

The Big Idea





Roger L. Martin was the dean of the Rotman School of Management at the University of Toronto from 1998 to 2013. His most recent book is *Playing to Win: How Strategy Really Works* (Harvard Business Review Press, 2013), written with A.G. Lafley.

The Rise (and Likely Fall) of the Talent Economy

How to rein in the dynamic that enriches executives and financiers—at everyone else’s expense *by Roger L. Martin*

When Roberto Goizueta died of cancer in 1997, at the age of 65, he was a billionaire. Not bad for a Cuban émigré who had come to the United States as a teenager. He was by no means the first immigrant to America to become a billionaire, but the others had made their fortunes by founding and building companies or taking them public. Goizueta made his as the CEO of Coca-Cola.

His timing was impeccable. In 1980 he became the chief executive of a company that owned no natural resources and had precious little physical capital. The talent economy had just come of age, and rewards for its key productive assets made an epochal shift—in his favor. His company was among the most

valuable in the world for its iconic brand and the talent that built and maintained it. Goizueta epitomized that talent, and investors paid for it as never before.

A century ago natural resources were the most valuable assets: Standard Oil needed hydrocarbons, U.S. Steel needed iron ore and coal, the Great Atlantic & Pacific Tea Company needed real estate. As the 20th century progressed, America’s leading companies grew large and prosperous by spending increasing amounts of capital to acquire and exploit oil, mineral deposits, forests, water, and land. As recently as 50 years ago, 72% of the top 50 U.S. companies by market capitalization still owed their positions to the control and exploitation of natural resources.

To be sure, those companies needed lots of labor as they continued to grow—but mainly for

routine-intensive jobs. Those jobs were largely fungible, and individual workers had little bargaining power; until they were enabled and motivated to unionize, suppliers of labor took a distant third place in the economic pecking order, behind natural resources and providers of capital.

The status quo began to change in 1960, with an extraordinary flowering of creative work that required substantial independent judgment and decision making. As the exhibit “The Rise of the Talent Economy” shows, creative positions accounted for a mere 16% of all jobs in 1960 (having grown by only three percentage points over the previous 50 years). That proportion doubled over the next 50 years, reaching 33% by 2010.

The top 50 market cap companies in 1963 included a relatively new breed of corporation, exemplified by IBM, which held the fourth spot. Natural resources played almost no role in IBM’s success, and although capital was not trivial, anybody at the company would have argued that its intensively creative employees—its scientists and engineers, its marketers and salespeople—were at the heart of its competitive advantage and drove its success in the marketplace. The same could be said for Eastman Kodak, Procter & Gamble, and Radio Corporation of America, all businesses whose success was built on talent.

By 2013 more than half the top 50 companies were talent-based, including three of the four biggest: Apple, Microsoft, and Google. (The other was ExxonMobil.) Only 10 owed their position on the list to the ownership of resources. Over the past 50 years the U.S. economy has shifted decisively from financing the exploitation of natural resources to making the most of human talent.

From Dream Asset to Dream Deal

Through the 1970s the CEOs of large, publicly traded U.S. companies earned, on average, less than \$1 million in total compensation (in current dollars)—not even a tenth of what they earn today. In fact, from 1960 to 1980 the providers of capital got an ever-improving deal from the chief executives of those companies, who earned 33% less per dollar of net company income in 1980 than they had in 1960. In that era the

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situation was similar across the talent classes, from professional to scientific to athletic to artistic.

After 1980, however, it seemingly became essential to motivate people financially to exercise their talent. Skilled leaders saw a major boost in income for two reasons:

High earners kept more money. After the Great Depression, tax policy shifted to a focus on sharing the economic pie. It was thought that a high concentration of wealth had contributed mightily to the Depression and that the rich should pay a fair share to finance the creation of secure jobs and the consumption of goods that accompanied them. Consequently, the top tax rate on high earners—a modest 25% in 1931—rose steadily to 91% by 1963, at which point someone who earned \$1 million kept only \$270,000 after federal taxes, and someone who earned \$10 million kept a mere \$1.5 million.

This started to change in the mid-1970s, when a group of economists that included Arthur Laffer and the future Nobel laureates Robert Mundell and Herbert Simon argued that above a certain tax rate on the last dollar of their earnings, the amount of work individuals supplied to the marketplace would begin to fall, and the higher the rate, the more precipitous the drop. In fact, according to Laffer’s famous curve, the strength of this effect would at some point yield fewer dollars to the U.S. Treasury.

This supply-side thinking justified a major shift in tax policy. The top marginal rate plummeted from 70% in 1981, to 50% in 1982, to 38.5% in 1987, to 28% in 1988. Thus, in a mere seven years, \$1 million earners saw the amount they kept after federal taxes increase from \$340,000 to \$725,000, while the \$3.0 million that \$10 million earners had been keeping grew to \$7.2 million.

They were paid in stock and profits. In 1976 Michael Jensen and William Meckling published the now legendary “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” in the *Journal of Financial Economics*. The article, which brought agency theory to the world, argued that corporations needed to align the interests of management and shareholders—talent and capital—to keep agency costs from causing damage to shareholders and the economy in general.

For corporate executives, the alignment mechanism of choice was stock-based compensation. It has done wonders for CEO pay, which doubled in the 1980s, quadrupled in the 1990s, and has continued to grow in the 21st century



Idea in Brief

THE PROBLEM

Talent is now the prime asset in the global economy, and in the United States it commands a hugely inflated share of the rewards for economic growth. The resulting inequality of income between top talent and routine workers is unsustainable—and the volatility that talent creates is more ominous still.

WHY IT HAPPENS

The reward structure of hedge funds and leveraged buyouts foments price volatility in asset trading, while stock-based compensation encourages corporate executives to further the interests of traders rather than those of long-term investors.

THE SOLUTION

Governmental regulation, tax reform, and the voluntary cooperation of top executives, private equity managers, and pension funds should combine to create a better mix of rewards for capital, labor, and talent.

despite increasing criticism and the devastation caused by the global financial crisis. Another, less well-known mechanism that has boosted income for the possessors of talent is the notorious “2&20 formula.” Its roots lie in a 2,000-year-old practice whereby Phoenician ship captains would take 20% of the value of a cargo successfully delivered. In 1949, when a fee of 1% to 2% of assets under management was typical in the investment management field, Alfred Winslow Jones, the first acknowledged hedge fund manager, adopted the Phoenician formula. He set himself up as the general partner of what would come to be referred to as a private equity firm and charged the limited partners who invested in his fund a 20% cut of the profits that he generated (“carried interest,” in industry parlance) on top of a 2% asset management fee.

When the venture capital industry, which had also started in the immediate postwar period, shifted to the private equity firm model at the end of the 1950s, it adopted this lucrative 2&20 fee structure, as did the leveraged buyout industry, which took shape in the mid-1970s. But the biggest beneficiary was the hedge fund industry, which grew to immense size and applied the 2&20 formula to ever larger and more lucrative pools of limited partner capital.

It’s no surprise that talent got much richer after it was recognized as the linchpin asset in the modern economy. It’s also unsurprising that ordinary employees have long accepted this rebalancing of income—after all, it fits the American Dream, in which hard work and the cultivation of talent deserve rewards. People don’t mind your being rich if you made the money yourself; what they don’t like is your inheriting wealth. And the evidence is clear that the vast majority of *Forbes* billionaires are self-made. But the assumptions underlying that complacency are starting to change. People increasingly ask whether talent is overcompensated—and whether

it’s quite the unalloyed good it has historically been made out to be.

The Downside of the Deal

Our basic grievance with today’s billionaires is that relatively little of the value they’ve created trickles down to the rest of us. Real wages for the 62% of the U.S. workforce classified as production and nonsupervisory workers have declined since the mid-1970s. The billionaires haven’t shared generously with investors either. Across the economy, the return on invested capital, which had been stable for the prior 10 years at about 5%, peaked in 1979 and has been on a steady decline ever since. It is currently below 2% and still dropping, as the minders of that capital, whether corporate executives or investment managers, extract ever more for their services.

As a consequence, since the mid-1980s inequality has rapidly increased, with the top 1% of the income distribution taking in as much as 80% (estimates vary) of the growth in GDP over the past 30 years. Serious as this is, rising inequality is not the most ominous aspect of the situation. Our current system of rewarding talent not only doesn’t lead to greater overall value for society but actually makes the economy more volatile, with all but a fortunate few moving sideways or backward.

Evidence can be seen in the changing composition of the *Forbes* 400. Over the past 13 years the list’s number of hedge fund managers, by far the fastest-growing category, has skyrocketed from four to 31, second only to computer hardware and software entrepreneurs (39) in possessing the greatest fortunes in America. If the LBO fund managers on the list are included, it becomes clear that far and away the best method of getting rich in America now is to manage other people’s money and charge them 2&20. As Steven Kaplan, of the University of Chicago, and Joshua Rauh, of Stanford, pointed out

in a recent paper, the top 25 hedge fund managers in 2010 raked in four times the earnings of all the CEOs of the *Fortune* 500 combined.

What are those 25 people doing?

Essentially, the business of a hedge fund is to trade. James Simons, the founder of Renaissance Technologies, ranks fourth on *Institutional Investor's* Alpha list of top hedge fund earners for 2013, with \$2.2 billion in compensation. He consistently earns at that level by using sophisticated algorithms and servers hardwired to the NYSE servers to take advantage of tiny arbitrage opportunities faster than anybody else. For Renaissance, five minutes is a long holding period for a share.

Modern market structures enable hedge funds to trade like this by borrowing stock in large amounts, which means they can take short positions as well as long ones. In fact, hedge fund managers don't care whether companies in their portfolios do well or badly—they just want stock prices to be volatile. What's more, they want volatility to be extreme: The more prices move, up or down, the greater the earning potential on their carried interest. They aren't like their investment management predecessors, long-term investors who wanted companies to succeed.

But trading doesn't directly create value for anyone other than the hedge funds. One trader's gain is simply another trader's loss. It's nothing like building a company that gives the world a better product and generates employment. Of course, hedge fund aficionados argue that the funds help corporations offload interest-rate or exchange-rate risk, thus adding economic value to the world. It's a nice rationalization, but a tiny fraction of the multitrillion-dollar industry could take care of the relatively modest task of hedging corporate financial asset risk. Besides, market volatility has increased dramatically as the hedge fund industry has grown, undermining any argument about the net risk-management benefit of hedge funds.

The shift from building value to trading value is worrisome, but the real problem for the economy is that hedge fund talent and executive talent both

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have an incentive to promote volatility, which works against the interests of capital and labor. Executive talent, as we saw earlier, is now rewarded primarily with stock-based compensation, which was supposed to align managers with the long-term interests of owners. But a stock price is nothing more than the shared expectations of investors as to a company's future prospects. If expectations for performance rise, the stock price rises, and vice versa. Thus stock-based compensation motivates executives to focus on managing the expectations of market participants, not on enhancing the real performance of the company.

What's more, because stock-based compensation is generally conferred annually at the prevailing stock price, managers have an interest in volatile expectations for their company. If expectations fall during the course of a given year, the options or deferred stock granted a year later will be priced low. To reap a big reward, all managers have to do is help expectations recover to the prior level.

That's why the global financial crisis was not all bad for CEOs. Consider John Chambers, the CEO of Cisco Systems since 1995. Like Roberto Goizueta, Chambers became a billionaire by running a publicly traded company. But during his tenure Cisco shareholders have suffered through two bubbles and busts. The share price peaked at \$80.06 in March 2000 and plummeted to \$8.60 in October 2002. It worked its way into the \$25–\$33 range for most of 2007 and reached \$34.08 in November of that year. In the wake of the subsequent financial crisis it collapsed to \$13.62 in March 2009, climbed to \$27.57 in April 2010, fell to \$13.73 in August 2011, and had recovered to \$24.85 by the end of June 2014.

It was a pretty wild ride for the shareholders of record as of November 2007. Those who hung in through the end of June 2014 experienced a decline of 27% in their stock price and two 60% drops along the way. But it wasn't so bad for Chambers. Those two big dips were handy for picking up attractively priced stock-based compensation—options in November 2009 at \$23.40, and restricted stock units in September of 2010 through 2013 at \$21.93, \$16.29, \$19.08, and \$24.35. His \$53 million in stock-based compensation from these five grants appreciated by about 18% through June 2014. If, instead of exposing shareholders to massive volatility, Chambers had overseen a steady decline from \$34.08 to \$24.85 during that period, his stock-based compensation would have lost about 20% of its value rather than gaining 18%.



The Rise of the Talent Economy

The effect of modern stock-based compensation is to drive volatility, not appreciation. Of course, the providers of capital are constantly pressing executives to deliver better returns. What the executives do in response is fairly simple: They cut back on labor, the variable they can most easily squeeze in order to signal that they are addressing performance. Such creative destruction can be a good thing for the company and the economy—but it can also compromise the company's long-term capabilities. And managers' incentives to create large changes in the market's expectations suggest that cuts in labor are more likely to be overdone than underdone.

Increasingly, therefore, jobs disappear and usually don't return. Consequently, labor's earnings have been suppressed and real wages have stopped growing. This has exacerbated income inequality in America, especially between the very rich and everyone else: The differential between 50th percentile incomes and 90th (or 99th, or 99.9th) percentile incomes has widened dramatically since 1980 and shows no signs of stabilizing, let alone narrowing. Meanwhile, the differential between 10th percentile and 50th percentile incomes has changed very little.

The income gap between creativity-intensive talent and routine-intensive labor is bad for social cohesion. The move from building value to trading value is bad for economic growth and performance. The increased stock market volatility is bad for retirement accounts and pension funds. So although it's great that the proportion of creativity-intensive jobs is now nearly three times what it was a century ago, and terrific that the economy is so richly endowed with talent, that talent is being channeled into unproductive activities and egregious behaviors.

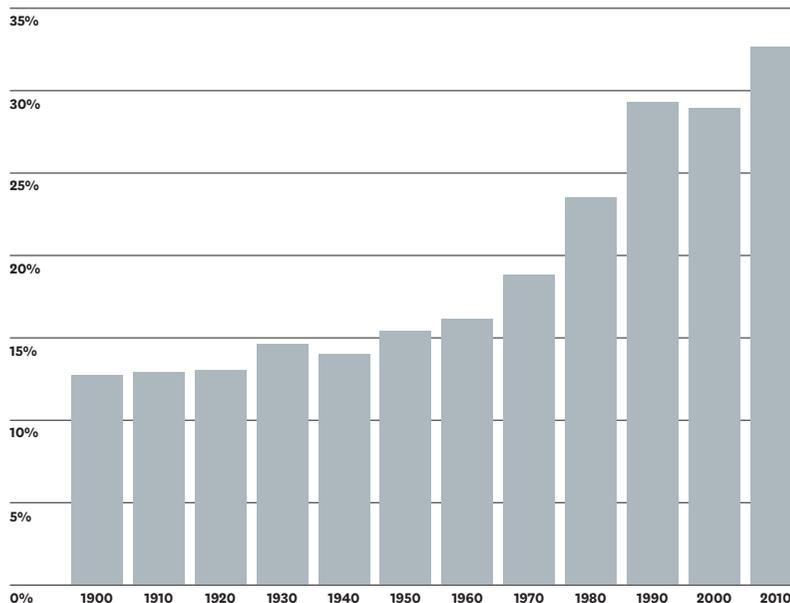
Saving the Talent Economy

In a democratic capitalist country, it is not sustainable to leave the members of the largest voting bloc out of the economic equation. Think back to 1935, when the United States was still in the throes of the Great Depression. Real incomes were falling, and unemployment hovered around 25%. Employers had put pressure on wages both before the Depression and during it. Labor had no power whatsoever, and efforts to unionize were met with aggressive, even violent, countermeasures.

The Roosevelt administration passed sweeping pro-labor legislation—the National Labor Relations Act—that both facilitated unionization and instituted protections for the rights of unionized workers.

My colleague Richard Florida at the Martin Prosperity Institute studies the composition of the U.S. workforce by using Department of Labor job classifications and descriptions of job content. These data make it possible to determine the proportion of jobs that are routine-intensive versus creativity-intensive. The fundamental difference is that the latter require independent judgment and decision making. Of course, the actual content of every job in America varies: Some executive assistants file and type, for example, while others are the shadow decision makers for their bosses. But a consistent measure reveals broad patterns over time.

As the chart below shows, from 1900 to 1960 the proportion of creativity-intensive jobs in the U.S. economy was stably low, starting at 13% and growing only to 16%. Today 33% of all jobs are creativity-intensive, a proportion that will continue to increase for the foreseeable future.



It also established the National Labor Relations Board to ensure that corporations adhered strictly to the letter of the act. From 1935 to their historical peak, in 1954, unionization rates rose from 8.5% to 28.3% of U.S. workers, an unimaginably high level by today's standards, and real wages for unionized employees rose faster than both nonunion wages and general economic growth.

Of course, the wages, benefits, and work-rule inflexibility for which labor successfully bargained priced it out of the market after 1960, especially as postwar Europe and Japan recovered. Also, corporations responded to labor's demands by increasing mechanization, moving to "right to work" southern states, and beginning to source internationally. By 2000 unionization was back down close to 1935 levels. But all this rebalancing took time and arguably had a negative impact on overall growth.

It seems clear that the economy is heading toward another 1935 moment. It is hard to see the Occupy Wall Street and We Are the 99 Percent

demonstrations as anything other than a shot across the bow. Zuccotti Park may have been cleared, but the sentiment hasn't gone away. Unless the key players work together to correct what's causing the current imbalance, the 99% will vote in a rebalancing that is radically in their favor, as they did before. Frankly, it's surprising that they haven't done so already. To avert that, three things have to happen:

Talent must show self-restraint. The new generation of talent does itself few favors in terms of public image. A prime example is Steven A. Cohen—the principal formerly of SAC Capital Advisors (which pled guilty to insider trading and paid a \$1.8 billion fine) and now of Point72 Asset Management—who was number two on *Institutional Investor's* 2013 hedge fund list, with reported personal earnings of \$2.4 billion. Not satisfied with the largesse of 2&20, Cohen charged 3% of assets and as much as 50% in carried interest, according to the *New York Times*. Perceived greed of this magnitude will encourage retribution. If top financiers and executives want to avoid that, they need to scale back their financial demands.

One egregious demand the hedge fund and LBO community might reconsider is its insistence on the continued treatment of carried interest as capital gains. Obviously, both asset management fees and carried interest are compensation for professional services rendered. However, the former are taxed as regular income (at a top marginal rate of 39.6%), and the latter is taxed at the preferential capital gains rate (15% from 2003 through 2012; 20% since). In 2008 that preferential rate allowed John Paulson—who famously benefited from the pain and suffering of homeowners as he aggressively shorted the mortgage market—to realize a personal tax saving of as much as \$500 million on his \$2 billion reported earnings.

From both a tax theory and a public interest standpoint, the favorable capital gains treatment is unjustifiable for hedge funds, because they simply trade existing stocks, creating no net benefit for society. Furthermore, many hedge fund managers are so fiscally aggressive that they negotiate the option

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of “fee conversion” with their limited partners. That is, they may periodically convert their asset fees to carried interest and thus reduce their taxes. By doing so, they clearly demonstrate that fees and carried interest are interchangeable in their minds—but they continue to insist that the tax authorities treat the two differently.

Investors must prioritize value creation. Those with by far the greatest opportunity to contribute positively are pension and sovereign wealth funds. As Peter Drucker correctly predicted in 1976, pension funds (and sovereign wealth funds) have become the largest owners of capital in the world. The top 50 pension and sovereign wealth funds combined invest \$11.5 trillion. They currently engage in three practices that facilitate abuse by talent:

- *They supply large amounts of capital for hedge funds.* Because pension funds have ongoing obligations, they are hurt by dips in asset price levels. The often-illusory promise of high returns has caused them to channel substantial quantities of capital to hedge funds. The problem, as we've seen, is that hedge funds achieve their returns by encouraging volatility; they can and do profit whether company stocks go up or down. But pensioners want and need steady appreciation.
- *They lend stock.* Pension and sovereign wealth funds are the world's leading lenders of stock, and short-selling hedge funds are its leading borrowers. Every pension fund makes a small contribution to its annual returns through the fees it earns from lending stock, and the amount each one lends has an imperceptible impact on the market. Their lending facilitates approximately \$2 trillion worth of short selling on a perpetual basis. The continual placing and unwinding of these short positions generates volatility that is great for hedge fund financial engineers but bad for the pensioners whose funds they use.
- *They support stock-based compensation.* The funds usually vote in favor of stock-based compensation for executives of the publicly traded companies



in which they invest, believing that it benefits the pensioners and citizens they serve. But if anything, broad returns on public equities have gone down while volatility has increased as stock-based compensation has increased. Thus these funds—the longest-term investors in the world—are voting against their own interests.

Even though the imbalance in favor of talent is greatest in the United States, all democratic capitalism is heading in the same direction, so a U.S. effort alone would be ineffective in correcting it. Although the notion of global collaboration might seem unrealistic, just 35 funds from 15 countries could put \$10 trillion in assets behind this goal. And if those leading funds stopped funneling capital to hedge funds, lending stock, and supporting stock-based compensation, it would be hard for smaller funds to justify not following suit.

The government should intervene early.

Governmental regulation to rein in the excessive appropriation of value by the top 1% is preferable to a radically anti-talent agenda that could seriously compromise America's entrepreneurial capabilities. The U.S. government's late and aggressive intervention in 1935 arguably ended up hurting labor, the constituency it aimed to rescue, more than helping it. Four actions might avert a repeat of that phenomenon:

- *Regulate the relationship between hedge funds and pension funds.* Individuals who own shares should be perfectly free to lend them to whomever they wish. However, stock lending by fiduciary institutions should be banned if pension funds don't voluntarily cease the practice. And if they don't reduce their investment in hedge funds, governments could ameliorate the effects of hedge fund behavior by banning the collection of both an asset management fee *and* carried interest. For even a small hedge fund of \$1 billion, the asset management fee over the five-year life of the fund is \$100 million—enough to make the fund's principals rich. With that certainty, they can take huge risks on their investments in order to win the proverbial lottery on their carried interest. Permitting only an asset management fee would discourage volatility-producing behavior, and permitting only a carried interest fee would discourage excessive risk taking. Allowing the use of one or the other while banning the use of the two in combination would be dramatically better for society than the current structure.
- *Tax carried interest as ordinary income.* This would promote tax fairness—hedge fund billionaires

would no longer pay lower average income tax rates than ordinary laborers—and would reap additional billions for the Treasury.

- *Tax trades.* Government should impose on trades something like the proposed Tobin tax on international financial transactions. Anything that discourages high-frequency trading strategies is an unalloyed good.
- *Revisit the overall tax structure.* Since 1982 the U.S. taxation strategy has been unique in the developed world, and not in a good way: It features a very low personal income tax, a very high corporate income tax, and no national value-added tax (the most economically effective form of taxation in the world). Just when capital required help in battling talent, which had started earning outside returns, the tax system flipped to side entirely with talent. Capital needs an incentive to invest in creating more jobs, and the incentive for U.S. companies is low by global standards. It is no surprise that, rather than investing, they have been accumulating record levels of cash on their balance sheets, lots of it offshore. Furthermore, no evidence suggests that this tax regime has benefited the U.S. economy, though it has clearly contributed to the dramatic rise in income inequality.

Unfortunately, political gridlock in the United States makes it unlikely that government can implement such reforms. The Republican Party seems foursquare behind hedge funds, which it sees as embodying capital—even though hedge fund managers are in fact talent, a breakaway branch of labor (their overcharged customers are the real representatives of capital). The Democratic Party, traditionally supportive of organized labor, has increasingly transferred its allegiance to capital, largely because pension funds have become the most important form of capital and their beneficiaries represent the traditional Democratic power base. Neither party represents labor directly.

ROBERTO GOIZUETA lived to see and benefited from talent's rise to become the key asset in the modern economy. But he died before the positive aspects of this phenomenon began to give way to its dark side. The trend cannot proceed unabated in the United States without provoking a political reaction. Top executives, private equity managers, and pension funds can avoid such a reaction by showing the leadership of which they are fully capable and modifying their behavior to create a better mix of rewards for capital, labor, and talent. ♥ **HBR Reprint R1410B**

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