly greater than the mean number viewed by those who did not request help (13.5). The results suggest that consumers use requested help to broaden, rather than narrow, the amount of information they obtain.

Our studies have shown that the effectiveness of consumer help strategies in increasing consumer satisfaction depend, in part, on the shopping context. Firms can use these results to help design their help strategies. For example, retail stores can encourage salespeople to offer or impose help rather than waiting for consumers to request it. Internet firms, by comparison, should rely more on requested help. If they do wish to use imposed or offered help, web retailers should give consumers advance notification that they may be helped, to alleviate their privacy concerns. This notification, however, should be phrased in a way that encourages consumers to still request help if they need it, so that they are not disappointed if they decide to request help.

Since consumers who request help tend to look at more web pages than those who do not, it is important that the web representatives providing help be knowledgeable about the product line and the site itself, so that consumers can obtain the information they seek to expand their web shopping.

"Comparisons among participants showed that when shopping in a store, satisfaction with the retailer was higher when help was imposed than when it was requested."

Other Factors

A number of factors not investigated in this paper might also affect consumer reactions to help or their willingness to request help, and are areas for future research on consumer help. For example, willingness to seek help can be affected by how the person in need of help perceives the physical attractiveness of the potential helper, and whether the two have the same or different genders. Males are often less willing to seek help than females, but are more willing to help. This behavior has implications not only for retailer's in-store help strategies, but also for the picture and name of the helper that consumers see in an online-help facility.

Web retailers might also develop capabilities for asking shoppers, at the beginning of a site visit, which type of help they would prefer to receive. For example, web shoppers who are allowed to choose which ad message they will view are more resistant to later information contradicting those ads, and have higher purchase intentions, compared to shoppers who were not allowed to choose among ads. Similarly, reactions to help might become more positive if consumers are allowed to choose from a menu of help types.

While most consumer help in stores and on the Internet is provided by human beings, automated help systems for Internet retailers exist that do not require human intervention, such as ActiveBuddy. Given that peoples' propensity to seek help is affected by whether they believe a computer is providing the help, there is a need to examine the potential advantages and disadvantages of such help systems, and identify contexts where automated help is most effective.

Just as companies have combined online and off-line retail strategies – so-called clicks and mortar – there are signs that retailers are taking both approaches. Liveperson has developed software that allows retailers to use decision rules or intelligent agents to decide whether and when to provide offered or imposed help to web shoppers, but then connects consumers who consent to help to a real person for further assistance. Consumers may also be less likely to feel that their privacy is invaded by offered or imposed online help if they know that the web retailer's decision to contact them is the result of a computer applying an automated rule, and not because a human being was monitoring their behavior.

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Salad Course

By **Daniel Gross**

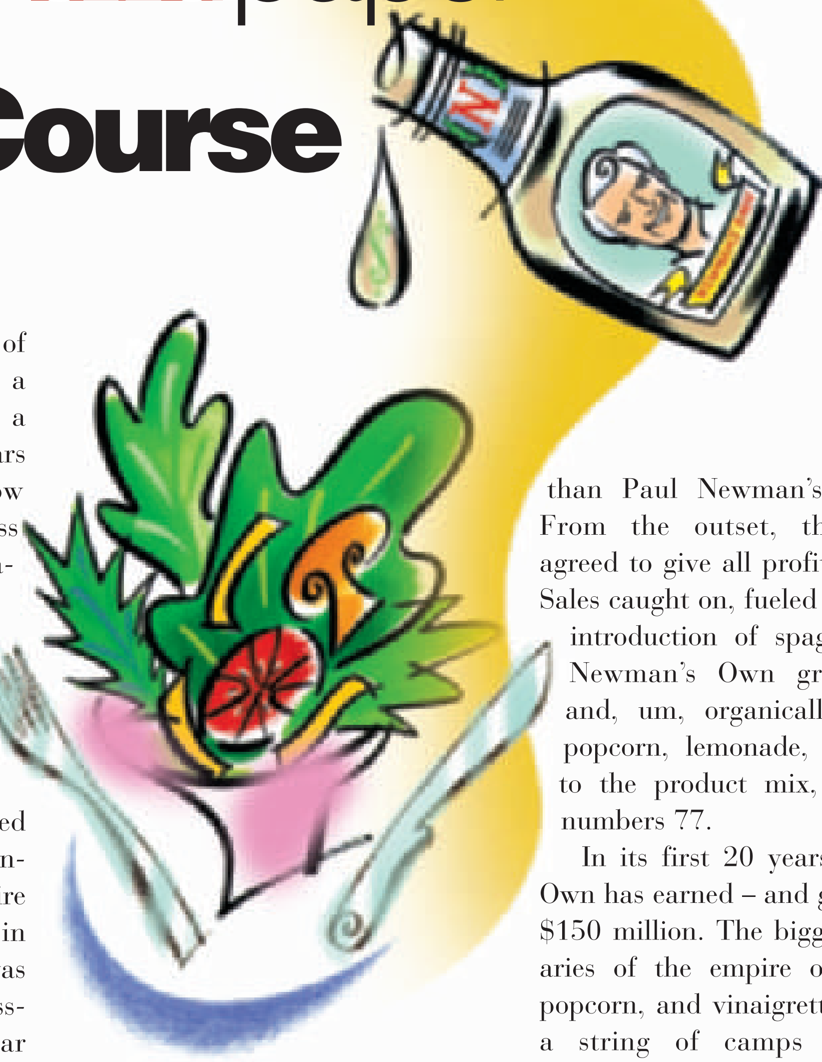

ILLUSTRATION BY STEVEN SALERNO

Can you make a ton of money and build a brand that racks up a quarter of billion dollars annually in sales if you know absolutely nothing about business and management? In their occasionally hysterical new book, *Shameless Exploitation in Pursuit of the Common Good*, Paul Newman and A. E. Hotchner, say you can – but only if you give the profits away.

The tale of how two middle-aged men whipped up the $250-million-a-year Newman's Own food empire from scratch starts in 1980, in Westport, Connecticut. Newman was somewhat obsessed with salad dressing. He took an oil-and-vinegar cocktail of his own design everywhere he went, "not just as a taste preference, but also as a defense against those insufferable artificial additives."

Newman and A.E. Hotchner, a novelist and biographer of Ernest Hemingway, wanted to market a mix they had stirred up in Newman's basement. But they knew that celebrity-related products frequently failed at the consumer box office. And so did industry professionals. "No offense, Mr. Newman," one marketing consultant said, "but just because they liked you as Butch Cassidy doesn't mean they'll like your salad dressing." His droll response: "Maybe we should call it Redford's Own."

But Newman's star status helped out. They held – and won – a tasting test at the kitchen of "a local caterer we knew named Martha Stewart." In September 1982, when the all-natural salad dressing was formally introduced at a bar in New York – with Newman and his wife, Joanne Woodward, providing the entertainment – film reviewer Gene Shalit showed up. The bushy-mustached critic raved.

Newman's Own had another selling point that proved more powerful than Paul Newman's blue eyes. From the outset, the founders agreed to give all profits to charity. Sales caught on, fueled by the rapid introduction of spaghetti sauce. Newman's Own grew steadily and, um, organically – adding popcorn, lemonade, and cookies to the product mix, which now numbers 77.

In its first 20 years, Newman's Own has earned – and given away – $150 million. The biggest beneficiaries of the empire of lemonade, popcorn, and vinaigrette have been a string of camps created by Newman's Own that serve children with cancer.

"There are three rules for running a business; fortunately, we don't know any of them," the co-authors protest. But they knew at least one. A company competing in a market dominated by giant, deep-pocketed brands – Kraft, Ragu, and Orville Reddenbacher – needs an edge. And the goal of any successful brand manager is to have the target audience develop positive associations with the brand. What better way to do so than to give away your profits to a good cause?

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