Shift Index 2011: The Most Important Business Study - Ever?

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Shift happens. And, if we can measure shift, we can manage it.

John Hagel, John Seely Brown & Lang Davison

At a time when much of our current business writing resembles the self-help, the science fiction or the even romance novel section of the bookstore, it is wonderful to have the 2011 edition of the Shift Index issued by Deloitte's Center for The Edge. This magisterial study of the performance of 20,000 US firms from 1965 to date shows us not just gossip, froth and bubble, but the underlying drivers of corporate performance in great detail. In an economic downturn, it is all too easy to fixate on cyclical events, and lose sight of the deeper trends of longer-term change. The Shift Index thus goes deeper than the business press which shows the twists and turns in the winding corporate road, without ever giving us a clear picture of where the road is leading. It provides a clear, comprehensive, and sustained view of the deep dynamics changing our world. It documents what it calls "the Big Shift".

Years ago, if you wanted something more substantive by way of data, you could go to the Composite Index of Leading Indicators. In the 20th Century economy, that was often good enough. It showed hours worked, unemployment applications, orders for capital goods, new building permits and the like. For the 21st economy, those indicators lag behind real changes and don't show qualitative transformations already well under way. Using the Composite Index to track shifts in business today is like driving a car by staring into the rearview mirror. By contrast, the Shift Index lets us look out the front windshield.

The Shift Index 2009

As the authors of the Shift Index, John Hagel III, John Seely Brown, and Lang Davison, said with the first edition of the Shift Index in 2009:

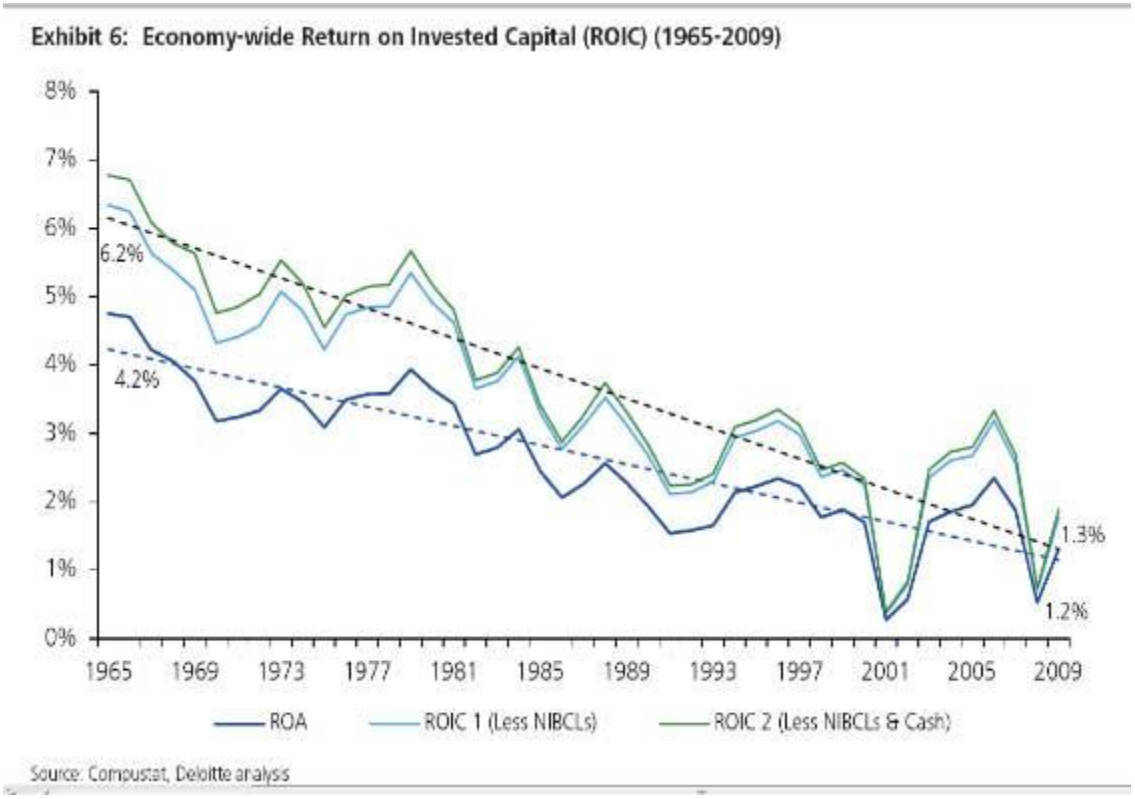
A seemingly endless stream of books, articles, reports, and blogs make similar claims: The world is flattening; the economy has picked up speed; computing power is increasing; competition is intensifying. Though we're aware of these trends in the abstract, we lack quantified measures. We know that a shift is underway, but we have no method of characterizing its speed or acceleration or making comparisons. Are rates of change increasing, decreasing, or settling into stable patterns (e.g. Moore's Law)? How do we compare exponential changes in bandwidth to linear increases in Internet usage? Without times series data and a methodology for integrating those data, we cannot identify, anticipate, or plan for change. The Deloitte Center for the Edge fills that void.

The Shift Index builds on Richard Foster's book, Creative Destruction (2001) which showed that the life expectancy of firms in the Fortune 500 had declined from 75 years half a century ago to less than 15 years.

The Shift Index confirms that trend and shows us why. First published in 2009, it analyzes the long-term underlying performance of 20,000 US firms from 1965 to 2009 and shows for the first time the drastic decline in the performance of those organizations, particularly the 75% decline in the rate of return on assets over that period. Labor Productivity modestly improved over the same period, but the gains of that productivity were mostly captured by "talent" (more on "talent" below) on the one side and customers on the other.

The Shift Index 2010

In the Shift Index 2010, the analysis was extended to the rate of return on invested capital and on equity. These new analyses showed essentially the same decline. It also showed why adding intangible assets into the picture, merely increase the denominator: ROA performance deteriorates even further.



What's new in the Shift Index 2011?

The Shift Index 2011, published just over a month ago, shows that while there has been a modest improvement in the rate of return on assets (ROA) over the past couple of years as the downturn eases up, this appears to be a short-term adjustment similar to the improvements in ROA seen in previous economic cycles. The long-term deteriorating trend is still an underlying reality. The

authors see no reason to believe that these short-term adjustments, achieved largely through significant layoffs, mark a reversal of the long-term trend.

- The ROA Performance Gap between winners and losers continues to increase, with the "winners" barely maintaining previous performance levels, while losers experience rapid deterioration in performance.
- The "topple rate," the rate at which big companies lose their leadership positions, has more than doubled, suggesting that "winners" are in a precarious positions.
- Competitive Intensity in the United States has more than doubled during the last 40 years.
- The exponentially advancing price/performance capability of computing, storage, and bandwidth is driving an adoption rate for our new "digital infrastructure" that is two to five times faster than previous infrastructures, such as electricity and telephone networks.
- The full study also shows how these disruptive forces are affecting US industries at varying speeds. Ironically, those least affected by disruption are those industries most controlled by regulation: aerospace, defense, and health care.

Next steps for the Shift Index 2012

Since three editions of the Shift Index have already given us so much, it is tempting to ask for more in the 2012 edition. On my wish list are the following:

(a) the global picture: the Shift Index focuses on US firms. How does the scene look when you include the Global 1000 firms? My sense from talking with many international firms that the picture described in the Shift Index is not limited to the US. It would be useful to get confirmation with hard data.

(b) the inverse relationship between executive compensation and corporate performance;

(c) some disaggregation of "talent" into its component parts, particularly (i) executive compensation; (ii) financial sector compensation and (iii) the rest.

(d) more success stories of firms that are successfully coping with the Big Shift.

The inverse relationship between compensation and performance

The Shift Index shows how starkly real corporate performance is declining. The rate of return on assets and the rate of return on invested capital are today less than one third of what they were in 1965. Yet during this period, we know that executive compensation has been growing exponentially. In the decade from 1980 to 1990 , CEO compensation per dollar of net earnings produced *doubled*. From 1990 to 2000 it *quadrupled*. Since then, the pace has accelerated further. It would be illuminating if the Shift Index 2012 could shed some light on this extraordinary phenomenon.

The disaggregation of talent

This in turn would require a disaggregation of what Shift Index calls "talent". The study has repeatedly said that one of the reasons for the declining performance is that firms are caught in a

squeeze between "customers" who are exerting customer power and "talent" which is claiming an increasing share of the modest productivity gains that have been realized.

What exactly is included in "talent"? On page 142 of the full study, we learn that "talent" here means the categorization of jobs that make up the "creative class" in Richard Florida's wonderful book, *The Creative Class*. Florida thus categorized the Bureau of Labor Statistics occupational classifications into five classes: the super-creative core and creative core, including management, sales and financial operations. The Shift Index aggregates all these classes into a single group, which it calls "talent".

A reader might get the impression from calling all these jobs "talent" that these elements are all very positive for the economy. However if we take the inverse relationship between executive compensation and corporate performance, one has to ask whether management's contribution warrants the positive appellation of "talent". It would be helpful to know at least how much of the problem it constitutes.

It would thus be useful to separate out extraordinary gains in compensation documented in Lucian Bebchuk and Jesse Fried's comprehensive book, Pay without Performance), the retirement benefits documented in Ellen Schultz's incisive book, *Retirement Heist* (Portfolio, 2011) and the returns to private equity documented in Josh Kosman's book, *The Buyout of America*, (2005).

Similarly it would be good to separate out the gains made by the financial sector, which, in the views of some, is not contributing to growing the real economic pie. As Gerald Epstein, an economist at the University of Massachusetts has said: "These types of things don't add to the pie. They redistribute it—often from taxpayers to banks and other financial institutions." Tom Friedman is thus not alone in thinking that a lot of the activities here "have no more societal value than betting on whether Lindy's sold more cheesecake than strudel)." How much of losses to "talent" are going here?

After these items are separated out, it would thus be interesting to know how much of gains by "talent" are left. We would then be left the occupations that we normally think of as "talent". One suspects that this residue would actually be a relatively small part of the overall increase in compensation to "talent" as defined in the study. By breaking "talent" into its component parts, one could see more clearly the nature of the problem that business is currently facing.

This might also shed light on why corporate America has paid so little attention to the findings of the Shift Index. Declining rates of return on assets, invested income and equity, accelerating topple rates of business leaders, accelerating executive turnover, combined with exponentially growing corporate compensation, isn't a picture that business leaders are eager to draw attention to. Upton Sinclair's dictum may be applicable here: it is difficult to get to man to understand something when his salary depends on his not understanding it.

More success stories?

What's to be done with this disastrously declining performance? The Shift Index has tended to dwell on the problem rather than the solution. The 2011 edition does include a few boxes

showing how some firms are successfully coping with aspects of the new world, such as e-discovery (page 56), online video (page 59), childrens' games (page 63), cell phones (page 65), law suits (page 67) sommeliers (page 77), oil spills (page 81) and participatory medicine (page 84). But these examples tend to be more about specific management practices than whole companies embracing change.

For the 2012 Shift Index, it would be helpful if there could be more discussion of entire firms that have embraced the principles of Flow. This isn't rocket science and Deloitte's Center for The Edge isn't the only one writing about it. Roger Martin calls it customer capitalism. Ranjay Gulati calls it Reorganizing for Resilience. I've called it radical management. Whatever we call it, it means creating new value for customers and delivering it sooner, with managers acting as enablers of self-organizing teams, coordinating work through the Agile approaches of dynamic linking, reflecting values of radical transparency, continuous improvement and sustainability, and communicating with employees in adult-to-adult conversations. Some firms such as Apple [AAPL], Amazon [AMZN], Salesforce [CRM], have embraced many aspects of this Big Shift. They are showing us what the future can look like, with exponential growth and gains. If we had more firms operating like this, it would be clearer how the disastrous performance of the private sector could be reversed. The Shift Index 2012 could play an important role in showing how this necessary change can happen.

Is there a more valuable business study than the Shift Index? If there is, I don't know of it. What we have here is already wonderful. Given the progressive deepening and broadening of the analysis over the first three editions, I look forward to the 2012 edition with great anticipation.