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The Fall of the Talent Economy?

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Roger Martin, former dean of the Rotman School of Management, on why talent's powerful economic position is unsustainable. For more, read "The Rise (and Likely Fall) of the Talent Economy" in the October 2014 issue of *HBR*.

SARAH GREEN: Welcome to the HBR IdeaCast from Harvard Business Review. I'm Sarah Green. I'm talking today with Roger Martin who was Dean of the Rotman School of Management at the University of Toronto from 1998 to 2013. His most recent HBR article, which we're talking about today, is "The Rise and Likely Fall of the Talent Economy." Roger, thanks so much for talking with us.

ROGER MARTIN: It's always great to talk to you, Sarah.

SARAH GREEN: Well, thank you. It's great to have you back on the show. I thought we could just start by defining our terms here. When you're talking about the talent economy as opposed to capital or labor, how are you defining these kinds of terms?

ROGER MARTIN: Sure. What I mean by the talent economy is an economy in which highly specialized talent is the key asset of production for corporations, the linchpin asset, as opposed to a big, large labor force of well-organized but generally fungible labor where you could substitute one for another. If somebody falls ill, you could easily substitute somebody else in. Versus highly specialized labor where- oh, dear, if that programmer gets hit by a bus, it'll be hard to replace them or, if that research scientist leaves to do something else, it will be hard to replace them.

What I think is that, during the '60s and '70s, the economy started to change from one in which the most important things to have were control of raw materials like oil, like land, like timber, or to have all sorts of capital available to buy those resources to build factories, to a world in which having highly skilled, highly talented people was the single most important feature of your company.

SARAH GREEN: And now, when you talk about the likely fall of this kind of economy, what are you seeing now that makes you think we might be shifting to a different kind of economy?

ROGER MARTIN: If you look at the composition of large companies in the early '60s, Sears or the great A&P, in that world, capital in some sense acted as a governor on how much talent could extract out of the economic equation. So there was somewhat of a balance where talent got paid perfectly well to have a perfectly nice life, although the average total compensation, in 2013 dollars of a CEO of a large American company in the 1970s, was still under million dollars, which is unthinkable today. It's more than 10 times that now.

But you had this governor on talent and a bit of a equilibrium between what talent, what labor, what raw materials owners, and what capital providers got out of the economic equation. And in that period, the US economy grew well in the postwar period where there was that balance. And what I see now happening is we're going to a world in which it's unbalanced, where talent is so much in the catbird seat that it is just saying to the other factors of production, hey, we're it.

We're so important that you need us and we don't actually need you. And for that privilege, we're going to take the vast majority of the spoils of our joint activity. And so where I see the potential fall coming from is talent is extracting too much. And they're extracting so much that the other factors of production are, I think, increasingly going to say, I don't like this.

And this is what's behind, in my view, the greater income inequality. Income inequality is getting worse and worse because talent is asking for more and more of the spoils. And there's going to be a reaction to that because talent is so tiny, right? It's a tiny percentage, and in a democratic, capitalist system, if you have 1% or 5% of the population saying, we want to extract the dominant amount of the value out of this economy, there's 99% who will say, well, that's not exactly how we want to vote to have the economy work.

That kind of moment, I think, we're going to be approaching soon if the balance of talent taking too much of the pie continues to increase.

SARAH GREEN: I do want to get into some of the political ramifications more deeply, but I also, just before we move on, have a clarifying questions. When you're talking about the talent, in this case, being a very small percentage and extracting a high rate of return, it sounds like you're not talking about creative talent in the terms of like a choreographer or an advertising executive or even a CEO. It sounds like you're actually really talking about a specific kind of financial manager. Is that a fair assumption to make?

ROGER MARTIN: No, no, no. It's a good question, Sarah. No. I would say that choreographer is in the realm of the talent world. There's, of course, all sorts of talent and all kinds of levels of talent.

I think what's most conspicuous these days is the earnings power of financial management talent, hedge fund managers being the most obvious example. And they're the group that, if you look in the Forbes 400 list of the 400 richest Americans, the biggest growth category by

far is hedge fund managers, one category. They've gone from a tiny participation in that list in 2000 to being second highest to high tech, high tech entrepreneurs like Zuckerberg or Gates or Ellison.

So they're the most conspicuous version, but in many of these fields- so in choreography, there isn't as much money in general. There isn't as much capital to extract value from. You see, that's talent's game. What talent's game is in the modern world is attach yourself to pools of capital, use those pools of capital, and try and make sure capital gets the least possible and you get the most possible.

A great story of this was after the success of Star Wars, which came out in '77, massive success of epic proportions, George Lucas went to Paramount Pictures, which was then run, interestingly, by Barry Diller and Michael Eisner, and said, I've got another project. And it's called "Raiders of the Lost Ark," and here's the deal that I want. I would like to have 50% of the pre-studio overhead, pre-marketing and distribution gross profit.

And Eisner and Diller at first sort of said, well, OK. That's interesting. This guy wants to co-invest because studios often co-invest. They assumed he wanted some kind of a better co-investment because he was bringing the project and he was the creative person on the project. So they said, well, and what are you going to pay for your 50%? And you know what Lucas's answer was?

SARAH GREEN: I have a guess.

ROGER MARTIN: What do you think?

SARAH GREEN: Nothing?

ROGER MARTIN: Exactly. He said, zero. And actually, according to the story, which may be apocryphal, Diller and Eisner just booted him out and said, well, that's ridiculous. We have to put up all the capital and you get half of the return- not even half of the real profit, half of the

profit before overhead, which are costs that we actually have to bear and are huge costs.

And they booted him out. Then they went back and did the calculations and said, hmm, 50% of something is better than 100% of nothing and gave him the deal. This is indicative of the increasing attitude of talent, which is, we don't care. We don't care if you make money or not. I want to extract the maximum I can possibly extract.

So the most lucrative places for talent to inhabit are those places where there's large pools of capital required that create a revenue stream that you can extract the most possible from. And so the power of talent varies and the remuneration of talent varies to the degree to which they can convince capital to invest behind them. And many choreographers can't convince much talent to invest, and so the ability to extract massive amounts of value isn't as great as if you're running a hedge fund.

If you're running Bridgewater, it's got $50 billion worth of capital from which you extract 2% of assets under management every year. And that's $1 billion a year for five years plus 20% of the upside. For that, you need half a dozen partners, an office in Stamford, maybe a couple hundred employees. $1 billion dollars goes a long way to fund that even if you don't get 20% of the upside.

SARAH GREEN: I'm glad you mentioned that because one of the data points the really surprised me in the article was actually how much the return on investment capital has fallen because I've read a lot of statistics on income inequality before and wages being stagnant for the majority of the workforce. But it was sort of a surprise to me that something like- as the fees for different financial services have risen, the return on invested capital has actually been declining since 1979 and is- I think you had it's now at 2% and it's still dropping.

That sort of caught me by surprise.

ROGER MARTIN: It's a stunner, isn't it?

SARAH GREEN: Yeah, it is a stunner.

ROGER MARTIN: And the reason it's a stunner for you, Sarah, and for me when I first started studying this is because we're used to an era when capital was in the catbird seat, when you had to have capital and you had to have control of capital to do anything. Right? But now two kids in a garage with no capital, whether they be guy's named Hewlett and Packard or guy's named Jobs and Wozniak, they had no capital compared to who they ended up decimating.

They had talent. So I think you and I both think of an era when capital could say to people like that, screw you. If you want your idea to go anywhere, you need us. And you need us to give you the capital, and we will therefore be in charge. We will control things, and we will determine how much you get to make.

That was an era, but that era, in my view, is largely gone because the world is awash in capital. You can talk to any substantial company except probably natural resources companies and say, what's the asset that you don't have enough of, that you always need more of? And they will say, in one form or another, talent.

SARAH GREEN: But, In some ways, isn't it a good thing that people are now at the center of business?

ROGER MARTIN: Absolutely. In the chart in the article about- there are more jobs that require independent judgment and decision making now. Which I think is a healthier world, and I look forward to getting even healthier. But it brings with it this problem, which is there is no governor on talent now. The economy is unbalanced in favor of talent, and that's creating a challenge for democratic capitalism.

Because in democratic capitalism, the 51st percentile voter, in some sense, decides who runs the country on what platform. And if 1% or as economists now look a little closer, it's not the- the 1% is not the problem. It's the one tenth of 1%. If the one tenth of 1% are getting a

disproportionate amount of the spoils of economic growth and progress, that creates a problem.

Why should the 51st percentile person say, I'm going to continue to support this? I think their rationale for continuing to do that is weakening. It was always there because the 51st percentile person, up until 1989 for most of the 213 previous years since 1776, their life was getting better each and every year. But since 1989, between 1989 and 2013, median income in America did not rise at all.

SARAH GREEN: So what would be your sort of ideal solution, keeping in mind that, obviously, what we can actually achieve and what we can ideally achieve are different things?

ROGER MARTIN: I think that we need to see investors deal with talent in a more intelligent way. And right now, they are not to the extent they could and should. And I'm placing a lot of my hope and faith, for what it's worth, on pension funds. Sovereign wealth funds have become the biggest holders of capital in the world.

And I'd like to see them exercise a much more intelligent approach to managing power of talent. Right now, they do the opposite. Pension funds are the biggest source of investment capital for hedge funds. Hedge funds are simply the most clear manifestation of greedy talent in the world and are causing volatility rather than working against growth.

SARAH GREEN: To that point, you had another stunning example in the article of a stat that showed, in 2010, the top 25 hedge fund managers made four times as much money and earnings as all the CEOs in the Fortune 500 combined. I mean, I was blown away by that.

ROGER MARTIN: Yeah. And, if anything, those are four year old numbers. If anything, it's gotten even worse. And so, essentially, the pension funds are giving money to these folks who make all of their money on volatility. What a hedge fund manager doesn't want is stability.

2008 was awesome for hedge funds. So pension funds have got to wake up and say, we shouldn't actually be supplying people who are working at cross purposes with our pensioners, or our citizens in the case of sovereign wealth funds, who just want long term appreciation of the value of their pension fund or their sovereign wealth fund. And we're feeding people who get in the way of that.

So I think the pension funds need to wake up to their power and say, we have to act in a way that's more consistent with the interests of our constituents. And I think, if they don't, I think government has to. Government has all sorts of rules already, fiduciary rules, regarding what pension funds and other fiduciary institutions can or cannot do. But I would argue that, if you look at the compensation structure of hedge funds, it works exactly in the opposite of the interests of pensioners.

And it's because they get 2% of assets under management, which generally, for any medium to large size hedge fund, is enough to make partners rich, plus 20% of the upside. What that is is the formula for getting them to take huge risks because they're going to be fine. If they lose half the money, they'll still get their 2% of assets under management and make a fortune.

And so it causes them to swing for the fences. So I would argue that the government should enhance the fiduciary laws that are currently in existence to say, if you're a pension fund or managing money on behalf of somebody else, you could pay either a asset fee, which was the case until 1978, virtually nobody charged anything but an asset fee for managing money before then- so it's returning to that world where things worked just fine that way. Or you can charge profit share.

You can't do both because that creates a bad incentive. One other thing that I say in the article is I believe that talent has to ask themselves, is this in our interests to keep figuring out if I push even harder, how much more could I extract? Which is too dominantly what they're now asking. What I would argue is, until the mid '70s, talent tended to ask the question, what's enough?

What's enough to have a comfortable life, a nice house, a college education for my kids, a retirement fund, maybe a vacation property? And that's enough. And somewhere in the '70s, talent woke up and started asking a different question. The question was, how much could I actually get if I pushed as hard as possible to get as much as possible? CEOs started saying is $1 million a year enough? Well, maybe enough, but we could get $10 million if we pushed harder.

And I just think, just like capital got exactly what it deserved in the National Labor Relations Act- they absolutely got what they deserved for beating up people who tried to unionize, laying people off, having no grievance procedures, not caring whether the wages they were paying allowed their workers to feed their family and have more than a subsistence existence. They didn't care about any of that stuff, and they got hammered for it.

If talent continues to act the way talent does, it'll pay for it.

SARAH GREEN: Roger, thanks again for talking with us today.

ROGER MARTIN: It was a pleasure, Sarah, as it always is.

SARAH GREEN: That was Roger Martin. You can find his article, "The Rise and Likely Fall of the Talent Economy" on HBR.org.