# Inefficient markets

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Corporate eugenics

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It is becoming clear that corruption at Enron was not confined to the higher echelons, but was widespread throughout the firm. This corruption appears to have been engendered by a combination of overly-demanding profits targets and management's practice of weeding out supposedly "under-achieving" employees. Such practices have become commonplace among America's top companies. In Enron's case it seems that the crooks cooked up the profits, while the honest objectors were let go.

During the late bull market, companies which wished to receive the highest rating on Wall Street aimed to produce steady earnings growth of 15 per cent a year. To sceptics, this was an absurd target, since the economy was growing in nominal terms (including inflation) at about 6 per cent a year, at a time when corporate profits as a percentage of GDP were actually falling. Furthermore, companies' profits are subject to so many unforeseen variables that a high degree of earnings volatility is normal. To the astonishment of the sceptics, however, companies almost achieved their goal. According to Fortune magazine, between 1995 and 2000 US corporate profits grew at around 14 per cent annually.

One cause of this extraordinary performance was said to be the vast improvement in US management practices during the second half of the 1990s. General Electric, for instance, pioneered a policy known as "forced ranking," by which the workforce was subjected to a bell-curve analysis, with employees ranked according to performance. Under this system, 20 per cent of employees are graded over-achievers, 70 as pedestrian, and the remaining 10 per cent deemed under-performers. Those who draw the short straw are told to improve or be "terminated."

Enron, a trend-setting company stuffed with MBAs, aggressively pursued a policy of "rank and yank." Twice a year, its employees were graded on a five-point scale with 15 per cent falling into the bottom rank. Until recently, this policy of corporate eugenics was widely praised. Last year, Fortune ranked Enron as the number two company in the US for "getting and keeping talent."

As we now know, things were not as they seemed. According to Frank Partnoy, a derivatives expert who testified recently before the US Senate hearings, Enron's traders employed tricks in order to produce the steady stream of earnings demanded by management and Wall Street. Partnoy claims that the traders set aside excess profits in "prudency" reserves, which could be used to pad out the next quarter's earnings.

Because Enron had created many of the markets in which it operated, such as the trade in weather futures, its traders were able to fabricate the value of the contracts they entered into. It is now claimed that junior staff were sacked for attempting to ascertain the market value of Enron's derivative positions from rival energy-trading firms. I have been told that when employees in another part of the firm wished to enter into a genuine contract to deliver a certain amount of natural gas in five years time, traders exerted pressure to cancel the deal which would have exposed their own rigged valuation methodology.

Salesmen at Enron Energy Services, which provided services to other firms, also entered into long-term contracts whose profitability was inflated. Once again, junior staff were bullied into accepting the false assumptions in these contracts. How could this happen? It seems that the "high performers" who met the demanding quarterly earnings targets dominated the bi-annual performance committees. Anyone who failed to come up with the required profits, or who dissented from the manner in which these profits were contrived, was shown the door.

Those with long memories will recall that during the late 1980s Japanese corporate practices-such as the promise of lifetime employment and a consensual decision-making process-were hailed as

the source of Japan's vitality. When the bubble economy collapsed the very same practices were deemed to be responsible for many of Japan's problems. In recent years, US politicians, corporations and media have lectured the rest of the world on the superiority of US management. Will the collapse of Enron give them second thoughts?

## Lucky fools

"Survival of the least fit" might be a fitting epitaph for Enron. In fact, it is an intriguing chapter-heading in a recent book, Fooled by Randomness, by an American derivatives trader. Nassim Taleb argues that the world is populated by what he calls "lucky fools." These are people who appear outwardly successful, but who are really benefiting from what economists term "survivorship bias."

Take a collection of 5,000 people-they might be fund managers or senior executives-and imagine that, at random, half of these fail each year. After five years, around 300 of them will have performed well every year. Given man's natural vanity, the survivors will be inclined to view their success as owing to special qualities rather than good fortune, and expect to be paid accordingly.

Randomness is so pervasive, says Taleb, that in many walks of life it is impossible to tell who is a fool and who is a genius. But the longer a fool stays in the game, the more likely he is to be exposed. Over the past year, many top executives have been kicked out after their companies stumbled. Is it possible that men like John Mayo at Marconi and Peter Bonfield at BT were simply lucky fools whose time was up?