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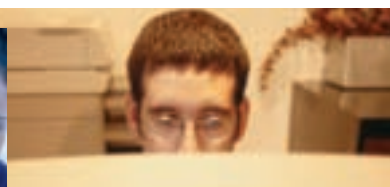
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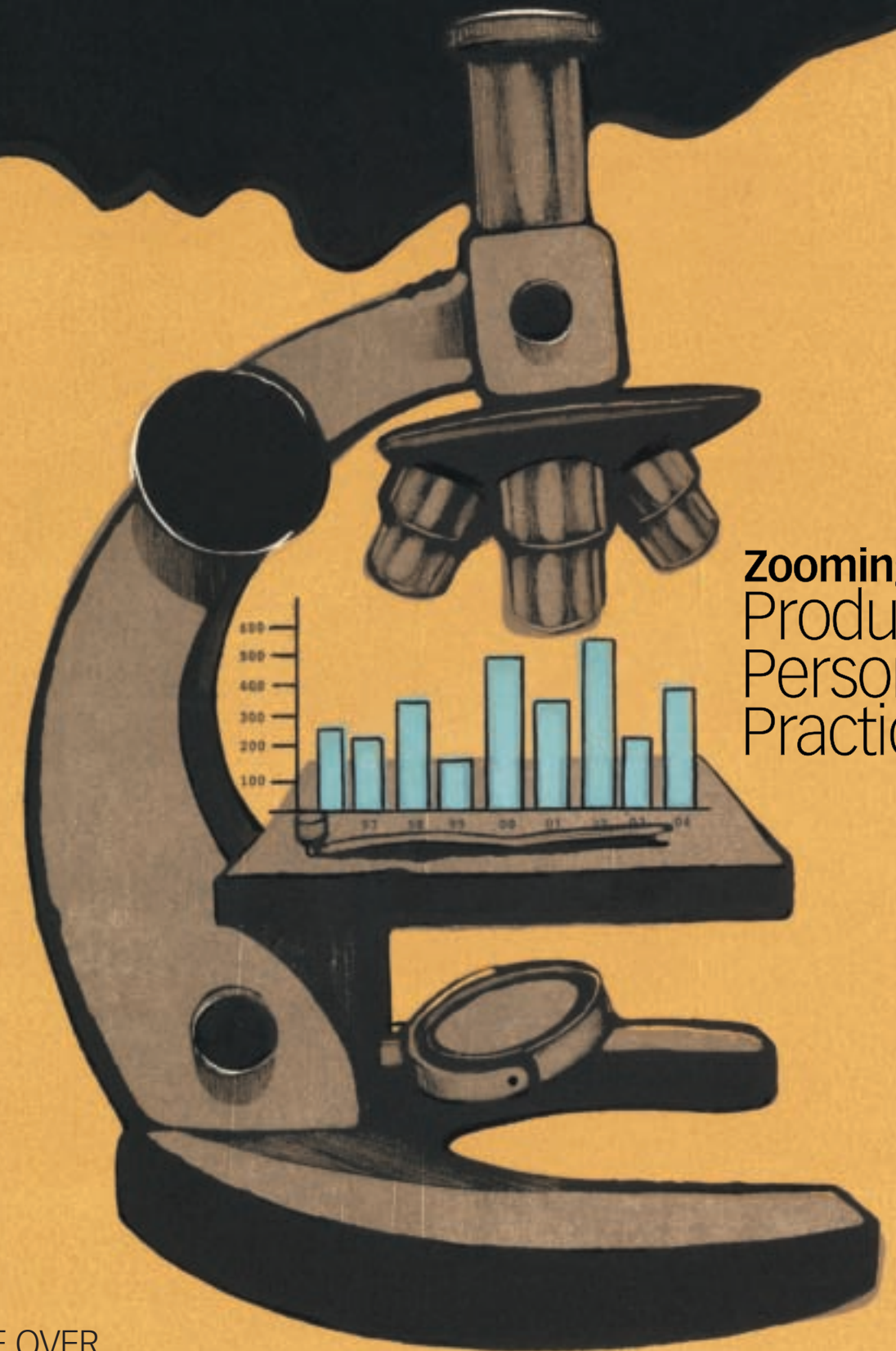
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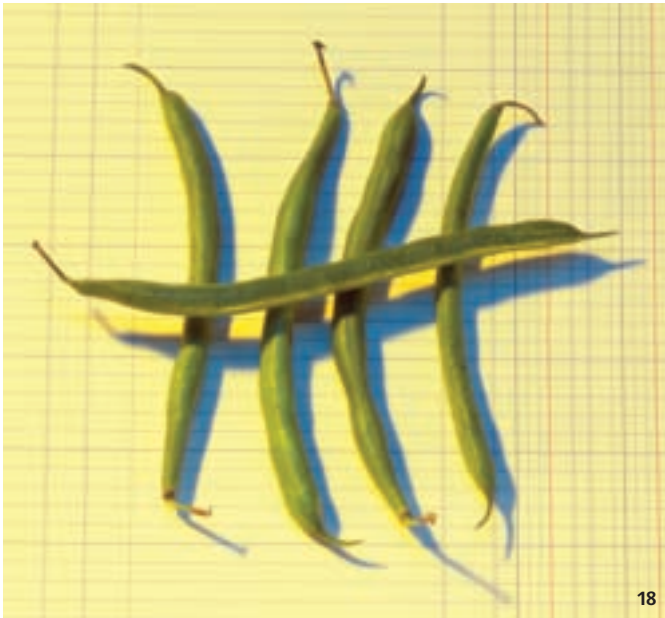


LOOK BACK. THINK AHEAD. KEEP LEARNING.



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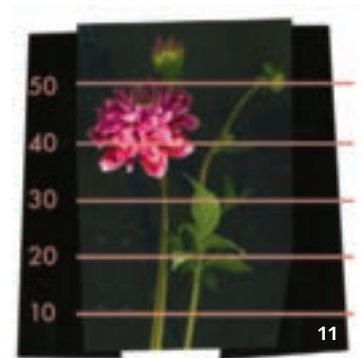
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A QUARTERLY PUBLICATION FOR
ALUMNI/AE OF THE STANFORD UNIVERSITY
GRADUATE SCHOOL OF BUSINESS

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PRINTING
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STANFORD BUSINESS Published quarterly
(February, May, August, November) by the
Stanford University Graduate School of Business
(ISSN 1094-5423). © 2004 by the Board of
Trustees of Leland Stanford Junior University.
All rights reserved. Printed in the United States.
Periodicals postage paid at Palo Alto, CA.

POSTMASTER Send address changes to
editorial office: *Stanford Business*, News and
Publications, Graduate School of Business,
Stanford University, Stanford, CA 94305-5015
(phone: 650.723.3157; fax: 650.725.6750;
email: gsb_newslines@gsb.stanford.edu).

SUBSCRIPTIONS For nonalumni — \$10/year in
the U.S. and U.S. possessions and Canada; else-
where \$12/year. For faster delivery outside the
U.S., add \$14 per year to subscription payment.

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sions, and letters to the editor, contact our editor-
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MAGAZINE WEBSITE
www.gsb.stanford.edu/news/bmag

about this issue

Introducing Christa Amsden

WITH THIS ISSUE WE INTRODUCE A NEW CLASS NOTES EDITOR, Christa Amsden. She has joined Gale Sperry, who is tiptoeing toward retirement. Gale began working with class secretaries in 1983, at a time when there were fewer than 10 pages of class notes per issue. As more of you had more to talk about, her job grew more complex. We talk about shepherding the project, but frankly, it's a bit like herding cats. With empathy for Christa, Gale has offered to stay on to aid her transition. I overheard Gale the other day, for instance, imparting to Christa that a statistically improbable number of class secretaries have owned pets who ate their columns just before deadline.



Christa Amsden

Christa is not exactly wet behind the ears, however. Married to a Stanford MBA, she already has read a fair number of your fabled golf and tennis scores. Having worked nearly three years in the School's Alumni Relations office, she has communicated with a number of you about other alumni services, and in a past life she supervised sophisticated customer support systems in high-tech companies. The School can't always afford the latest, greatest automated customer support, but staff members like Gale and Christa work hard at applying skills learned in the for-profit sector toward better service to you and to current students.

We will have a more formal farewell to Gale sometime next year, but for now we look forward to Christa's involvement in producing this magazine and trust you will too.

Kathleen O'Toole
EDITOR

LETTERS TO THE EDITOR

SINCE WHEN IS A PIECE about a gay graduate's "marriage" a newsworthy article for the Spreadsheet department of your [August] magazine? If you must publish such "news," the ClassNotes section is a much more appropriate spot.

R. K. WINGO, MBA '57
Gainesville, Va.

THE PICTURE AND DESCRIPTION of the same-sex couple and their twins in the August issue reflected questionable judgment by the editors. The legal definition of marriage has remained the same for centuries. It's the joining of a man and a woman. Until that is changed by state law, such marriages as this one are illegal, not legal as represented by the magazine. This has now been confirmed by the California Supreme Court.

LAWRENCE M. TILTON, MBA '51
Carlsbad, Calif.

EDITOR'S NOTE: *Since we wrote the caption, the California Supreme Court invalidated the*

San Francisco marriages, and judges in Oregon and Washington have declared unconstitutional state laws banning same-sex marriages. By the time you read this, other court decisions could be rendered on this issue.

I WAS THRILLED TO READ Dean Joss's column "Why We Want Some Early Career Students." What the dean might not remember is how flexible and supportive the GSB was to those of us who were admitted directly out of undergraduate college. Accepted by the GSB in early 1980, while still a 19-year-old at Dartmouth, I was offered the option to come right away or to defer my admission one or two years. Even better, the GSB offered to distribute up to 300 copies of my resume to firms specifically looking for pre-MBAs. I quickly turned down Harvard Business School, which insisted I had to enroll right away, and sent the GSB my resumes. Weeks later, I was hired, for two years, by a tiny and largely unknown consulting firm: Bain & Co.

JOHN C. WILEN, MBA '84
Frisco, Texas

The Story Behind One Bright Idea

ONE OF THE MOST EXCITING STORIES to come out of the Business School recently has to do with a venture started by recent Stanford business and engineering graduates. Their idea developed in an unusual project-based elective and is a vivid illustration of how Stanford provides an environment in which students are encouraged to be innovative, apply entrepreneurial skills, work in teams across disciplines, and develop a sense of social accountability.

In 2003, the students enrolled in an experimental one-quarter seminar called the *Social Entrepreneurship Startup*, designed to apply the intellectual energy of students and faculty to a social need. The class looked at developing a cheap, clean lighting system that could service people in the developing world who live without electricity. As many as 1.5 billion people light their homes with kerosene, a dangerous and polluting fuel.

The class was taught by the Business School's James Patell along with Bill Behrman and David Kelley of the School of Engineering. In the preceding quarter, professor Behrman worked with 14 undergraduate students to research the needs of developing countries and concluded that China, India, and Mexico would be the best places to start. Using the research from the first quarter, 21 graduate students from the Business School and the Engineering School set to work on prototypes and business plans. The course is an excellent example of the project-oriented, cross-disciplinary, and team-based experiential learning that our faculty members are introducing more and more into the curriculum. But the outcome of this particular class exceeded all our expectations.

The course resulted in Ignite Innovations, a startup that is working to bring light to the developing world. For now, Ignite is focused on India. While this is a for-profit effort, the company has a social purpose. "Charity alone is not enough; we believe lighting the entrepreneurial flame of market forces is the best way of igniting the fire of social change," says the company's website.

During their 2003 elective, students discovered that kerosene was surprisingly expensive, eating up about 4 percent of a typical rural family's monthly income. Gathering information like the cost of kerosene was a critical part of the research that went into the development of the Ignite Light, a solar-powered lamp built around a light-emitting diode (LED). In just 10 weeks, class members studied low-cost technologies, developed several prototype lamps, and drafted business plans for manufacturing and distribution.

The lightweight lantern produces nearly 50 times the amount of useful light per dollar of a conventional bulb and up to 200 times more useful light than a kerosene

lamp, the students calculated. The company is now grappling with prototypes and factory specs. "Focusing on the world's largest problems is really exciting," Matt Scott, MBA '03, one of the founders, told our Business School Advisory Council during a visit earlier this year. "To really do this requires a new way of thinking." The company's vision is to someday create a non-profit foundation "that can afford to put social objectives first" and provide resources to develop other products, such as an affordable way to purify drinking water that Ignite Innovations can bring to market. Working on the project, students said, helped them develop new skills, including the ability to improvise.

These sorts of opportunities not only give our students exposure to problem-solving experiences they would otherwise not have but also provide opportunities to make a difference. Scott, for one, passed up a consulting offer to pursue Ignite. "This came out of left field," he has said. "This is a movement proving you can do good things and have a financially self-sustaining life at the same time."

Mechanical engineering graduate Sally Madsen, an Ignite cofounder, explained that "this is exactly the kind of career I hoped I would find at Stanford."

Indeed, the Business School, through its 33-year-old Public Management Program and the Center for Social Innovation, has inspired scores of students to develop ideas and take on challenges that will have social impact in both the nonprofit and the for-profit sectors.

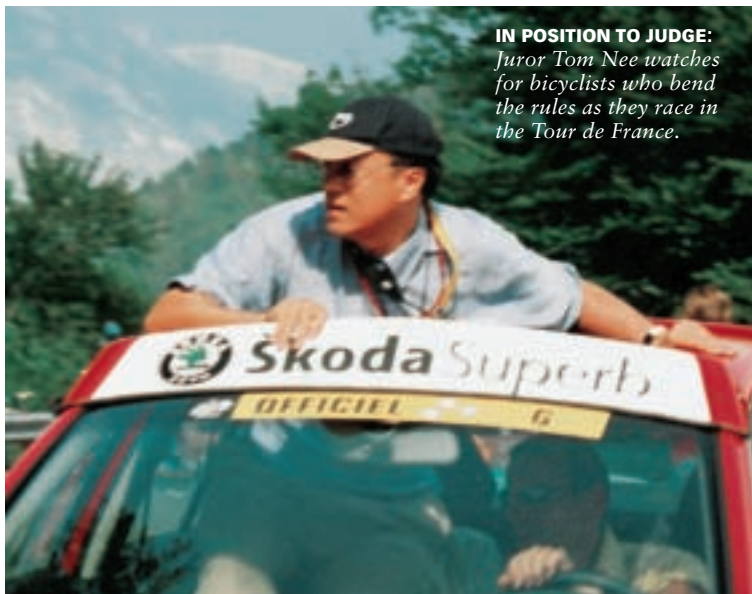
Like the elective that spawned Ignite Innovations, we are excited about another new two-quarter elective this year: *Biodesign Innovation*, a class that will identify new devices for unmet medical needs and develop prototypes and business plans for them. Business School professor Stefanos Zenios will teach the course with faculty from medicine and engineering. In the sort of mixed teams that students will someday encounter on the job, our future MBAs will work with peers from across campus on projects that span the curricula of all three schools. With classes like these that capitalize on teaching across the Stanford campus, I know our students will be getting experiences that show them they can make a difference. ■



In the sort of mixed teams that students will someday encounter on the job, our future MBAs will work with peers from across campus on projects that span the curricula of all three schools.

Spreadsheet

WHAT'S UP | News About the GSB and Its Graduates



IN POSITION TO JUDGE:
Juror Tom Nee watches for bicyclists who bend the rules as they race in the Tour de France.

Bucket Seat View of Tour de France

TOM NEE, MBA '87, saw the 2004 Tour de France up close and comfortable. The first American juror of France's most famous sporting event, Nee rode the 23-day, 3,390-kilometer (2,106-mile) course in an official car to observe racers and make on-the-spot calls on infractions. At the end of each of the event's 20 stages, Nee and the other international jurors met behind closed doors to view videotapes of the day's race and make final rulings. "The jurors can affect the entire sport," Nee says.

Nee's interest in bicycle officialdom came early. As a second-year MBA student, he served as the youngest full-time board member of the United States Cycling Federation and helped create a national collegiate conference. Nee still remembers the look on Professor Van Horne's face when he asked for two weeks' assignments in advance to take to a cycling meeting.

Now, as vice president for marketing for the pharmaceutical firm Forest Laboratories in Manhattan, Nee sees business possibilities in the Tour de France. "It's the top annual sporting event in terms of global media," he says. "Only the World Cup finals and Olympics eclipse it, and they're four-year events."

Last summer's record-setting sixth victory by Texan Lance Armstrong boosted American interest in the Tour, but marketing a sport like cycling in the United States poses problems. American spectator sports are stadium-based. "You have advertising in stadiums, named stadiums, skyboxes. So how do you do a skybox during a bike race?"

Just ask the Tour organizers. Last July, as Nee rode the course, he had two unspoken-for seats in back. Each day the Tour filled them with visiting VIPs—a foundation president, a couple of horseracing execs. That's how you do a skybox at a bike race.

Small-Loan Program Empowers Beggars

MUHAMMAD YUNUS WAS a young economics professor at Chittagong University in Bangladesh when he had a revolutionary idea: He would loan money to poor village women to start and run their own businesses. In the three decades since, Yunus's micro-loans succeeded beyond his or anyone's dreams.

His Grameen Bank, which made more than \$11 million last year, has given \$4.5 billion worth of small loans (the average is about \$200), with a 99 percent recovery rate. It has seen its methods adopted in 58 countries, and in Bangladesh Grameen has had an extraordinary effect on the status of women in their families and communities. Now, Yunus told an audience at the inaugural conference of the Business School's Center for Global Business and the Economy, he has a new target population: beggars.

Grameen enlists store owners to extend up to \$35 in credit to individual beggars and guarantees the loans. Beggars who go door to door can offer products or shop for the lady of the house. Even beggars who aren't ambulatory can take part in the program. They can keep "some soft

drinks, some bananas, some cookies" next to the begging bowl, Yunus explained, and "people have a choice whether they want to throw a coin or buy a banana." Yunus figures he will have 25,000 beggars in the program by the end of the year and hopes that by next year a good number of them will have left begging for business. "All we need to do is put a roof on top and she becomes a businesswoman right there. Just because one cannot move doesn't mean one is totally incapable," he said.

Students Rate Job Recruiters

IT DIDN'T HURT to stock a hotel room with Pepsi products, but that was hardly the reason PepsiCo was named one of three recipients of the inaugural, student-selected Recruiter Excellence Award. The other companies honored at the June Recruiter Conference sponsored by the MBA Career Management Center were the Boston Consulting Group and Eli Lilly & Co.

The awards committee noted PepsiCo's CEO Steve Reinemund interviewed one of the job finalists. He also gave a View from the Top speech and lunched with students. The committee praised the company for clear communication and for quickly telling students if they had been selected for further interviews.

The Boston Consulting Group also was commended for its communication. BCG recruiters "provided feedback throughout the process and made each interaction pleasant," students said, and they had "seamless communication between San Francisco and their satellite offices." BCG also was praised for its outreach



to minority students.

Eli Lilly has “shown a genuine, long-term interest in recruiting Stanford students,” according to the committee. “The company sends its best speakers to the School, holds informational sessions, and sponsors conferences. Lilly also is appreciated for its friendly, accommodating, and highly available staff.”

At the conference, Andy Chan, assistant dean and director of the career center, offered tips for successful recruiting. Besides presenting clear and consistent communication, he advised recruiters to:

- Make the process personal. Think one-on-one rather than mass marketing.
- Remember that career changers and international students offer unusual talent.
- Create big jobs that use Stanford MBAs’ full intellectual capacity and education.
- And finally, Chan said, recruiters should set reasonable goals for themselves. With the Business School’s intimate size, hiring one exceptional student is a success, he explained.

No Carb-Counting for This Student Body

EFFECTIVE National Football League management is about more than just minding your x’s and o’s. For the past two years NFL executives have visited Stanford to take classes in subjects

QUOTABLE

“There are a lot of rich people around the world who live very hollow lives of dedication only to themselves. This is narcissism. It’s not management. It’s not accomplishment.”

Richard Fisher, MBA ’75, managing director, Kissinger McLarty Associates, speaking to prospective students at MBA Admit Weekend.

such as team economics and stadium management, negotiation, and team effectiveness. Directed by GSB professor George Foster and Football Hall of Fame coach Bill Walsh, the one-week, custom-designed NFL–Stanford Executive Education Program has brought together leaders of the league and all 32 NFL teams.

The program has not been without problems, however. Last year there were complaints about the food. Not about quality; it was quantity. Portions at the Vidalakis Dining Room



apparently left some participants yearning for the training tables of yore. Not surprisingly, Exec Ed rose to the occasion. This year, participants’ portions grew by 50 percent. In a further bow to the boys of autumn, the written menu changed. One example: Last year’s “potatoes *au gratin*” returned this year as “scalloped potatoes.” The following week they reappeared as just plain “potatoes.”

Yes, Yes to Sí TV

FIVE HUNDRED STATIONS and nothing to watch. Most channel surfers have made that complaint but, says Albert Chavez, MBA ’85, one group of Americans is especially underserved by television—second, third, and even fourth-generation Latino Americans whose primary language is English.

Chavez is CFO of Sí TV, a new English-language cable network aimed at urban viewers ages 18 to 34. Sí TV got its first financing in December, built sets in January, and went on the air in February.

“It’s a different animal,

starting a company from scratch,” says Chavez, who cofounded El Dorado Communications, a holding company of Spanish-language radio stations, in the early nineties.

The company’s productions may feature Latino-American actors and themes, but don’t let Chavez hear you call Sí TV a minority network. “Our target demographic is 18 to 34,” he says. “In the major urban areas, Hispanics will be up to 30 percent of the audience. If you add in African Americans—our programming tests very well with them—you have a majority of the population.”

School Wins Bid for Social Sector Forum

MORE THAN 1,000 visitors are expected on campus next year when the Business School hosts the 13th annual Net Impact Conference. Scheduled for November 11–13, 2005, the theme for the event is “Social Innovation Without Borders: Reaching Across Sectors to Advance Social Change.” Participants will range from working professionals to academics and MBA students who share an interest in applying business solutions to social sector problems.

Net Impact began as Students for Responsible Business and grew into an international organization of some 9,000 business and nonprofit leaders and MBA students. A group of GSB students proposed Stanford as the venue for the 2005 conference and cross-sector collaboration as its theme. They are now planning panels and recruiting speakers and sponsors.

Dean Robert Joss said the event “represents an extraordinary opportunity to showcase Stanford’s global leadership at integrating entrepreneurship and social innovation in developing tomorrow’s leaders.”

For further information, contact Public Management Program director Peggy Reid (reid_peggy@gsb.stanford.edu) or student leader Lorri Elder (elder_lorri@gsb.stanford.edu).



Stanford Trustee Sums Up Decade

“The test of our success as trustees is not what happens next week but what the place is like in 25 years,” said former Stanford University Board of Trustees chairman Isaac Stein, MBA/JD ’72.

Stein, who is president and founder of the private investment firm Waverly Associates, stepped down this year from his 10-year stint on the Stanford board due to term limits.

In an interview with *Stanford Report*, Stein noted that the past two decades were a perfect time for Stanford. “We had a booming economy, a significant increase in government-funded research in the sciences; we had tremendous growth in the technology industry. It was a good time to be a major research university with a strong science capability in Silicon Valley.” But, he said, the trustees believe “it would be very dangerous to assume that those trends will continue for the next 20 years. It doesn’t mean we see the sky falling. It simply means we need to look at different ways in which benefits would come.”

Reflecting on his role as a trustee, Stein said: “There are very few times in our lives that we get to touch an institution that truly makes a difference in the world and not just to us as individuals. Stanford is such a place.”

Stein’s successor as chairman of the University Board of Trustees is Burton McMurtry, a former member and chair of the Business School Advisory Council.

Spreadsheet

FOR THE RECORD



MEET AND GREET: First-year students Vanessa Klivecka and Andrew Turner chat at a barbecue before pre-term courses begin.

MBA '06 Student Profile

GENERAL

Total Applications	4,696
Enrollment	372
Women	35%
Minority	24%
International	30%
Students with Advanced Degrees	9%
Median Years of Work Experience	4.0

SCHOOL/GEOGRAPHIC REPRESENTATION

U.S. Institutions	87
Non-U.S. Institutions	68
Countries (including the U.S.)	46

UNDERGRADUATE MAJOR

Humanities/Social Sciences	52%
Engineering/Math/Natural Sciences	32%
Business	16%

TOP 5 INDUSTRIES

Investment Management	23%
Consulting	18%
Manufacturing (non high-tech)	14%
Nonprofit/Government	12%
High-tech (services and manufacturing)	9%

Source: MBA Admissions office

Marty Gerstel, In at the Beginning

AS THE third employee of ALZA Corp., Marty Gerstel, MBA '68, was in at the creation of today's biotech industry. In fact, Gerstel told a Business School audience in April, he also witnessed the birth of venture capital.

Barely out of the GSB, Gerstel was invited by legendary biochemist Alex Zaffaroni, who had just left Syntex, to become CFO of his new venture, ALZA. As purveyor of the birth control pill, Syntex was then the hottest pharmaceutical firm on the market. But ALZA?

"This company had nothing—no technology, no money, no nothing," Gerstel said. ALZA was "pure hope and dreams." The hope was not to invent new drugs but to find new ways to administer them, he said. "But how were you going to start a company where you knew your prod-



ucts would be 5 or 10 years away, and you would have to invest 100, 200, 300 million dollars before ever getting to the marketplace?"

The Securities and Exchange Commission did not take kindly to the idea of an initial public offering of a company with nothing to offer. But ALZA already had some 20,000 shareholders. Zaffaroni, sensing a potential conflict of interest with Syntex, had given his old company a quarter interest in ALZA, which Syntex then distributed to its own shareholders.

"The SEC couldn't say it was an unfair offer, so they let us go public," Gerstel said. "It was actually the first United States company to go public without any revenues."

Gerstel rose to CEO and co-chair before he moved to Israel in 1993. He is currently chair of the biotech firm Compugen. And the first and second ALZA employees? They were the cook and chauffeur Zaffaroni brought with him from Syntex. One can only presume they too fared well.

Gold Spike Award Honors Rosenberg

CLAUDE ROSENBERG, MBA '52, who in 1984 received the GSB's highest alumni honor, the Arbuckle Award, was conferred the University's highest alumni prize, the Gold Spike, in June. Stanford President John Hennessy presented the honor.

An investment manager, Rosenberg has been an active fundraiser and donor at Stanford for more than four decades. He was a founder of the Business School Trust, which since 1966

has grown from \$100,000 to more than \$80 million, and served for many years as one of its alumni investment managers. Rosenberg and his wife, Louise, created the Rosenberg Corporate Research Center at Jackson Library, helped found the Center for Social Innovation, and support a Rosenberg Faculty Scholar at the Business School.

Since selling his investment company, Rosenberg has written five books on philanthropy and founded the nonprofit NewTithing Group, which recently released an Internet calculator called Prudent-Pal to assist people in determining the amount of charitable support they can afford.

Sloan Graduates Create Endowment

THE NEW SLOAN ENDOWMENT Fund, which raised \$177,000 in its first year, owes its success to three Sloan Fellows who have never met. Tim Wray, Sloan '02, had the idea for the fund and began working out logistics with the GSB development office. Greg LeClaire, Sloan '03, took the idea and ran with it. He saw the fund officially established in his final quarter on campus and accepted donations from 44 percent of his class. Erik Charlton, Sloan '04, headed a committee that successfully solicited donations from 76 percent of the Class of '04. Now Charlton and his classmate Jay Backstrand are leading a campaign to encourage all Sloan alumni to take part.

As the fund grows, its income will be used to address the needs of the Sloan Master's Program. Says LeClaire: "While I firmly believe the GSB is a tightly bonded community that generously shares resources among its programs, I and those who contributed to the Sloan endowment want the program to have its own funds available for specific program-enhancing uses. Whether to improve the quality of teaching, increase academic offerings, or bring in prominent speakers, the endowment provides for the continuing support and enhancement of the Sloan Master's Program." ■



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FOR FURTHER INFORMATION, PLEASE CONTACT LAURA MOORE AT: +650.723.2694 OR MOORE_LAURA@GSB.STANFORD.EDU



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GSB Deans,
left to right:
A. Michael Spence,
Robert K. Jaedicke,
Arjay Miller, and
Robert L. Joss

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PETER STEMBER

Flavor Maven

MELANIE DULBECCO, MBA '90

IN CHINA, sophisticates have acquired a taste for a smidgen of blueberry in their tap water. In Japan and the Philippines, where coffee has caught on, some have picked up the original Seattle habit of adding hazelnut or vanilla flavoring to their lattes. In North America in the past year, the low-carb craze prompted increased sales of sugar-free ingredients for smoothies and cheesecakes, and in the hot climates of Saudi Arabia and Israel, religiously authorized flavorings for frozen drinks are catching on.

This is from the intelligence desk of R. Torre & Co., where CEO Melanie Dulbecco has adapted mixing and bottling technology developed for the wine industry to the production of 70-plus bottled flavors for varied, global palates. (One of the latest, most difficult products to develop: sugar-free caramel sauce.)

San Francisco North Beach grocers Rinaldo and Ezilda Torre launched the company's Torani syrups based on five recipes from their native Italy, in 1925. By 1991, seven employees made 27 flavors for carbonated drinks and liquors. Enter Dulbecco, fresh from the Class of '90. She dropped the liquors and focused on growing the flavors. Within five years, the company was too big for its plant and moved to South San Francisco.

"We are growing by about 25 percent this year, and we need to find space for a new distribution center," she said recently. In 2002, the company received the President's "E" Award for being one of a few U.S. companies to increase its exports by 100 percent. Exports sales are still only about \$3 million, in the 5 to 7 percent range of total

sales, so there is room for growth.

But if it sounds easy, think again. Most of Torre's competition has been bought out by a giant Irish firm, and there are always niche newcomers. Success depends upon being part of a family-owned company that cares about profit today but also wants to be around for the long run, Dulbecco says. It also depends on a horizontal value chain that can respond to consumer trends faster than a vertically integrated company.

With that in mind, white tents were erected recently on the company parking lot so employees, suppliers, and customers could plan for the next 10 years together. When the low-carb fad passes, Dulbecco expects those up and down her value chain to have not just fresh market intelligence but new programs in the wings.

—KATHLEEN O'TOOLE

India Stargazer

NANDAKISHORE KABRA, MBA '63

PART IMAX-STYLE MOVIE EXPERIENCE, part planetarium show, the 16 space theaters launched by Nandakishore Kabra throughout India are attracting new generations to the galaxies beyond. Traditional planetariums project stars, constellations, and galaxies onto a domed surface. By incorporating a high-quality sound system as well as video projection, the new theaters offer a more engaging educational experience. Geared to reach students and astronomy enthusiasts, the theaters are located at educational centers.

Kabra worked in California for a few years after receiving his MBA in 1963 and then returned to his native India, where he worked with corporate giants such as Otis

Melanie Dulbecco and colleagues

Elevator and Union Carbide. At the time, government control of businesses limited management consulting opportunities, so he decided to leave the field entirely and try something in a then fledgling industry. In 1981, he partnered with Japanese manufacturer GOTO Optical, which is in direct competition with IMAX and similar companies to sell, service, and operate projection equipment. Although planetarium projection systems have limited growth potential, Kabra says he finds the work rewarding.

With no comparable business model in India, he had to rely on instinct and lessons learned at the Business School. Starting with a team of two, the company now has 40 employees and services theaters in 16 cities with populations from 200,000 to 12 million. "We're proud that our planetariums never have had to suspend shows due to mechanical failure," he said. Currently, he is trying to produce shows for the primary school level and distribute them free of charge to students.

Opening these educational theaters has been a collaborative effort with support from state and central governments and public and private charitable trusts. Kabra says the market for planetarium goes is there, but the success of individual theaters depends upon the marketing abilities of their owners. The next few years offer a great challenge as the industry shifts to an entirely digital system. Because of this, business will be more in the survival mode than the expansion mode, Kabra says. Although who knows what the stars have in store. ■

—ARTHUR PATTERSON



LINA KEIRWAL

Charity in the Spotlight

As baby boomers get closer to inheriting vast sums of money and philanthropic organizations face more scrutiny, foundations must strike a delicate balance in fulfilling their missions.

SOME OF THE BIGGEST NAMES in the foundation world spent their lunch hour with Business School audiences last spring discussing everything from scandals over executive compensation to grant-making techniques. The sessions were informal, interactive, and often packed with observers looking for clues to how managers stay atop this field. Bill Gates Sr., cochair of the Bill and Melinda Gates Foundation, and the other speakers collectively manage billions of dollars and make decisions daily that can bring attention to unrecognized social problems or expand society's capacity to tackle existing concerns.

Sponsored by the Business School's Center for Social Innovation and the University's Haas Center for Public Service, the

Philanthropy Discussion Series focused on a foundation's responsibility to the public. The managers who spoke acknowledged tensions between their responsibilities to the communities they serve and donors' personal interests. One suggested congressional intervention, while others urged more management attention on public accountability.

Besides Gates, the speakers were Susan Berresford, president of the Ford Foundation; Peter Hero, president of the Community Foundation Silicon Valley; Kathleen McCarthy, director of the Center for the Study of Philanthropy at the City University of New York; Jim Canales, president of the James Irvine Foundation; Tom Tierney, chairman of the Bridgespan Group; and Sally Osberg, president and CEO of the Skoll

Foundation. The foundation community is at a critical juncture as the field grows rapidly and faces more public attention, they said. Statistics from the nonprofit Foundation Center, which tracks the industry, indicate U.S.-based foundations increased from 56,582 in 2000 to 71,000 in 2004. With baby boomers set to inherit \$40 trillion to \$130 trillion in the next 40 to 50 years, the number of foundations will only swell.

Public and media scrutiny of foundations has increased, driven by both corporate- and nonprofit-sector scandals over executive pay and other expenses or operational practices. Observers are asking more questions about what tax-exempt foundations do with their money, and some question whether they should remain largely unregulated. Because much of foundation money would otherwise end up in government coffers, some critics say, foundations should not make grants to causes that might seem frivolous or extreme to the general public.

These criticisms weren't new to the speakers, who called for their sector to take action quickly to gain public and government trust. Canales of the Irvine Foundation knows firsthand what it's like to face critical publicity. When he took the helm of the \$1.4 billion organization in 2003, the past president had resigned and the *San Jose Mercury News* had just published a story examining the foundation's spending on office space and the former president's compensation and retirement package. Addressing the scrutiny proactively, the foundation's leaders called in counsel to analyze the claims and then publicly acknowledged some misdeeds while defending other practices on Irvine's website. In the future, Canales said, he plans to be "transparent to a fault. We need to communicate more effectively and strategically the results of the investments we are making."

Berresford of the Ford Foundation advocated more formal regulation of foundations. "Compliance issues should be addressed with legal and regulatory mandates and codifications of professional standards of administrative and operational practice,"



ILLUSTRATIONS BY MARGARET REGEL

Insights from Philanthropists

Besides focusing on issues of responsibility, the 2003–04 Philanthropy Discussion Series touched on innovative ways of thinking about philanthropy and effective grant-making initiatives. Some of the insights:

Grants aren't the only way to advance a cause. The Skoll Foundation says it believes social entrepreneurs are capable of making effective, systematic change, but simply funding them around the world isn't enough. In an effort to connect these individuals and create a dynamic community, the foundation created Social Edge (www.socialedge.com), an online community that fosters debate, networking, and learning opportunities for social entrepreneurs, activists, and nonprofit professionals. To celebrate social entrepreneurs and educate the public about their work, the foundation also helped fund a documentary, *The New Heroes*, which profiles social entrepreneurs around the world.

Foundations can use data to help focus their missions. The mission of the James Irvine Foundation is to “promote the general welfare of the people of California.” Still, the foundation's understanding of exactly who Californians are and will be in the next 20 years wasn't clear until it gathered and analyzed a significant amount of demographic data. The foundation discovered key information about where population centers are growing—the Inland Empire's Riverside and San Bernardino areas will account for 20 percent of the state's population in 20 years—and where Californians come from—26 out of 100 were born outside the United States. Armed with this new data, Irvine plans to focus effectively on what areas of the state it wants to fund (the Central Valley and Inland Empire) and what populations to target (youth ages 14 to 24).

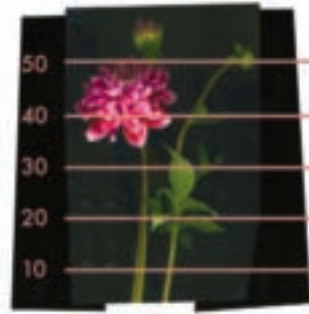
Community foundations aren't just local. The Community Foundation Silicon Valley now makes about 5 percent of its grants outside the United States. Just a few years ago it sent no contributions abroad. Driving this trend are the residents of Silicon Valley who want to give back to their native countries. According to a recent CFSV study, there are 200,000 Silicon Valley residents with family ties to India and with about \$30 billion in combined net worth. So when an earthquake struck India's Gujarat region, CFSV sent about \$6 million to that area. The foundation also is connecting a local group called Czech Tech with community foundations in the Czech Republic.

Foundations may face more competition for wealth. Many people believe that the foundation sector is on the cusp of a golden age. After all, baby boomers will soon inherit a tremendous amount of wealth and will be able to seriously start to give away their money. But with the mounting federal deficit and possible problems for the U.S. Social Security system, Kathleen McCarthy of the Center for the Study of Philanthropy at the City University of New York says that may not be the case. Boomers may be forced to use their wealth to pay their own living expenses and medical bills, she says. The deficit also could push Congress to increase foundation taxes or impose grant requirements to help pay for federal budget shortfalls and social programs that would otherwise be cut.

she said. “This is something our field can help develop. If we don't, it will be developed for us and done badly.”

She appealed to groups like the Council for Foundations, the Philanthropic Roundtable, the Association of Small Foundations, and the Center for Family Philanthropy to band together and collect reliable data about foundations' administrative costs and other finances. Creating an accountability and policing system will take money and manpower, however, and she urged foundations to press Congress to designate more money—specifically an excise tax paid by foundations—for monitoring and law enforcement.

Despite their large challenges, the managers who spoke were, for the most part, optimistic about the future. As Gates argued before an overflow audience, foundations can use their money to take risks in research and cutting-edge social programs that the government can't afford. And, he said, their grants help promote and advance such a wide variety of causes that foundation giving most likely mirrors how taxpayers and the government would spend like amounts of money. The implied social policy, Gates said, is that “it's as good to have private money going to private charitable purposes as it is to have money coming from the government for governmental purposes.” ■



School Annual Fund Marks 50 Years

FIFTY YEARS AGO, a committee of the Business School Alumni Association came up with an idea it thought would help the School. Committee members created a fund that today is the backbone of the School's financial health, channeling over \$62 million in gifts during the past 26 years alone to support everything from faculty recruitment to improving facilities.

The Business School Fund, established in 1954, was seen as a way alumni could help the School grow. “If we unite our efforts,” Bert Carr, MBA '30, the first chairman of the fund committee, said at the time, “we will aid the GSB materially in maintaining its position as one of the leading professional schools in the country.” His fellow alumni apparently agreed. In the first six months, 304 of them contributed \$6,500 (about \$46,000 in today's dollars). Last fiscal year, more than 5,000 alumni gave approximately \$8.8 million to the Business School Fund.

“Our goals are exactly the same today as they were when the fund was created,” said Ellen Otto, director of annual and reunion giving. “Fifty years ago, the alumni wanted to maintain and increase the reputation of the School by providing resources for expanded research leading to new and challenging courses, more faculty, financial aid for students, as well as better facilities. Today, the Business School Fund supports those same goals: This discretionary income gets to work immediately for the School, even before we begin to raise endowment for new programs.”

The School has just launched the five-year 50th celebration of the Business School Fund, with a goal of raising \$10 million annually, about 10 percent of the School's operating revenues. It is part of a larger fundraising initiative that will be launched early next year.

“Income from the Fund is our competitive advantage,” says current chairman Rocky Barber, MBA '75. “Flexible seed funding is what has moved the GSB from a modest local school to one of the elite business schools in the world within the relatively short institutional timespan of 50 years. We've come this far in just 50 years. Imagine what we can do in the next 50.”

Development Economics Must Reform

Half-filled promises, dissension, trade barriers, inadequate representation, and economic instability impede growth of developing economies, says South Africa's finance minister.



FIRST-WORLD NATIONS ARE NOT LIVING UP to their commitments to help the developing world, including the pledge to provide up to 0.7 percent of their gross domestic product in development aid, Trevor Manuel, South Africa's minister of finance, told the Business School's recent Conference on Global Business and Global Poverty.

"On balance, the developed world is not living up to its own commitments made at the Millennium Summit in Monterrey, Mexico, and Johannesburg, South Africa," Manuel said. "Very few come even close to achieving that [level of aid], in particular the United States, which gives a mere 0.13 percent of its GDP."

Rich nations also have failed to sufficiently lower trade barriers and subsidies to exporters of goods such as textiles and agricultural products, he said at the May event. "It becomes increasingly difficult for developing countries not to view the lack of commitment as a veiled attempt to constrain development in developing countries," Manuel told the conference organized by the School's Center for Global Business and the Economy. He was one of 10 business, government, and academic leaders from three continents who presented their ideas on coping with global poverty at the daylong conference.

Manuel, who is a governor of the World Bank,

argued that European countries are overrepresented on the boards of the International Monetary Fund and the World Bank. "Why is it that the managing director of the IMF must come from Europe, when almost all of its lending, whether short or medium term, goes to developing countries?" he asked.

Developing regions must overcome economic expansion and industrial diversification barriers through extra-regional trade and financial alliances, he said, citing the examples of Brazil, India, and South Africa, which have begun to build and strengthen cooperation on international financial issues and trade.

At the national level, Manuel observed, African countries need macroeconomic stability and microeconomic policies that help shift workers from old and noncompetitive industries to new industries and new forms of economic activity. Such policies require introducing new skills into the workforce, "high-quality education, and access to social and other forms of capital and open environments," he said. To qualify for financial assistance, certain countries should be required to reform their domestic policies so that the burden of economic adjustment is not continually pushed onto the poor and marginalized.

The problem, however, is that weak states are unlikely to achieve such reforms, and they often find themselves in an even weaker position when large-scale financial assistance comes with strict conditions. He urged African countries to band together to build regional economies—a main objective of the African Union. African countries have been slow to integrate regionally, in part because many African communities hold dear their recently won national sovereignty. Manuel argued, however, that the European experience of economic integration demonstrates that national sovereignty may actually be enhanced through regionalization.

"Poverty in Africa is of such scale that efforts to address it require far more than reform in individual countries. It requires a wide range of actors; reform to our multilateral institutions, their instruments, and their attitudes; and a sea change in political attitudes on trade and agriculture in developed countries." In trying to globalize their economies, African nations face inconsistent growth and widespread poverty that can tip them in the wrong direction—away from good governance, effective regulation, and pro-growth policies—and further weaken already inadequate social policies and institutions.

For details on the conference and the Global Center, see www.gsb.stanford.edu/cgbe. ■



2003-2004

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All support acknowledged here was received between September 1, 2003, and August 31, 2004.

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EXAMINING WORKER PRODUCTIVITY

Kathryn Shaw's detailed research inside steel mills set a higher standard for how to evaluate the impact of management practices on worker productivity.

by Bill Snyder

| *Illustration by* DANIEL BEJAR |

figure 1.



100x

figure 2.



500x

IF YOU'RE A MANAGER, YOU'VE HEARD IT ALL BEFORE: Build teams, develop trust, empower your workforce, be proactive, etc., etc., etc. There's no shortage of management gurus and consultants to sell you expensive advice about how to make your workforce more productive. And no wonder. With the rise of globalization and an ultra-competitive economy, managers who don't understand the imperatives of increasing efficiency and productivity and, ultimately, shareholder value are quickly "pursuing other interests."

But how do managers know which of the many human resource practices currently being heralded as innovative really work? Human resource departments often propose that managers adopt new practices such as offering employees more flexible hours, job sharing, employment guarantees, and ongoing training. One study in 2000, for instance, found that 85 percent of 700 companies surveyed had implemented at least one of these relatively new HR practices.

Meanwhile, productivity has been on the rise since the mid-nineties. Is there a link between the two trends? Hard evidence that innovative HR practices boost employee productivity—much less the bottom line—is hard to find. And that's a problem for thoughtful managers. After all, you'd never spend money on a machine tool or computer unless you had good reason to think you could demonstrate a reasonable return on your investment.

In a series of groundbreaking studies, economist Kathryn Shaw, the Ernest C. Arbuckle Professor of Economics at the Business School, identified quantifiable links between imaginative HR practices and increased productivity. Characterized by deep analysis of individual plants and data collection across an entire industry, her work sets a new and higher standard for research in the developing subspecialty of personnel economics.

Shaw, who served on the Council of Economic Advisers during the Clinton administration, began her study of productivity while a member of the faculty at Pittsburgh's Carnegie Mellon University. Fittingly enough, her work focused on the steel industry, the historic heart of western Pennsylvania's economy.

Although she grew up in California's San Fernando Valley, Shaw was born in Youngstown, Ohio, and many of her relatives had a connection to the mills, as engineers or accountants or plumbers, or simply residents who knew the local economy depended upon Big Steel. When money became available to do research in the mills, she saw it as "a great opportunity to get inside firms and see how they improve performance."

"There is no business that is more interesting to visit—you can really 'see' what matters and what doesn't," she says. "The mills are also a work of art—of color and drama and people—and, in fact, I have a collection of oils and original photographs of them." Shaw now works on productivity in high-tech companies where she

figure 3.



1000x

figure 4.



2000x

sees people sitting at computer terminals—low key in comparison.

After months of observation of 36 integrated steel finishing lines, Shaw found that plants that used the most innovative human resource management system were rewarded with a gross annual payout of \$2.24 million more annually per line than those with traditional systems.

More recently, Shaw examined the effect of new information technology and new human resource practices on another classic old-economy industry: valve production. “When people think of IT, they usually think of computers on desks,” she says, “but in this case the technology was embedded into the machine tools.”

Plants that combined the most advanced machinery with better training and development of better employee communication and teamwork skills were able to produce customized products, a significant competitive advantage over shops that could produce only standard valves, she says. Workers in the advanced plants need more than excellent mechanical skills. They must be trained to be flexible and to work on varied products at the same time, and to take more responsibility for solving problems as they arise.

Her ongoing studies of the steel industry eventually cost approximately \$2 million, an unusually large, if not unheard of, bill for social science research.

Don't Just Stand There—Talk to Me

IF SILVER BULLETS REALLY WORKED, management would be a snap. But in the real world, managers need to adopt complementary sets of practices that take into account their company's overall business strategy.

Shaw and Ichniowski visited 75 steel lines owned by 50 different companies around the world. Although those companies used many practices, the researchers found that there were really just four HR systems within the plants.

At one extreme is a “high involvement” system that incorporates innovative practices across all seven areas of HR management they considered—flexible job design, ongoing training in skills and problem solving, work teams, information sharing, elaborate pay for performance plans, employment security guarantees, and extensive employee screening.



“Managers need to adopt practices that take into account their company's overall business strategy. More sophisticated systems give the worker an incentive to push for quality and the ability to do something about it.” — KATHRYN SHAW

The high level of precision in the studies was not coincidental. Shaw and her colleague Casey Ichniowski, a professor of business at Columbia University, interviewed experienced workers, supervisors, HR managers, union officials, and production experts to understand the production process and to determine the best data for measuring technology and productivity. Their demanding approach was aimed at producing empirical estimates of the value of alternative human resource management practices and eventually became known as “insider econometrics,” because it goes so deeply within industries and individual workplaces to acquire and analyze performance data.

Deeply indeed.

Integrated finishing lines coat and treat very large coils of flat-rolled steel. Shaw's sample of 36 included nearly every such line in the country that survived the meltdown of the steel industry in the eighties; her monthly data panels consisted of 2,000 separate observations. In a related study a few years later, she examined 34 steel minimill production lines that reheat very large steel beams and thin and shape the steel into thinner rods or bars for use in construction or manufacturing. Again, her sample encompassed most mills of that type.

Studying an entire population, or almost all of it, Shaw says, eliminates the problems inherent in any study that relies on a relatively small sample. Not surprisingly, the project was very expensive, but the research was backed by the Alfred P. Sloan Foun-

At the other extreme is the traditional system with no innovative HR practices. In between are a “communications system” of information sharing and a “high teamwork” system. In general, they found that the more innovative the system, the higher the gain in productivity relative to a traditional HR management system. The gain at the high end was 6.7 percent more “uptime,” which may not sound like a lot but is in fact “huge,” says Shaw.

Uptime, she explains, is the percent of time the mill is up and running and not down due to problems. Mills without innovative HR practices have uptime of about 88 percent, so if you have all the innovative practices and add 6.7 percent, your uptime rises to 94.7 percent—and a top-line benefit of about \$2.24 million annually per finishing line. The study did not attempt to translate the gain in productivity to an increase in margins or overall profitability.

Did improved productivity mean lower product quality? Not at all. The study found improvements in the quality of output in roughly the same proportion as improvements in quantity.

In the past, Shaw says, incentive plans in steel mills were generally based upon tonnage produced. If a worker saw a problem, he or she might well let it slide rather than slow down to fix it and reduce output. But more sophisticated management systems not only give the worker an incentive to push for quality, they give the worker the ability to do something about it. Although some production problems are very obvious, many others are not. Workers need training to recognize and understand subtle problems and the

opportunity to communicate their observations, something that rarely happens in the hierarchical setting of the traditional factory.

When the researchers (in a follow-up study) looked specifically at communication among workers on the more productive finishing lines, they found that nearly all crew members communicated with 70 to 100 percent of the operators on their crew and with about 50 percent of workers on the same line but in different crews. Measurable communication among workers on the more traditionally run lines averaged only 16 percent. Simply put, Shaw wrote, “Employees on the [traditionally run] lines are doing their own jobs on their own.”

Making HR and IT Work Together

SHAW’S OVERALL CONCLUSION—that managers seeking to reach the highest performance levels need to find the set of practices that are right for their situation—continues the Stanford tradition of pathbreaking work in HR.

In December 1995, Business School professor Edward Lazear completed a study of the Safelite Glass Corp., the nation’s largest installer of automobile glass, which had just made the transition from an hourly to a piece-rate compensation structure for its production workers. Like Shaw, he found that changes in HR management practices could do much to boost productivity. “Lazear’s work again emphasizes that HR practices must fit the technology,” Shaw says. “When individuals work alone to install windshields, piece rate is optimal.”

To name just a few other professors: Charles O’Reilly and Jeffrey Pfeffer focus on the “hidden value” that surfaces in companies when managers find the HR practices that are right for their firm’s overall strategy. James Baron and Michael Hannan developed the Stanford Project on Emerging Companies, showing that in high-tech startups, company founders choose a set of HR practices that are right for them and rarely change these practices over time. Tim Bresnahan emphasizes the importance of a good fit between HR practices and new information technologies.

The challenge for managers is to find the set of HR practices that best fits the overall strategy of their firm. When Shaw concludes that innovative HR practices raise productivity, the obvious question is, should everyone adopt these same practices? Clearly, the answer is no—practices must fit the technology and the strategy.

The West Wing

IN ONE-ON-ONE CONVERSATION, Shaw is thoughtful and easy to talk to. But her 16-page resume is, well, intimidating as hell. Before the Harvard-trained economist came to Stanford in 2003, she taught economics at Carnegie Mellon University for 22 years, including two years in which she held the Ford Distinguished Research Chair, and three years as chair of the Industrial Management Department. She was a visiting economist at the Federal Reserve and is a research associate at the National Bureau of Economic Research.

She writes as frequently as she can, but the time-consuming nature of her specialty has kept her output a bit lower than she would like. Nevertheless, Shaw has earned a half-dozen major awards for the quality of her teaching, and she finds time to take her kids to hockey practice.

Appointed to the Council of Economic Advisers by President Bill Clinton in 1999, she helped formulate the administration’s eco-

nomics policy, attended morning briefings conducted by the president’s chief of staff in the Roosevelt Room, had monthly lunches with Federal Reserve chairman Alan Greenspan, and meetings with the president in the Oval Office.

But there was a downside: weekly commutes from Pittsburgh and long separations from her three children and husband, a trauma surgeon. Hard as the arrangement was, she says, “I’d do it again in a nanosecond.”

IT—A Key Driver for Innovative HR Value

ALTHOUGH MOST OF US ASSUME that advances in information technology have had a major impact on productivity, very few studies have found a provable link between the two. Shaw’s paper on valves is one of the few. Still, it is already clear that linking new information gained on the shop floor to new human resource software makes it much easier to base pay on measurable objectives. “We have seen from talking to companies that IT measures things that couldn’t be measured easily before,” Shaw says, “and that feeds into selection of optimal HR practices.”

Consider a system that bases a manager’s incentive pay on production, quality, and employee turnover. Production data can be collected using handheld computers or tablets, entered into relevant forms, and then downloaded, perhaps wirelessly, to a company database. That information can be linked to attendance records and then assembled in an easy-to-understand report by business analytics software.

“We do see that companies making changes in incentive pay and teamwork are also linking production monitoring software to HR software—firms see this software as an enabler,” Shaw says.

Mark Lange, MBA ’94, vice president of global marketing for PeopleSoft, which pioneered the development of human resource software, says that better software and better networks are allowing companies to link what formerly were separate streams of data—and then analyze it.

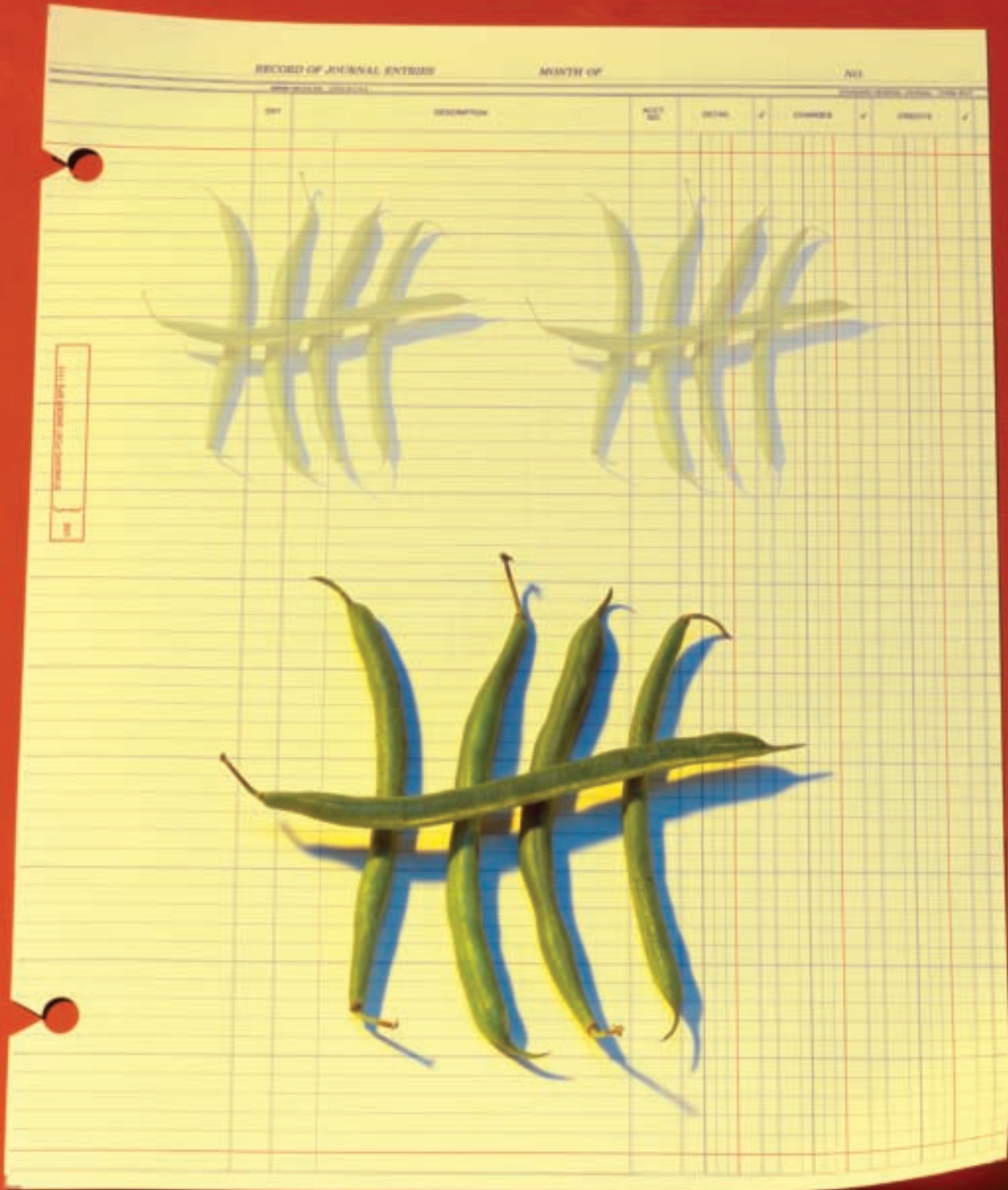
Suppose, he says, a manager notices that broken drill bits are causing a slowdown. The next step is to identify a fix—perhaps workers need more training on procedures to drill a certain type of metal. The company might then place a learning program on a kiosk in the plant and encourage (or require) workers to use it. Kiosk records then could be matched against repair records to establish if, in fact, the training program had done its job.

Although this punch press scenario is hypothetical, the technology already exists. The barrier, says Lange, is resistance to change. “Some HR folks will never get it; there’s an old guard that wants to stay in a room and manage the administrative trivia. Those are the folks whose job will be outsourced.”

Maybe so. But Shaw believes HR lies in the domain of all managers. She notes that Lazear’s auto glass installer could shift to piece-rate pay for production because it introduced the IT to measure individual performance efficiently. Her steel companies and valve companies give more decision-making authority to front-line workers because IT provides them with the information to make informed decisions instantly.

Shaw and her colleagues are developing the tools to satisfy the executive demand for deeper, more precise information about human resource management. Now it’s up to the managers, not just HR professionals, to pay attention to HR practices and show their own companies the relevance. ■

Toting Up Stock Options



IT HAS BEEN A WILD RIDE, these years of employee stock options. Fortunes have been granted to some option recipients, while others have seen dreams dashed, as failed employers' options took on the charm of losing lottery tickets.

Win, lose, or draw, much of corporate America has argued successfully that, despite enormous potential value, option grants should not appear on an income statement: No cash involved. Not direct compensation but another form of incentive. Backers of employee options would also point to the instrument's inherent uncertainty. Perhaps most potent politically, enthusiasts have contended that employee stock options are a key part of the machinery of American innovation. Craig Barrett, CEO of Intel Corp., said earlier this year, "As a CEO of a major company with 30 years of management experience, in my estimation stock options are one of the great competitive weapons the United States has to participate in the world economic infrastructure."

For years, many economists, accountants, and investors have for years argued that successful options dilute shareholders' future returns, that they have value inherent in any other option, and that they therefore must be considered in corporate expenses. Über-investor Warren Buffett, CEO of Berkshire Hathaway, asked pointedly a decade ago: "If stock options aren't a form of compensation, what are they? And if compensation isn't an expense, then what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

Accounting for employee stock options thus has been a riddle. After some 30 years of dispute and countervailing pressures, options are once again the focus of accounting debate. Companies currently must follow a Financial Accounting Standards Board ruling cobbled together in 1995, when the last major battle over options accounting was fought. Forces that favored compulsory expensing lost that earlier policy debate. The current rule, known as FAS 123, came into effect for fiscal years ending after December 15, 1995, and began to lift the veil around options. But, while FAS 123 requires employers to disclose some calculations for employee options grants in financial notes, there is no stipulation that costs be expensed on the corporate income statement. The FASB and its supporters were routed at the last minute and compelled to permit a giant loophole. The loophole frees employers to avoid income statement recognition of options expenses by opting for the 1972 Opinion 25 that had allowed avoidance of options expensing in the first place. FAS 123 added the requirement for footnote disclosures.

Now, the Financial Accounting Standards Board is again moving toward requiring options expenses. "Let the mud-slinging begin—again," *CFO* magazine sniped earlier this year. And indeed it did. Global pressure played a hand this time. The International Accounting Standards Board—Business School professor and associate dean Mary Barth is a member—has adopted requirements

much like those of FAS 123, but stipulating that the calculations be used to determine income statement expenses. The international standards will come into force January 1, at which time American accounting standards could be weaker than elsewhere. At press time, U.S. standard setters had not finalized changes.

On this round of debate there has been new insight. In a potential breakthrough, two Stanford professors created a key to the accounting quandary. An approach proposed by economists Jeremy Bulow and John Shoven identifies a feature common to virtually all current employee option programs and uses that to overcome many of the problems of uncertainty that blocked options expensing in the past. Accounting and securities regulators expressed considerable interest in Bulow and Shoven's proposal, and earlier this year a *Financial Times* opinion piece endorsed the approach. Importantly,

the *Financial Times* piece was written by a triumvirate of options experts. They included Robert Merton, who with Stanford Business School's Myron Scholes was awarded the 1997 Nobel Memorial Prize in Economic Sciences for groundbreaking options valuation analysis developed with the late Fischer Black that has emerged as the Black-Scholes formula.

Bulow, who is the Richard A. Stepp Professor of Economics at the Graduate School of Business, and Shoven, the Charles R. Schwab Professor of Economics and director of the Stanford Institute for Economic Policy Research, opened up this

accounting approach by chopping up the continuous time of an option's run into discrete units. We'll consider the theory in more detail, but it is important to first look at present accounting problems with options.

Accounting Dissected

Graduate School of Business research has produced disconcerting evidence that while current accounting footnotes influence investors and add to their understanding of a company, they appear to have been used at times in distorted ways that fail to fully reflect the weight of employee stock options. Mary Barth and Ron Kasznik, together with David Aboody of the Anderson School of Management at UCLA, in a paper this year found that options—even where they are absent from the income statement—are viewed by investors as a cost to the firm. The study sampled more than 750 companies between 1996 and 1998 with elaborate statistical checks.

Barth, Kasznik, and Aboody used footnote disclosures required by FAS 123 to consider assumptions used by the reporting companies. These notes require an estimated value of options grants using the Black-Scholes formula. The calculation appraises the time value of options through an assumed risk-free interest rate, projected volatility of the stock, and forecast dividend yield. So there is considerable guessing about future periods as much as a decade ahead. If investors believed that options stimulated employees to substantially improve performance—rather than just dipping into the shareholders' cookie jar—companies with substantial employee

Public companies have been criticized for granting stock options to employees without adding costs to the corporate expense pile. AS REGULATORS AND SOME SHAREHOLDERS ARGUE FOR NEW RULES, BUSINESS SCHOOL RESEARCHERS TRY TO FOLLOW THE MONEY — AND THE LOGIC.

BY FREDERICK ROSE

PHOTOGRAPH BY PETE McARTHUR



Friends since their student days, economists Jeremy Bulow (right) of the Business School and John Shoven of the Stanford Economics Department teamed up to devise a new way to value employee stock options.

Stanford—and the most fun,” Bulow recalls during a joint interview in Shoven’s airy, sunlit office. Calls went out to Silicon Valley compensation experts, who confirmed that a 90-day accelerated expiry on leaving a firm was an almost universal feature of options. What to accountants had perhaps seemed a trivial fillip in the process jumped up at the economists. “Until we started looking at this, I thought the word ‘vested’ meant the same thing in options that it does in pensions—where if it’s vested it means it’s yours come hell or high water,” says Shoven. Not so.

It took almost a year of theorizing, research, and writing to hammer out their approach. Bulow and Shoven, who have worked together and been friends since they met as undergraduate (Bulow) and graduate student (Shoven) working for economist James Tobin at Yale, brought an entirely different background to the options issue. Both men had done research on economic issues of pension plans, which share some features with options. Moreover, Bulow’s doctoral thesis

had in part proposed a somewhat similar approach to valuing employee pension expenses.

“We are not among the several hundred top options pricing experts in the world,” Bulow adds with a chuckle. But “it turns out that to do something like this, the set of talents that were really helpful included knowing a little bit about options—just enough so that you sort of understood what they were doing. We did, but we had to throw off some of the rust. We had some false starts. Add to this a little knowledge about labor economics, and a little bit about game theory.

“There might be people who were way ahead of us in terms of the option pricing part, but on the margin, we just had enough. And the fact that they were more sophisticated than us just didn’t matter so much, as we knew a little bit about all the other things.” — *Frederick Rose*

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Wrestling with Stock Option Valuation

IN THEIR WORLDS OF EQUATIONS, economists rarely take up thorny questions of corporate accounting. Occasionally, however, they may bump into certain bean-counting questions when they go weightlifting with a pal, as GSB Professor Jeremy Bulow has discovered.

Bulow and economist David Yoffie, a Harvard Business School professor visiting Stanford, jointly hired a student to coach them on weight training a while back. After working out with the barbells, Bulow and Yoffie, who is a director of Intel Corp., used to head to the Arrillaga Alumni Center Cafe for lunch and gossip. Bent over the table one day, “we were talking about employee options and it came out that Intel had this feature that I hadn’t been aware of, that if you leave the firm you get only 90 days to exercise the options, regardless of the reasons for departure,” Bulow recalls.

“It wasn’t that anybody was keeping the 90-day feature of options secret,” says Bulow, but that mere scrap of information prompted the Stanford economist to consider one of the weighty matters of the accounting world. Unencumbered by years of accounting precedents, “it was a very small leap [from knowing of the 90-day limit] to figuring out how to deal with vested options,” Bulow says. “Really, it took just a moment.” But some important questions remained: Was this 90-day feature truly a widespread practice? What were the mathematical and accounting features of this element? Hardest of all, how should nonvested options be handled?

“I went to my friend John Shoven’s office, having thought about who would be the best person to work with on this at

options outstanding should perform better, not worse. Yet the Stanford researchers found that the market performance of those stocks with higher estimated options expenses lagged stocks with less. In short, whether the numbers are right or wrong, investors have their opinions, do react, and often don't like what they see.

The researchers, moreover, unearthed distressing signs that investor faith in FAS 123 footnotes could be misplaced. A separate work by Barth, Kasznik, and Aboody finds that wide management discretion over assumptions used in calculations has at times understated publicly reported options expenses. Analyzing over 3,800 corporate financial results during the years 1996 to 2001, the researchers concluded that understatement of these expenses was more likely in cases where companies granted large quantities of employee options and were active in capital markets, thus exposing themselves to more scrutiny by banks and investors.

Manipulation of key numbers is easy. While Barth, Kasznik, and Aboody noted little fudging of interest rate assumptions, which can be compared with other forecasts, they found that company estimates of future stock volatility, dividend yield assumptions, and expected option life were subject to "downward management" by firms anxious to keep perceived option costs low and implicit earnings high.

Moreover, research done by Kasznik and Aboody several years ago found that company managers tend to stick a thumb on the scales when it comes time to set stock option exercise prices—either releasing bad news shortly before options were usually granted or holding off good news until options were set. In either case, exercise prices would be depressed—to the prospective advantage of management option recipients.

Timeline Solutions

Such "gaming of the system" could be substantially reduced under the Bulow and Shoven approach. In their central thesis, the two economists write: "Most companies' long-term options are not really very long term at all. While an option may technically expire after 10 years, the employee has only 90 days to exercise if he either quits or is fired. Therefore, what an employee with a vested option really owns at any given time is a 90-day option." This understanding of a short, finite period greatly simplifies options accounting. With this short window, a Black-Scholes calculation can be based on far firmer estimates, using well-established short-term interest rates, recently observed stock volatility, and current dividend rates—and for larger firms, direct market prices of publicly traded options—to yield a firm expense number.

To implement this method, firms would expense the value of 90-day options at the beginning of each quarter, the value determined by the exercise price and the current stock price. This expense would be offset partially by the ending (intrinsic) value of any 90-day options expensed in the previous quarter and not exercised. Firms would have some flexibility in choosing when to begin expensing unvested options, but they would be taking the risk of a

large charge if the stock price rose before expensing began because there is no offset in the first quarter that an option is expensed.

This approach prompted keen interest. "The Bulow-Shoven method appears to remove one of the last valid arguments against expensing options. In the coming months, all sides of this debate will have to reconsider their views and positions," wrote *Financial Engineering News* in a recent article.

But the Bulow-Shoven proposal arrived late on the scene and conflicted in some important parts with standards the FASB had put forth in draft policy earlier this year. It also differed from the International Accounting Standard that is to come into effect on January 1 after extensive efforts to coordinate with U.S. standards. While the economists found substantial initial interest among regulators, the FASB in early August voted to stick with its earlier proposed revisions. Minutes of the board's meeting indicate the board—contending in part that elements of the approach were at

odds with current accounting concepts—sidestepped the economists' proposals.

Bulow is sympathetic with the FASB's position. "It's very tough for these regulators," he notes. "Accounting rules predate modern financial theory, and the regulators must develop each rule with an eye toward how it affects everything else."

He likens the problem to computer coding complexity. Microsoft's current Windows software is far bulkier and more convoluted than modern Linux coding "in part because it must

be made backward-compatible to previous systems, which in themselves were developed to be backward-compatible all the way back to DOS." Even so, once opened up, the economic interpretation of options accounting may yet give rise either to restructured employee incentives or eventually to yet another accounting change. "For a variety of reasons, most people not in the business of charging for option valuation software or suing companies would be better off if we adopted some version of Bulow-Shoven," he says.

All of this is evolving in part because the political landscape has changed since the mid-1990s, when major corporations in traditional industries joined newer-wave technology firms to oppose options expensing. The embarrassment of managerial and corporate overindulgence revealed in the market crash of 2001 and 2002 changed the tenor. Many heavyweight players have since abandoned the battle. Coca-Cola and General Electric already have elected to expense options under FAS 123. Opposition lingers in the technology sector, where employee stock options have been a way of life that is hard to leave behind.

History is on the reformers' side. Accounting standards have been through similar clashes in the past, as when the more accurate "successful efforts" accounting for oil exploration and production collided in the late 1970s and early 1980s with the flakey concept of "full cost accounting," which was widely used by small oil companies in a style so slack that cynics called it "no cost accounting." Despite forecasts of financial cataclysm, stiffer regulations were imposed to the ultimate benefit of investors and the institutions themselves. ■

Researchers found company managers tend to stick a thumb on the scales when it comes time to set stock option exercise prices—
EITHER RELEASING BAD NEWS SHORTLY BEFORE OPTIONS WERE GRANTED OR HOLDING OFF GOOD NEWS UNTIL OPTIONS WERE SET.

SHORTLY BEFORE HIS HIGH SCHOOL GRADUATION, Bernard Beal tried to cut a deal with his parents: Let him use the money they had saved for his college education to buy a fast-food franchise. Eventually they caved, and by the time his classmates were beginning their post-college careers in the early seventies, he was making \$26,800 a year.

“I had two motorcycles, my own apartment, and two girlfriends,” the New Yorker recalled recently. “It didn’t get any better than that.

“But then one day I was held up and got shot, so I decided college wasn’t such a bad idea.”

In 1979, with a law degree and a Stanford MBA, Beal had to beg his Wall Street employer to pay him slightly more than he had made running his Jack in the Box. Life as an employee got steadily better, however, until his firm was bought out and Beal realized he would be starting over at the bottom of a new hierarchy.

He dusted off a business plan he had written in an MBA class on entrepreneurial endeavors, found 13 investors, and started M.R. Beal & Co. in 1988. For the past decade the firm has been ranked as one of the top 20 U.S. underwriters of municipal securities.

In the high-tech euphoria of the late nineties, a number of Business School graduates started companies right after or just before

“We grew the business to 280 people with offices around the country and in Africa. I’ve had a lot of fun with the plan I developed here.” —Bernard Beal

graduation. These days, graduates tend to go to work for others, just as they did in Beal’s Class of ’79. A 1997 alumni/ae survey indicates, however, that Stanford is one of the most entrepreneurial of business schools: Fully one third of those responding said they eventually started a business, says Mary Burnham, staff codirector of the School’s Center for Entrepreneurial Studies. At this year’s milestone 25th reunion, the Class of ’79 heard from four such members of their own class. Attendees also were updated on how the School’s Center for Entrepreneurial Studies has vastly expanded the resources for those who want to try to start their own company.

Serendipity is often the mother of entrepreneurship, but preparation and networking are also involved, Beal and the other ’79 entrepreneurs said.

Roy Whitfield, cofounder of the biotechnology company Incyte, for example, claimed he would have fled back to his native England after graduation if someone had told him he would wind up running a 10-employee company desperate to convince venture capitalists of its potential.

David Marquardt of August Capital, who has sat on the boards of two dozen startups since leaving the GSB, said he happened into his career as a high-tech venture capitalist when a class speaker mentioned he was looking for a junior associate with an engineering background. “You can’t discount the element of luck,” he said.

Michele Klein, the founder of two venture capital-backed semiconductor equipment companies, said she used contacts and every skill learned at the School to make her companies work. “Many people think that a startup is going to be fun because it’s ad hoc. It

isn’t fun, and if it is ad hoc, it won’t be there very long,” Klein told classmates. She emphasized the importance of developing business processes simultaneously with product prototypes because in the semiconductor industry, chipmakers are reluctant to buy equipment from—and venture capitalists are reluctant to invest in—startups until the founders can demonstrate that they have a truly enabling technology and concrete plans for delivering it. “I was able to use everything I got from being here



and more in my semiconductor equipment companies, even when both were very small.”

After playing Mr. Mom while his wife started a company, Whitfield was eager to get back into investment banking, so he took an assignment to sell the research arm of a St. Louis company. He failed so badly, he recalled, that he and a partner decided to buy the unit themselves in 1989 for \$2 million. By 1997, the cofounder of Incyte was the Ernst & Young Northern California Entrepreneur of the Year for life sciences. By 2000, Incyte had become a 1,300-employee worldwide company with a market capitalization of \$8 billion.

Incyte’s market value sagged, dropping to a twentieth of its peak within a couple years, he said. Asked if he got his money out at the

Blast Off Experts

At their 25th reunion, the Class of '79 heard from four of its own entrepreneurs and about the School's Center for Entrepreneurial Studies. **A third of Stanford MBA graduates eventually start a business while many others apply entrepreneurial approaches as they move up organizational ladders.** By KATHLEEN O'TOOLE

“Many people think that a startup is going to be fun because it’s ad hoc. It isn’t fun, and if it is ad hoc, it won’t be there very long.” —Michele Klein

Photographed by Peter Stember at an Applied Materials research center in Sunnyvale



peak, Whitfield, like the other entrepreneurs, said it is extremely difficult for an executive of a public company whose stock sales must be reported to take money out at the peak. It's also difficult to do so because company leaders believe in what they are doing.

"I'm happy with what I got out with, but my wife isn't," Whitfield joked. Klein, whose technology companies High Yield Technology and Boxer Cross were acquired by larger, public companies, said her husband, an investment banker, has advised her that "there are easier ways to make a buck than compulsive entrepreneurship."

"Life science companies don't start in garages."

—Roy Whitfield

She and partner Peter Borden were happy when Applied Materials bought Boxer Cross "because the desert was getting pretty dry out there and a lot of companies didn't make it across" during the prolonged downturn. She still manages the unit, which she said feels great because "after all the hard work, our product's legacy continues. There is probably nothing an entrepreneur wants more."

Whitfield cautioned that "life science companies don't start in garages" like the stereotypes of Hewlett-Packard and Apple suggest. Although Whitfield had a substantial ownership stake in Incyte, he said, "these companies generally start from a patent out of Stanford or something a professor has done. The [venture capitalists] from Sand Hill Road sweep in and get the rights, hiring in experienced management from the pharmaceutical or biotech industry."

Faculty who teach entrepreneurship do not define it per se as ownership of startups, professor Garth Saloner told the class gathering. "We think of entrepreneurship as people who marshal and attract existing resources and put them together in novel ways to create new ventures."

The ownership stake of venture capitalists in companies pursuing



BLAST OFF EXPERTS



new technology may be one reason recent MBA students have shown more interest in starting or working for nontechnical companies. "More people understand the game now, so it's harder to attract employees for venture capital-backed companies," said Klein. "Everybody expects industry-average salaries plus stock and to take pretty much no risk at this point. On the other hand, as CEO I want the best people I can get. One of the lessons I learned from my first startup to my second is always hire

the best you can and hire them early."

Today there is "lots of deal flow," said Marquardt of August Capital, a private equity firm he cofounded in 1995, "not like the peak in 1999 or 2000 but better quality. The late nineties era of free capital [was driven by] tourists, interlopers. They came and they've gone," he said. "The thing that gets me up in the morning is the opportunity to build companies with lasting value. I was involved in the very early days of Microsoft and Sun Microsystems, Adaptec and Linear Technology, all still great companies. It has been a wonderful career."

For Beal, his class project also has turned into long-lasting satisfaction. His is now the oldest continuously operating African American-owned investment bank in the country. The industry has become more volatile, more regulated, and more competitive, he said, all aspects he researched for his class project. "We grew the business to 280 people with offices around the country and in Africa. We brought it down to 35 people, now back up to 85, and we are probably going to take it to 125 people," he told his classmates at the June reunion. In short, he said, "I've had a lot of fun with the plan I developed here." ■

"The thing that gets me up in the morning is the opportunity to build companies with lasting value." —David Marquardt

Training for the TOP

WHILE THE ENTREPRENEURIAL PANELISTS FROM THE CLASS OF '79 acquired some of their skills in Business School classes, not nearly as many MBA students focused on entrepreneurship then as now. Today, fully one quarter of the enrollments in second-year electives are in entrepreneurship-related courses, according to professor Garth Saloner, who traced the remarkable growth of the School's Center for Entrepreneurial Studies for the '79 class at their June reunion.

About 95 percent of Stanford MBA students take at least one entrepreneurial course, making entrepreneurship a core subject by election. Entrepreneurship classes may be the place where today's MBA students confront most directly the general manager's day-to-day conundrums, Saloner said. "A lot of the core courses tend to be functionally focused, but what happens in entrepreneurship is that you have companies of the size you can get your arms around."

The Center for Entrepreneurial Studies was created in 1996 under

former dean Michael Spence by faculty members Charles Holloway and H. Irving Grousbeck. Today, 10 tenure-line faculty teach in a curriculum of 21 courses, many alongside 12 entrepreneurial practitioner-teachers. Students are exposed to still other entrepreneurs, many of them alumni/ae, who serve as mentors or as panelists when student teams present their business plans. Students run annual conferences on entrepreneurship and private equity investing that contribute to the entrepreneurial atmosphere. The center also helps support summer internships for some students working in cash-starved startups.

The center has produced 170 cases. When a case is presented in class, the protagonist frequently sits in the back of the room while the professor provides frameworks to help students draw lessons from it, Saloner said. "Then the person stands up, says, 'That was a nice theoretical discussion; let me tell you how it really was.' Or, 'We thought of that, but it was not practical for these reasons.'"

The model has proved "terrific for students and fabulous for us" faculty, Saloner said.



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Educational Reformer Anthony Bryk Joins Faculty

ANTHONY BRYK, whose research has informed major school reform in Chicago and elsewhere, joined the Business School faculty in September. An expert in school organization, accountability, assessment, and educational statistics, he is the Spencer Professor of Education and of Organizational Behavior at the Business School and in the School of Education. He has an office in each school and teaches courses pertaining to the joint MBA/MA

Harvard, Bryk said he hopes to work with colleagues, alumni/ae, and students of the Business School who are interested in organizational enhancement. “Many of the core problems of school improvement are really organizational—how to develop better human resources, the startup of new charter management organizations, and the strategic redesign of complex bureaucracies,” he said. “These are problems that have been confronted in the private sector, and I hope to help bridge the divide between the two.”

THREE FACULTY MEMBERS recently published new books. They are *The Modern Firm: Organizational Design for Performance and Growth* by **John Roberts**, *The Highest Goal: The Secret That Sustains You in Every Moment* by **Michael Ray**, and the fourth edition of *Strategic Management of Technology and Innovation*, coauthored by **Robert Burgelman**.

The last takes the perspective of the general manager at the product line, business unit, and corporate levels, and addresses the interaction among them. About 40 percent of the case studies included are new with this edition.

Ray’s book is based on insights gleaned from 25 years of teaching personal creativity to Business School students. He includes exercises for developing one’s highest goal and cites alumni/ae who have found theirs and so contribute in new ways to their organizations, families, and communities.

Roberts looks at firms that are experimenting with new organizational designs, routines, and cultures to improve their performance. He develops frameworks for analyzing the interrelationships and argues that successful organizations go about change in a holistic manner.

FIVE JUNIOR SCHOLARS have been added to the Business School’s tenure track this fall. They are **Gráinne Fitzsimons**, **Ilan Guttman**, **Alan Jagolinzer**, **Stefan Nagel**, and **Ilya Strebulaev**.

Fitzsimons, an assistant professor of marketing, conducts her primary research into automatic processes in interpersonal relationships and self-regulation. She has shown that different situations can automatically

activate different portions of the self-concept and influence subsequent behavior. She received her PhD from New York University last spring.

Guttman and Jagolinzer are both assistant professors of accounting. Guttman’s research interests are in corporate finance and economics of information. He recently received his doctorate in economics from Hebrew University of Jerusalem. Jagolinzer, whose doctorate is from Pennsylvania State University, has research interests in empirical financial accounting, especially the interaction among managers of firms and capital markets.

Nagel and Strebulaev are assistant professors of finance. Nagel pursues research in asset pricing, institutional investors, and behavioral finance. He received his PhD in finance from London Business School in 2003.

Strebulaev has research interests in financial auctions, liquidity, credit risk, and capital structure. He received his doctorate in finance from London Business School this spring.

AN ARTICLE TITLED “The End of Business Schools? Less Success than Meets the Eye,” by Business School professor **Jeffrey Pfeffer**, PHD ’72, and **Christina Fong**, PHD ’03, has received the best paper award for 2002–03 in the journal *Academy of Management Learning and Education*.

Members of the journal’s editorial board chose the paper, published in its inaugural 2002 issue, as the outstanding work published in its first six issues. (It was summarized on page 9 of the November 2002 issue of *Stanford Business*.)

Arguing there is little or no evidence that an MBA degree increased the average recipient’s later earnings, the article subsequently drew a great deal of attention in mass media. An article in the *San Francisco Chronicle* (Aug. 27, 2002), for example, quoted Pfeffer: “It’s been in the wind for a long time, the fact that unless you get an MBA from a really top-notch school, the value is not clear.” Pfeffer is the Thomas D. Dee II Professor of Organizational Behavior. Fong is now an assistant professor at the University of Washington. ■



Anthony Bryk brings a focus on educational reform to the Business School.

degree program of the two schools, which produced 12 graduates last year.

Bryk came to Stanford from the University of Chicago, where he founded the university’s Center for School Improvement. As director, his goal was to produce people who would “bubble up to leadership positions” in the nation’s third largest public school system. Currently, one of his former students is second in command.

Bryk also created the Consortium on Chicago School Research, a federation of Chicago-area research organizations whose goal is to put pressure on those same leaders by producing research that determines which reforms work and which don’t.

An organizational sociologist who earned his doctorate in educational statistics at

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JUNE 19-JULY 15, 2005

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Photo: L.A. Okamoto/Stanford News Service

House Price Inflation Helps Some, Hurts Others



IF YOU SOLD A HOUSE anywhere in the country within the past 20 years, chances are you made something of a killing. Housing prices have risen steadily for decades, up 7 percent a year since 1995—and as much as 12 percent a year in the San Francisco Bay Area. This has been taken to be great news for homeowners, but terrible news for home buyers. Rising prices have meant more and more first-time homebuyers are being locked out of the market.

Stories of consumers struggling to scrape together down payments and meet expensive mortgages are legion, but are people as a whole worse off now as a result of the rise in housing prices? No, say researchers Lanier Benkard, Patrick Bajari, and John Krainer in a recent study. In fact, they conclude, the net effect of house price inflation on consumers has been virtually nil.

Benkard, associate professor of economics at the Business School; Bajari, associate professor of economics at Duke University; and Krainer, an economist with

the Federal Reserve Bank in San Francisco, have found that losses that buyers incur are exactly offset in the larger economy by the gains accrued by sellers. “A person buying a house will pay a high price, and the person selling will acquire that money,” says Benkard. “The aggregate effect of all those transactions means that, overall, there is no net loss to consumers. Assets are simply redistributed among them.”

The situation is different, he explains, when prices rise on consumable goods, such as oil. “Once oil is used, it’s gone, and there’s no way of recouping what you paid for it,” says Benkard. “So when prices rise on non-durable goods, consumers, in general, are hurt. The money goes to someone else outside the consumer pool.”

Unlike house price inflation, the rising price for construction and renovation has actually cost consumers \$127 per year, the researchers found. Consumers who buy newly constructed houses or pay maintenance costs on homes they own “lose” a small amount to builders and contractors, but it could be worse. “In the grand scheme of things, \$127 a year isn’t very much,” says Benkard.

The study provides a fresh look at how house price inflation affects the economy. In discussing house price inflation, Benkard says: “The press says that it’s bad for the economy because it [price inflation] prevents people from being able to afford to buy. The Fed, however, says it’s good for the economy because theoretically it gives people more assets to work with, and therefore should stimulate spending. Ours is the only paper that tries to look at both these effects together.”

The rising housing market has been a mainstay of the U.S. economy during the slump of the past few years, with housing costs making up about a third of the consumer price index. About 70 percent of the population owns homes, says Benkard.

Interestingly, one place in the country where the findings of the study don’t quite hold is the San Francisco Bay Area. “The market there has a higher percentage of young people and renters than does the rest of the country,” Benkard says. “These populations are always worse off when housing prices rise because they are less able to afford to buy. So in this localized economy, where house price inflation has been particularly high, consumers have experienced more net loss than people across the country as a whole.”

Those lucky citizens who own the foundation under their feet, says Benkard, “are essentially being paid to live in a home, once their total costs and selling price over time are taken into consideration.” For nonowners, the discovery that house price inflation does not have much of an effect on consumers as a whole may

BRIAN CAIRNS

be cold comfort. Benkard sympathizes but says: “It’s not the job of the economist to determine whether these movements are good or bad, but rather to observe and describe what’s going on.”

— MARGUERITE RIGOGLIOSO

“House Prices and Consumer Welfare,” Patrick Bajari, C. Lanier Benkard, and John Krainer, *Stanford Research Paper No. 1840*, January 2004.

Health Care Economics

Why Your Angioplasty Costs More than Mine

IT’S A POORLY KEPT SECRET in the health care industry that nobody—except maybe the uninsured—pays list price for hospital services. State deregulation of hospital pricing has pushed insurance companies into aggressive negotiations with hospitals to get the best deals, and the resulting discounts vary greatly from insurer to insurer. But why some insurance companies get much better deals than others has only been guessed at until recently, when Alan Sorensen, an assistant professor of strategic management at the Stanford Graduate School of Business, began researching the topic.

“The conventional wisdom was it was all about volume,” says Sorensen. “The bigger you were, the bigger discount you could get.” This notion is so pervasive that some industry insiders believe it may have led to the consolidation waves of the 1990s, when both insurers and hospitals raced to increase their bargaining clout by becoming bigger.

“That explanation never really did it for me,” says Sorensen. After all, even some small insurers were able to negotiate substantial discounts.

The real key, Sorensen suspected, was not size per se (that is, not the total number of patients the insurer represents) but rather the ability of insurers to take their business elsewhere. “In any bargaining situation, the more credible your threat to withdraw from the bargain, the better you’re going to come out in the negotiation,” he explains. For insurers, he reasoned, the bargaining power comes from the promise to channel all or most of their patients to a small set of hospitals, those who’d agree to substantial price breaks. This would mean that traditional indemnity health coverage plans, which offer enrollees free choice on where they get their medical services, would pay more for hospital services than insurers with restrictions on access, such as preferred provider organizations (PPOs) that limit reimbursements for hospital visits outside their network or health maintenance organizations (HMOs) that typically have even more restrictive plans.

But while this insight is intuitive, finding the highly confidential pricing data to test the idea proved tricky. The one exception was Connecticut, whose deregula-

tion laws required every hospital to list overall discounts for each insurer. Thus, while Sorensen couldn’t compare the price of, say, an appendectomy negotiated by insurer A versus insurer B, he did know which insurers had negotiated aggregate discount levels at a particular Connecticut hospital. As expected, the discounts varied greatly. At a single hospital one payer might be getting a discount of 3 percent while another had negotiated 25 percent. And, as predicted, managed care plans (PPOs and HMOs) were getting bigger discounts than traditional indemnity plans.

But that data wasn’t enough to show that better discounts were going to insurers because they were pushing their customers to certain hospitals. Other reasons—such as size of the insured population—could explain differences in negotiated price. Besides, Sorensen wanted to show why even insurers of the same type, say, the CIGNA PPO in Hartford and another regional PPO, were getting different prices from the same hospital. So Sorensen needed data showing actual charges incurred by different payers at the various hospitals. Luckily, this charge data for almost all the hospitals was available from the Connecticut Hospital Association.

By merging the discount data with the charge data, Sorensen could at last perform the kind of analysis needed to test his hunch. “For plans that can channel their patients, you should see big discounts associated with big market shares,” he explains.

And, indeed, he found that in cities with two competing hospitals—such as New Haven’s St. Raphael and Yale hospitals—insurers that didn’t receive a good discount from a given hospital incurred few patient charges there. In other words, the insurer channeled few patients to the hospital that offered the worst negotiated rate, just as Sorensen had predicted. And, on the whole, HMOs received substantially better discounts than did PPOs. Sorensen’s estimates suggest that while an insurer’s size does affect bargaining clout, the impact of size is small compared to the impact of the insurer’s willingness and ability to control the flow of patients to one hospital or another.

Fair enough, but it’s easier said than done. “Although it seems clear that [health care insurers] can increase bargaining power by tightening their network, the cost is that consumers don’t like it,” says Sorensen. If patients are loyal to a particular hospital because of its reputation in labor and delivery, for example, or because it’s the only hospital that can perform a particular procedure, insurers can’t credibly threaten to completely exclude that hospital from their network.

The same tradeoff to restrictiveness may well hold in other industries, Sorensen believes. Retailers can negotiate big discounts with manufacturers by promising to stock their brands exclusively, but merchants risk losing their customers to stores that offer wider selection. ■

— MARINA KRAKOVSKY

“Insurer-Hospital Bargaining: Negotiated Discounts in Post-Deregulation Connecticut,” Alan T. Sorensen, *The Journal of Industrial Economics*, 2003, 4 (December).

At a single hospital one payer might be getting a discount of 3 percent while another had negotiated 25 percent.

A Second Chance Can Make All the Difference



IT'S YOUR BIG NIGHT. You've somehow landed at the same party as the CEO of your dream company. You want desperately to impress him, but when you're introduced you find yourself trying too hard, talking too loudly, and even blurting out an off-color remark. You know this is not who you really are, but the expression on the guy's face makes it plain: You've blown it.

According to Jerker Denrell, assistant professor of organizational behavior at the Business School, what's key in dispelling negative images is making sure you get a second—and third and fourth—chance. Having the opportunity to show different sides of yourself to bosses and colleagues in numerous situations—both social and professional—is, in fact, critical to your career advancement.

From his research, Denrell concludes that when someone makes a negative impression on us, we're less likely to seek out that person again, making it difficult to gather additional information that could change our first impression. If, however, external factors force further interaction, there is opportunity to soften the first

negative judgment, if not reverse it altogether.

The problem has interesting workplace implications, particularly in environments where social activities are encouraged outside of work. "People tend to socialize with those who are similar to themselves in terms of gender, race, educational level, and so forth," Denrell says. In most organizations, for example, men tend to socialize with other men in bars or on golf courses. By getting to know one another better, they have the opportunity to change an incorrect negative opinion as they learn about that person's other qualities and strengths. But because men don't usually interact in this way with women coworkers, they don't have the same opportunity to alter false negative evaluations. The same phenomenon similarly affects people who are members of minorities or perceived to be in any sort of "out" group in an organization.

Such a dynamic can have serious consequences for people's careers. Individuals who actually possess similar skill levels may be evaluated differently simply because they have different social ties. People who come

across badly early on—whether due to real errors or biased perceptions on the part of their evaluators—can be disadvantaged when it comes to promotions because they don't have the same opportunity as others to interact with their evaluators and correct the poor image.

The power of second chances is a fairly intuitive but overlooked phenomenon in social psychological research. "Most of the literature of the past 50 years has stressed how our stereotypes and expectations about others influence the way we perceive them and what we remember about them," Denrell explains, but that's not the whole story. The research doesn't consider that when we have a negative reaction to someone, we generally try to avoid the person in the future and so never gather additional information. "Even if it were possible to evaluate that individual in a completely objective fashion—without stereotypes or expectations—a bias would still remain because we end up working with only limited information," he notes.

Denrell's broad area of research involves how people learn. "In learning, if you care only about accuracy, the ideal practice is to gather a lot of information about

each alternative,” he says. This, however, costs time and energy, so people often have to decide what and whom they want to learn more about. As a result, they are more likely to follow up on people they like rather than laboring to find out more about those who rub them the wrong way.

Organizations that are serious, then, about promoting diversity and equal opportunity will want to be on the lookout for ways to change those dynamics that prevent people from getting to know others outside their usual crowd. “Companies may want to establish more formal mechanisms that promote interaction among different groups of people, for example,” Denrell concludes.

—MARGUERITE RIGOGLIOSO

“*Why Most People Disapprove of Me: Experience Sampling in Impression Formation*,” Jerker C. Denrell, GSB Working Paper, 2004.

Marketing

The Psychology of Product Release

IF YOU’VE EVER AGONIZED over whether it’s the right time to replace an old gadget with a spiffy new model—knowing that the new one may well become obsolete in a few months—you probably have an inkling of the kinds of decisions high-tech marketers must make in planning their products. And if you’re marketing such products yourself, you probably have puzzled over when to time each release. Which bells and whistles should you introduce first? And how do you price the upgrade to make it attractive to existing users?

To help planners of high-tech consumer products make these sorts of decisions, V. “Seenu” Srinivasan, the Adams Distinguished Professor of Management at the Business School, and Sang-Hoon Kim, assistant professor of marketing at Seoul National University and a former student of Srinivasan’s, created a mathematical model that forecasts the sales path of a new version of an existing product.

“The model is quite simple,” says Srinivasan. It is based on how much the benefits of the new product (as compared to the old one) outweigh all the factors that typically hinder a customer’s decision to upgrade. For example, a customer is more likely to buy a new PC if it is significantly better than the one she already owns and if the upgrade seems painless and inexpensive. In this model, the hindrances include not only the upgrade’s various costs (financial, procedural, and psychological), but also expectations about how quickly future technological improvements will be made; consumer characteristics (such as innovativeness); and the consumer’s perceptions of the product in general (such as whether or not it saves time).

As might be expected, the greater the gap between the incremental benefit of the upgrade and its hindrances, the greater the probability that the consumer will upgrade within a given month.

Applying this probabilistic model to their retrospective study of the Palm Pilot PDA, Srinivasan and Kim predicted with 76 percent accuracy which volunteers had upgraded to a particular model within a given period. The prediction is significantly higher than the 53 percent accuracy expected through random guesses.

Conducting such a study in the real world is far from simple. First, a random sample of existing customers was asked to grade the importance of various product features—such as price, size, and memory capacity. Customers then filled out a personal questionnaire that measures about a dozen variables such as how guilty they feel about discarding a product that’s still working, expectation of how quickly new versions will continue to come out, the percentage of friends and colleagues who use the product, the time it took the customer to buy the first generation of this product, and even whether the current product was a gift. All the answers feed into a set of complex equations that generate probabilities that translate into time-to-upgrade durations.

Srinivasan estimates the cost of conducting such a study in a real market setting at \$100,000, but the bigger stumbling block may lie elsewhere. New releases of some products like laptops, printers, and cell phones may come so rapidly, says Srinivasan, that some technical managers believe there isn’t time for this kind of market research.

But academicians are excited because the model is an innovative mix of two existing methodologies in marketing science: conjoint analysis and hazard rate modeling. Conjoint analysis, which involves asking a sample of customers from the target market how important they deem different features, has long been used to determine which sets of product features to offer. But because conjoint analysis takes a static snapshot of the marketplace at a given moment, it alone doesn’t answer the sorts of questions intrinsic to product upgrades. Hence the addition of hazard rate modeling, which has traditionally been used to estimate the time difference between a product’s first purchase and subsequent, replacement purchases.

Making only brief mention of his model in his Marketing 343 class, *Customer-Focused Product Planning*, Srinivasan explains it to students in a way that avoids the hairy math. But in the future, the model could become more mainstream if the number crunching can be automated. Vendors, including Sawtooth Software, already offer tools for performing conjoint analysis, he says, and there’s no reason they couldn’t eventually do the same for this methodology.

—MARINA KRAKOVSKY ■

“*A Multiattribute Model of the Timing of Buyers’ Upgrading to Improved Versions of High-Technology Products*,” Sang-Hoon Kim and V. Srinivasan, GSB Research Paper #1720(R), September 2003.

The researchers predicted with 76 percent accuracy which people upgraded to a new model of Palm Pilot.

Newsmakers

WHO'S IN THE NEWS | A Roundup of Media Mentions



A self-described “philanthropic entrepreneur,” Alex Cranberg will provide tuition money for 550 Denver middle schoolers if they graduate from high school.

Opportunity Maker

Alex Cranberg, MBA '81, has pledged to put 550 Denver middle schoolers from financially poor homes through college if they graduate from high school, the *Denver Post* reports. Cranberg, who financed his own college education with scholarships and a summer job as a roustabout in oil fields, sees outside support as critical to his own motivation. He founded Aspect Resources, an independent oil and gas producer that has made millions as a result of early investments in three-dimensional seismic technology.

Explaining his rationale for the \$5 million pledge to Horace Mann School pupils, Cranberg told the newspaper: “Education is not just about gaining skills. It’s also about inspiration. The most important thing anybody

can get out of education is the motivation to make the most of himself or herself.”

49ers Draft Alum to Tackle Debt

Paraag Marathe, MBA '04, has been hired as an assistant to the San Francisco 49ers general manager with the task of rescuing the team from the financial mess it created by borrowing on its future in order to comply with the National Football League’s salary cap.

In the past, the team tried to restructure player contracts to delay expenses. This time it is bidding farewell to veteran players, including seven of last year’s offensive starters, and signing new contracts with young players, according to the *San Jose Mercury News*.

“The whole point is to be a consistently good team without having these one or two down years where you suck it up,” said Marathe, who studied sports management at the GSB. “We just wrote a check to pay off all of our credit cards. When we’re actually clean, we’ll be able to go buy what we want to buy with cash.”

CEO Drives the Stage from the Stage

“It’s a very short move from Who’s Who to who’s that,” Richard Kovacevich, MBA '67, quipped to a reporter recently. The CEO of Wells Fargo has become a media darling because Wells has outperformed larger competitors. Said *Forbes*: “Wells boasts the highest return on assets of the five largest banks (1.7 percent) and the fattest net interest margin (5 percent).”

Since Kovacevich, a former General Mills executive, became CEO more than 11 years ago, added the *Minneapolis Star Tribune*, “the bank’s shareholders have enjoyed a compounded annual rate of 18.9 percent—far outpacing the S&P 500 Index’s 10.7 percent.”

Kovacevich’s success is attributed to his eye for acquisition bargains, his willingness to buck banking trends such as closure of branches, and his instillation of a hokey but strong sales culture. At a sales meeting, he treated his best cross-sellers to “the spectacle of the boss lip-synching to the Beatles in a mop-top wig. It was apropos of nothing,” *Forbes* reported, but “the crowd howled and cheered anyway.”

Said Kovacevich: “I know it influences my company more than sitting in my office thinking of the next big idea.”

Lights, Camera, Allentown?

Following his passion for acting, business consultant Jim Fleigner enrolled at the Business School with hopes of transitioning to the entertainment business. Once inside that industry, however, the 1995 graduate decided that “studio executives are paid to say no all the time” and TV executives don’t have much chance to participate in the creative process either. So he started Hangin’ Hams Productions of Santa Monica and produced a few short films for the festival circuit. Now from a storefront in Allentown, Pa., he is producing and directing a full-length feature about three 12-year-olds during their summer of Little League baseball camp, accord-

ing to the *Allentown Morning Call*. It’s a little more sophisticated than his first hit, an office Christmas party video titled *Rudy, the Brown-Nose Consultant*.

Dialing for the Arts

It may seem old-fashioned to market by telephone, but Sara Billmann, MBA '95, finds the phone useful as director of marketing and promotion for the University Musical Society of the University of Michigan. The oldest college-related performing arts presenter in the country places a high priority on developing new audiences, according to *International Arts Manager*, a business magazine for the performing arts. These efforts require “mass customization” marketing, Billmann told the magazine, which involves finding out when and how individuals prefer to be contacted. “Some of our greatest moments have come from those occasions when we’ve ignored [new] technology,” she said, “and picked up the telephone to talk directly to our audiences.”

For Sara Billmann, a simple phone call can determine how to serve the diverse audiences she is trying to reach.





ANDREW HETHERINGTON

Investors Grow Small Businesses

Venture capitalists on Main Street? You may ask why. **Dan Levinson**, MBA '88, asked why not. The former Wall Street banker started Main Street Resources in Westport, Conn., with \$22 million from 90 entrepreneurs and executives interested in his idea of investing \$2 million to \$10 million in existing small businesses that could be grown. The U.S. Small Business Administration has since kicked in \$44 million, according to *Fortune Small Business*. "Most financial firms view themselves as four people sitting in a room writing checks," Levinson said. "We view ourselves as a real company, with a strategy of taking care of our CEOs and our investors."

Managing Risk During the Enron Hangover

Mayo Shattuck, MBA '80, deals with the specter of Enron despite his recent successes using risk management in the energy industry, according to the *Economist* and *SmartMoney* magazines. The former investment banker became chief executive of Constellation Energy Group in late 2001, not long after Enron brought disrepute to the power-merchandising business. Constellation is the energytrading arm of BGE, the regulated utility in Baltimore. Using futures, options, and

derivatives, he hedges every type of risk from interest rates to weather, the publications said, but that didn't stop Standard & Poor's from downgrading Constellation's debt largely on the belief that risk management is a risky business. Shattuck disputes this but acknowledges that energy companies need to repair lost confidence. He may be reading the third edition of the book *Managing Energy Risk*, published by Risk Books, which features a chapter on volatile energy prices coauthored by Business School finance professor **Darrell Duffie**.

Trivia Has Been

Attention, hoops fans: Who is the highest National Basketball Association draft pick in Stanford Cardinal history? If you answered Josh Childress, the sixth player to be drafted this year, you are correct, but Business School alums will get an A if they said **Rich Kelley**, MBA '89. Kelley now scouts for the Utah Jazz, the team that drafted him seventh in 1975 when it was still in New Orleans. Just before this year's draft, Kelley mused to the *San Jose Mercury News*, "I guess I'm a trivia question that's about to be obliterated."

Members Only, Cyber Style

What is the theory behind Orkut.com, a Google networking website that requires an invitation to join? "There are

Dan Levinson often calls on investors at his company, Main Street Resources, for advice and business leads.

lots of old-style country clubs that operate in exactly the same way," Business School professor **Chip Heath** told *Psychology Today*. That doesn't mean such websites will be as successful as their creators hoped. "An important part of real networking is vouching for somebody who is introduced," explained the social psychologist. "By automating that process, you make it less effective."

And then there is the fact that some Orkut memberships have made their way to eBay.

No Ties Required

Some folks think the Silicon Valley's tieless culture is a relatively recent phenomenon, but **George "Skip" Battle**, MBA '68, the executive chairman and former CEO of search engine company Ask Jeeves in Berkeley, reminds us that it dates back at least to the 1960s. After growing up in rural Rhode Island and attending pastoral Dartmouth, Battle chose the Stanford Business School because it was the only top business school where students didn't have to wear a tie every day, he recently told the *Oakland Tribune*.

Battle tied his neck up, however, by making partner at Arthur Andersen and helping launch the consulting branch that has since become Accenture. He later joined the no-ties-required search engine company to help it stave off collapse during the dot-com meltdown.

Protecting Treasures

If you don't want your life upset, beware of who you hike with. **Jeff Morgan**, Sloan '98, was hiking on Santa Cruz Island when a friend who had directed the California Nature Conservancy ambushed him. "Jeff, you've sure got a lot of energy. Why don't you do something to help the world out?"

Once a software sales execu-

tive, Morgan now travels one month out of three to places that often lack air conditioning, according to the *San Jose Mercury News*. He is the founder of the Global Heritage Fund, which tries to save archeological treasures. Projects with philanthropic partners and volunteers include preservation of an ancient town in China, royal tombs in Pakistan, and a Mayan civilization in Guatemala.

Behind the Headlines

Don Graham, SEP '83, who has headed the Washington Post Co. since 1991, "just might be the nation's most underrated CEO," *Fortune* editor Andy Serwer said in a recent column. The company's stock is up more than 50 percent over the past two years. Mentored by his mother, the late Katherine Graham, and investor Warren Buffett, Don Graham is a "model



Washington Post CEO for 13 years, Don Graham has quietly and effectively deployed capital for a more diversified company.

of integrity, modesty, and professionalism," but also "guarded and measured to a fault," the editor said. Buffett, the Post's lead outside director, said one of Graham's strengths is his redeployment of capital, because all newspapers will gradually see their competitive positions erode. The Post's fastest growing business is Kaplan Inc., the company that offers test preparation and other supplementary education services. ■

EVAN KAFKA



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*Edmund W. Littlefield Professor
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Strategy is Destiny:
A Perspective on
Strategic Leadership

V. Seenu Srinivasan

*Adams Distinguished Professor
of Management; Director of
the Strategic Marketing
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Brand Equity: Measuring,
Analyzing, and Predicting

upcoming events

November 10: Student-organized energy conference, 12:30 p.m.

November 17: France alumni chapter business lunch with guest speaker Francis Mer, former French minister of finance, in Paris

November 18: Student-organized marketing summit, 6–9 p.m., with speaker Paul Pressler, CEO of Gap

December 8: “Life Lessons from the Playing Field,” an executive education breakfast briefing by Jim Thompson, MBA ’86, executive director of Positive Coaching Alliance

January 6–12: Executive forums in India featuring sessions with School professors Seenu Srinivasan and Robert Burgelman in New Delhi on January 6, Bangalore on January 10, and Mumbai on January 12

January 12: “Nurturing Innovation in Companies Large and Small,” an executive education breakfast briefing by Judy Estrin, cofounder and CEO of Packet Design and chairman of two spinoffs

February 4–6: “GSB Back to School: Business Updates for Early Adopters,” a residential alumni education program with GSB professors

February 9: “Don’t Just Set Prices: Manage Them Strategically,” an executive education breakfast briefing by Tom Nagle, founder, president, and CEO, Strategic Pricing Group

February 23: Arbuckle Award Dinner honoring Robert Bass, MBA ’74, president, Keystone Inc., Arrillaga Alumni Center

March 11–12: Stanford International Alumni Conference in London

April 12: Excellence in Leadership Award Dinner honoring Herbert M. Allison, MBA ’71, chairman, president, and CEO, TIAA-CREF, at the Union League Club, Manhattan, New York

April 29–30: Spring reunions for MBA classes of 1990, 1995, 2000, and 2004, plus Half Century Club reunion for the classes of 1925–1954 on April 29

June 16–19: MBA 25th reunion for Class of 1980

All events are on campus unless otherwise specified. To register for an event, send an email to gbsb_newsline@gsb.stanford.edu. We will send you the appropriate Web link by return email. For events not open to the general public, you may need your GSB password to register.

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2005 Executive Education

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CHANGE THE WORLD

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Stanford Executive Program
June 19 – August 2

Executive Program for Growing Companies
July 17 – 29

**Stanford – National University of Singapore
Executive Program in International Management
(in Singapore)**
July 31 – August 19

Executive Management Program: Gaining New Perspectives
(at Stanford Sierra Conference Center)
September 18 – 24

Financial Management

Credit Risk: Pricing and Risk Management
April 17 – 22

Finance and Accounting for the Nonfinancial Executive
May 1 – 6 and November 6 – 11

Financial Management Program
July 10 – 15

Marketing

Strategic Marketing Management
August 14 – 24

Negotiation

Negotiation and Influence Strategies
April 3 – 8 and October 16 – 21

Advanced Negotiation Program
April 17 – 22

Leadership and Strategy

Leading Change and Organizational Renewal
March 6 – 11 (at Harvard)
October 30 – November 4 (at Stanford)

Corporate Governance Program
May 31 – June 3

Managing Teams for Innovation and Success
June 5 – 10

Executive Program in Leadership: The Effective Use of Power
July 10 – 15

Executive Program in Strategy and Organization
July 17 – 29

**Mergers and Acquisitions:
Creating and Claiming Shareholder Value**
August 14 – 19

**Human Resource Executive Program:
Leveraging Human Resources for Competitive Advantage**
September 18 – 23

Nonprofit and Philanthropy

Executive Program for Nonprofit Leaders
February 27 – March 10

Strategy for Nonprofit Organizations
March 16 – 18

Executive Program for Nonprofit Leaders — Arts
(in partnership with National Arts Strategies)
June 19 – July 1

Executive Program for Educational Leaders
July 3 – 8

Executive Program in Philanthropy **NEW!**
July 31 – August 5

Technology and Operations

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