Profit AND Purpose (and other Keys to Extraordinary Wealth)

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In a boom-and-bust world we can be forgiven for thinking that investing is all about risk and return and the almighty bottom line.

But can ideology and profits actually co-exist, or must investors choose between returns or their beliefs when selecting companies?

For example, would you invest in tobacco giant Philip Morris on the basis that you believed that the stock would outperform over time even if you were opposed to smoking?

Of course it's not just investors that face this perennial moral dilemma — companies also must decide which forces will drive their business. Should management focus purely on deriving maximum profit for their shareholders? Should companies even exist for any reasons other than the pure profit motive?

To contemplate this question I turned to a body of research that has shown that not only can profit and purpose co-exist but that the very existence of both motivating factors are indeed *necessary* for a company to outperform over time.

This co-existence of profits and purpose is one of the key defining characteristics of the most successful companies as documented in the international best selling business book, "*Built to Last*" (first published in 1994).

In the late 1980s, the authors James Collins and Jerry Porras embarked upon an intensive six-year study to examine what sets highly successful "visionary" companies apart from their closest peers[1] (these "comparison" companies while successful, did not have the same stature and performance as the visionary companies).

Collins and Porras found that from 1926-1990, the "visionary" companies had returned $6,356 for every dollar invested versus $955 for every dollar invested in the "comparison" companies. That means in terms of return to shareholders, visionary companies returned nearly 700% more than comparison companies over the investment period.

In turn, the comparison companies selected for the study were also relatively successful, returning shareholders nearly twice the general market returns. The market in general only returned $415 for every dollar invested over the same period.

As an investor then it makes sense to learn how to identify this rare breed of company that is characteristically "visionary".

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[1] Note: A list of the companies included in the study can be found at the end of this article.

To qualify as a “visionary” company as defined by Collins and Porras, a company must:

1) Be a premier institution within its industry
2) Be widely admired by knowledgeable businesspeople
3) Have made an indelible imprint on the world in which we live
4) Had multiple generations of CEOs
5) Have been through multiple product/service life cycles

For investors, this research can provide real insight into selecting outstanding companies that are going to generate superior returns, year in year out. It identifies the very essence of visionary companies and what makes them so successful.

More than Profits

> ***“We are in the business of preserving and improving human life. All of our actions must be measured by our success in achieving this goal.”***
> **— Merck and Company, Internal Management Guide 1989**

In its past, Merck elected to develop and give away Mectzan, a drug to cure painful blindness, to millions of people in the Third World in spite of no obvious financial return.

Merck decided it was not willing to risk *demoralising* its scientists; after all they were working for a company that explicitly viewed itself as being in the business of “*preserving and improving human life”*.

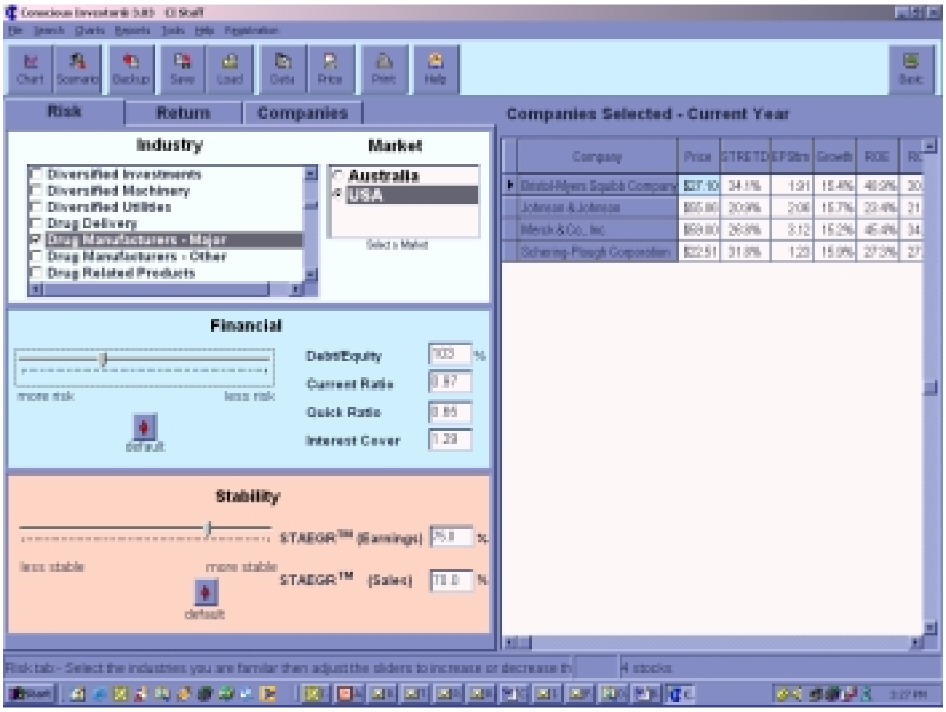
Similarly Merck took a product to eliminate tuberculosis to Japan after World War II in spite of making no money on the initiative. Collins and Porras argue that it’s no accident that Merck is now the largest American pharmaceutical company in Japan.

Throughout its history, Merck displayed both high ideals *and* pragmatic self-interest.

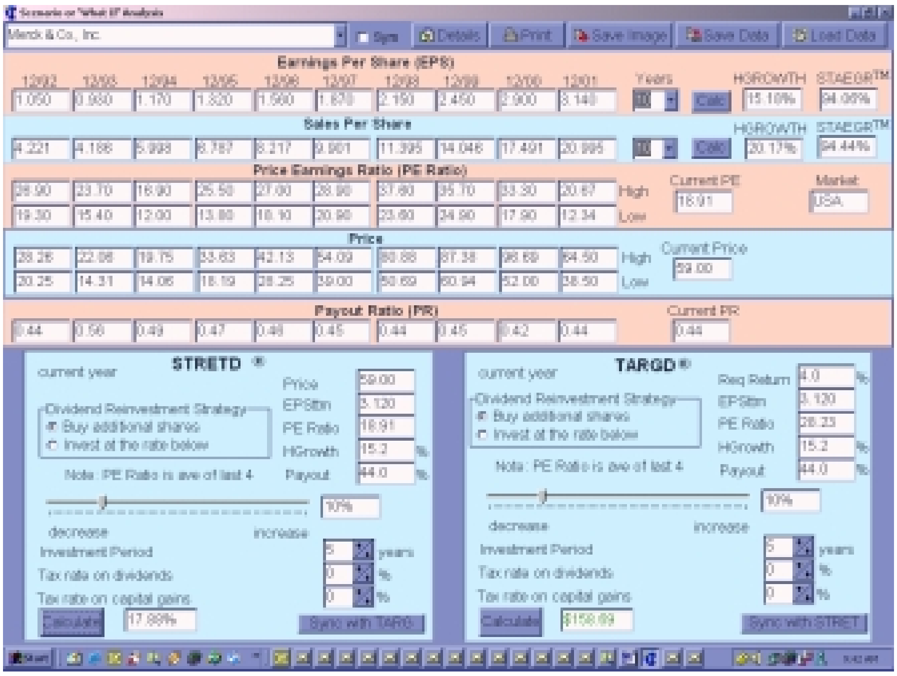
Collins and Porras concluded that what sets visionary companies apart is that they don’t get constrained by the “tyranny of the OR”. Visionary companies pursue both ideology AND profits. Collins and Porras described this phenomenon as the “Genius of the AND”.

Nearly a decade after *Built to Last* was first published, Merck is arguably still a visionary company.

When you select the “Drug Manufacturers – Major” sector within *Conscious Investor* you can see that Merck comes up on the default settings (except on the Financial Risk slider where liquidity measures are slightly less than our required settings).



Using the Current Price Earnings (PE) Ratio of 18.91 but without making any other adjustments to historical data, we can see that the STRETD (or expected STock RETurn) for Merck is estimated to be 17.88% per annum over the next five years.



Tobacco giant Philip Morris is a very different company that has also framed its work within the context of an ideology rather than just maximising shareholder wealth.

In 1979 Philip Morris Vice Chairman, Ross Millhiser, is quoted as having said:

> *"I love cigarettes. It's one of the things that makes life really worth living…Cigarettes supply some desire, some (aspect) of the fundamental human*

> *equation. The human equation is always trying to balance itself, and cigarettes play some role in that."*

Philip Morris executives framed the fight over cigarettes in almost self-righteous overtones: "we have a right to smoke"; "it's a matter of freedom of choice". An ex-employee even described working at Philip Morris as "the cult of smoking" and told how the company forced employees to take home boxes of cigarettes with their pay.

Collins and Porras argue that there is no *right* or *wrong* core ideology but what matters is the *authenticity* of the ideology and the extent to which the company attains consistent *alignment* with the ideology that counts.

While the core ideology at Philip Morris is extremely different from Merck, they both exhibit strong alignment with their particular ideology.

Progress Build Upon a Solid Foundation

In visionary companies, an unchanging "Core Ideology" ("Core Values" and "Purpose") works hand in hand with a relentless drive for progress that compels constant change in all that is not the core ideology (its strategies, tactics and policies).

Core Values refer to an organisation's essential and enduring tenets – a small set of guiding principles.

Examples[2]:	
Sony	Being a pioneer – not following others, but doing the impossible
American Express	Heroic customer service
Merck	Corporate social responsibility
Philip Morris	Winning – being the best and beating others
Wal-Mart	Pursue ever higher goals

Purpose is an organisation's fundamental reason for existence beyond just making money.

Examples	
3M	To solve unsolved problems innovatively
Nike	To experience the emotion of competition, winning, and crushing competitors
Walt Disney	To make people happy

Core Ideology – core values and purpose – provide the stability allowing visionary organisations to adapt to meet challenges.

In a visionary company, the drive to go further, to do better, to create new possibilities is an *internal drive* rather than market demands or other external forces.

It is the drive for progress that pushed 3M to continually experiment and solve problems that other companies had not even recognised *as* problems.

Scotch cellophane tape was invented to solve a problem for companies that sought waterproof packaging. Little known to the inventor that the product was destined to become a household item worldwide. Scotch tape wasn't planned. More important than Scotch tape itself, however, was the fact that 3M institutionalised the

[2] Visionary companies usually have between 3-6 Core Values.

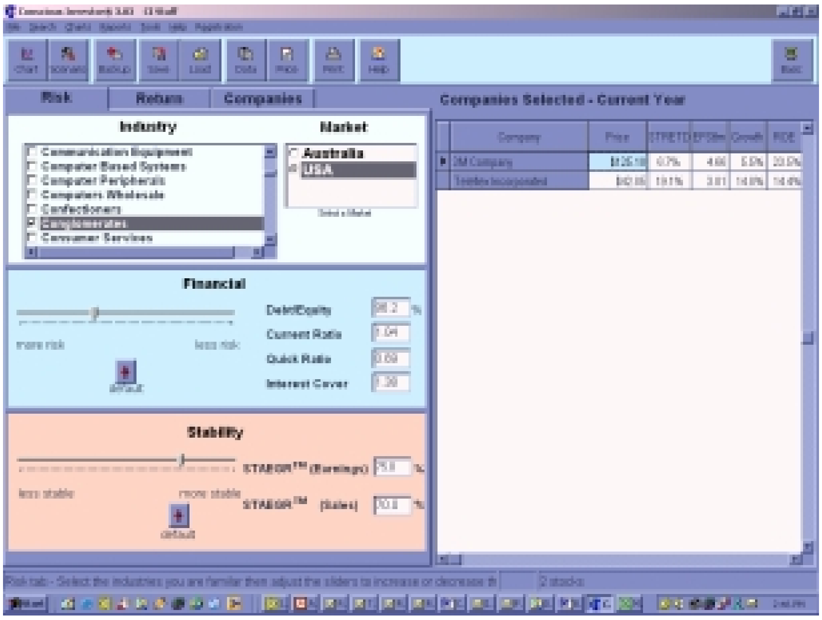
“evolutionary process” that led to Scotch tape. The Darwinian strategy of “variation and selection” was codified in 3M’s technical guidance manuals as early as 1925.

The “mutation machine” that is 3M has continued to evolve regardless of whoever has happened to be the chief executive. The company was built with a myriad of tangible mechanisms well aligned to stimulate continual evolutionary progress. An example is the “15 percent rule” which encourages technical people to spend 15% of their time on projects of their own choosing and initiative. There are numerous programs and policies that stimulate progress throughout 3M.

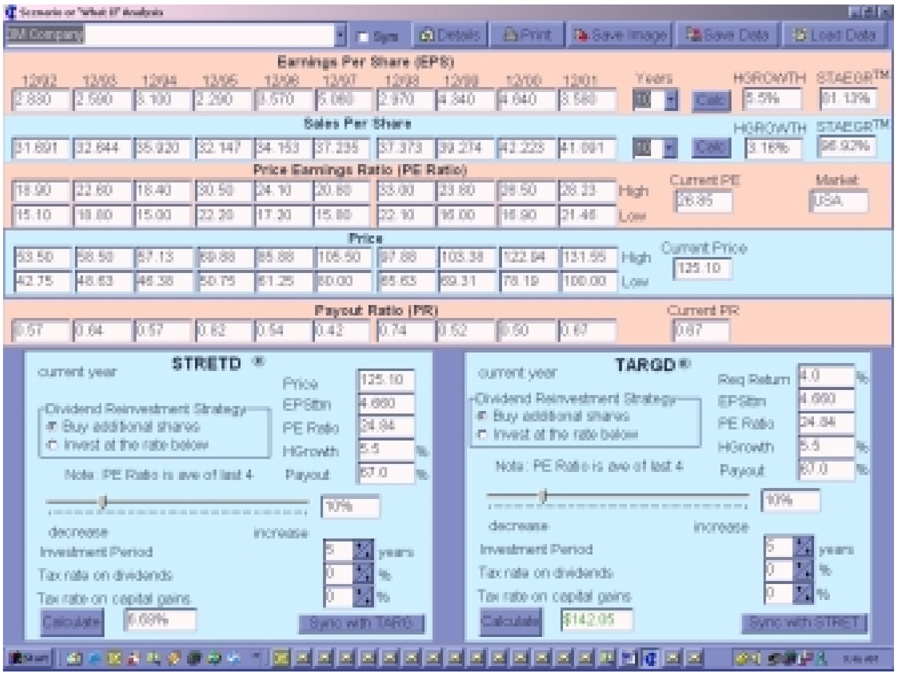
Collins and Porras surmised that “many of 3Ms greatest products (eg Post-it® Notes) were created by accident, but the creation of the 3M environment that allowed this was anything but accidental.”

In visionary companies the core ideology provide the very foundation upon which evolution and experimentation can take place successfully.

If we select the “Conglomerates” sector within *Conscious Investor®* we see that 3M basically passes all the defaults (again except for a minor adjustment for liquidity on the Financial Risk slider).



Using the historic data without adjustments we can see that the STRETD® (STock RETurn assuming that Dividends are reinvested) for 3M at the current price of $125.10 is estimated to be 6.68% per annum over the next five-year period.



Actions Speak Louder Than Words

Alignment refers to the specific methods companies use to preserve the core AND stimulate progress.

Collins and Porras identify a number of key methods that visionary companies use to align with their core ideology.

One popular method is the process of employee indoctrination. Walt Disney didn’t leave its core ideology up to chance; it created Disney University and required every employee to attend “Disney Traditions” seminars.

Many visionary companies achieve alignment through the creation of a “cult-like” culture. Hewlett-Packard didn’t just talk about the “HP Way”; it instituted an almost religious promote-from-within policy such that only employees tightly fitting into the HP mould would make it into senior management.

In fact, the study found that visionary companies are six times more likely to promote from within the company than in comparison companies (challenging the myth that progress and change can only be driven from outsiders). Visionary companies develop, promote and carefully select managerial talent grown from inside the company (specifically to ensure a tight fit with core ideology) to a greater degree than the comparison company.

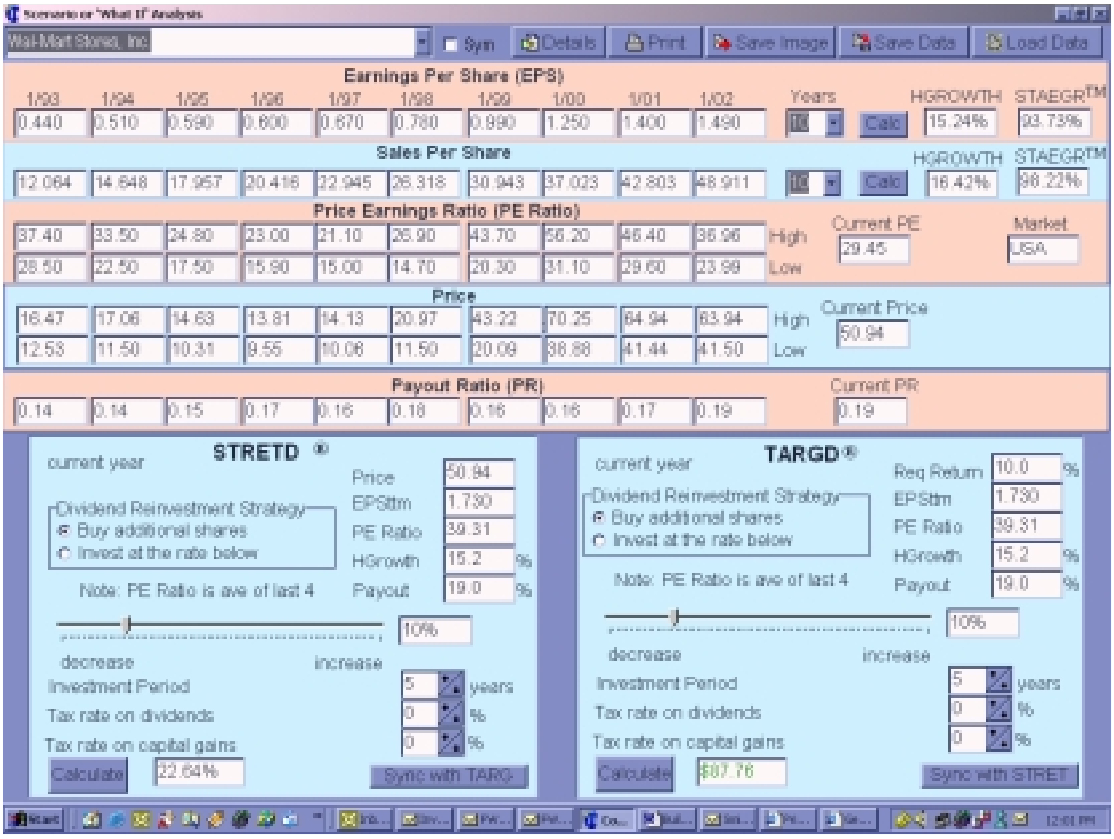
Visionary companies tended (to a greater degree than comparison companies) to pursue “Big Hairy Audacious Goals” (or BHAGs) that are strongly aligned to their core ideology.

Wal-Mart has a long history of setting and exceeding BHAGs. In 1990 the company set a BHAG to become a $125 billion company by the year 2000. At the time, the largest retailer in the world had reached just $30 billion in sales. Recently Wal-Mart became the largest company in the world as measured by revenues, reaching the $237.7 billion mark in the 2002 financial year!

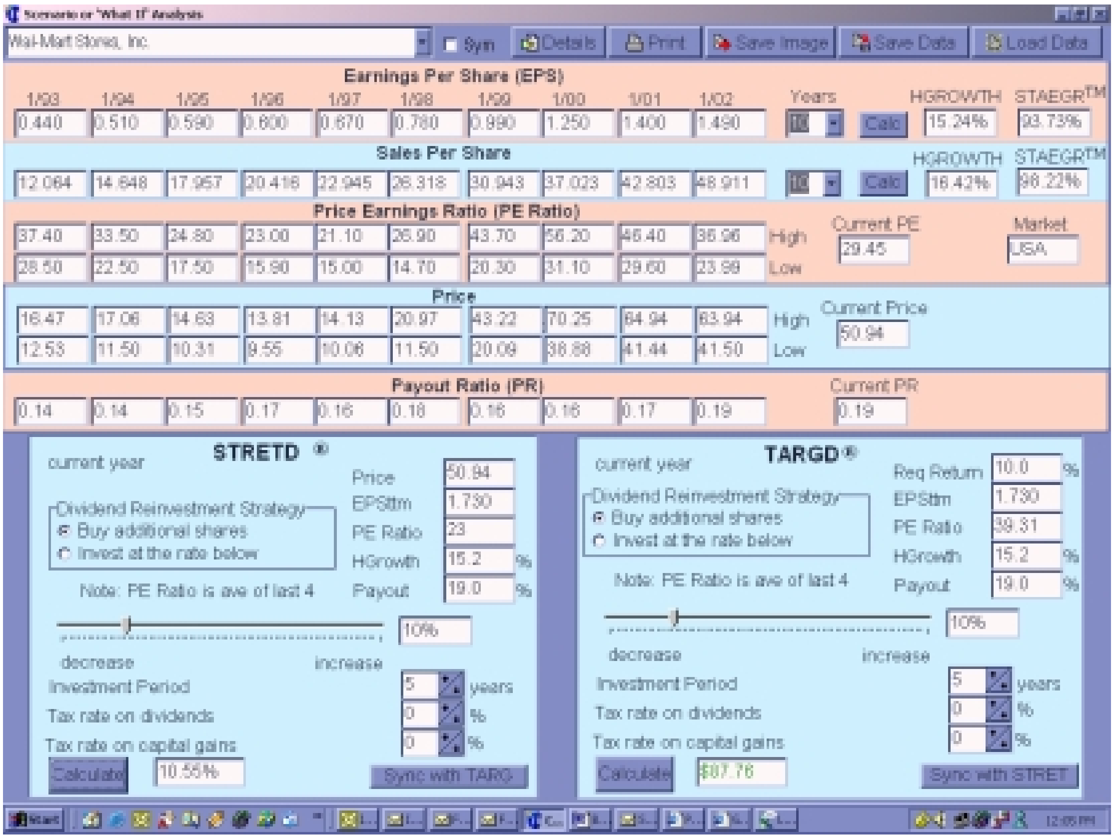
Viewing Wal-Mart through Conscious Investor (it's in the Discount Variety Sector) we see that the stock passes all the defaults within Conscious Investor except for the Liquidity measures (that is, Quick Ratio and Current Ratio) which is reasonable given the nature of the business.

The default STRETD using the historic data is forecast at 22.64% per annum over the next five years.

Note however that the Price Earnings (PE) ratio used is 39.31 (the average of the Current PE and the last three annual PE ratios) which is substantially higher than the Current PE of 29.45.



If we instead assume that the Price Earnings Ratio in five years time is going to be lower – say 23 (which is the lowest PE over the last three years) – then we can see that the estimated annual stock return (STRETD) falls to 10.55% at the current prices.



As always with *Conscious Investor* if you were not happy with a minimum return of 10.55% per annum then you would set a target price that will give you your required "margin of safety".

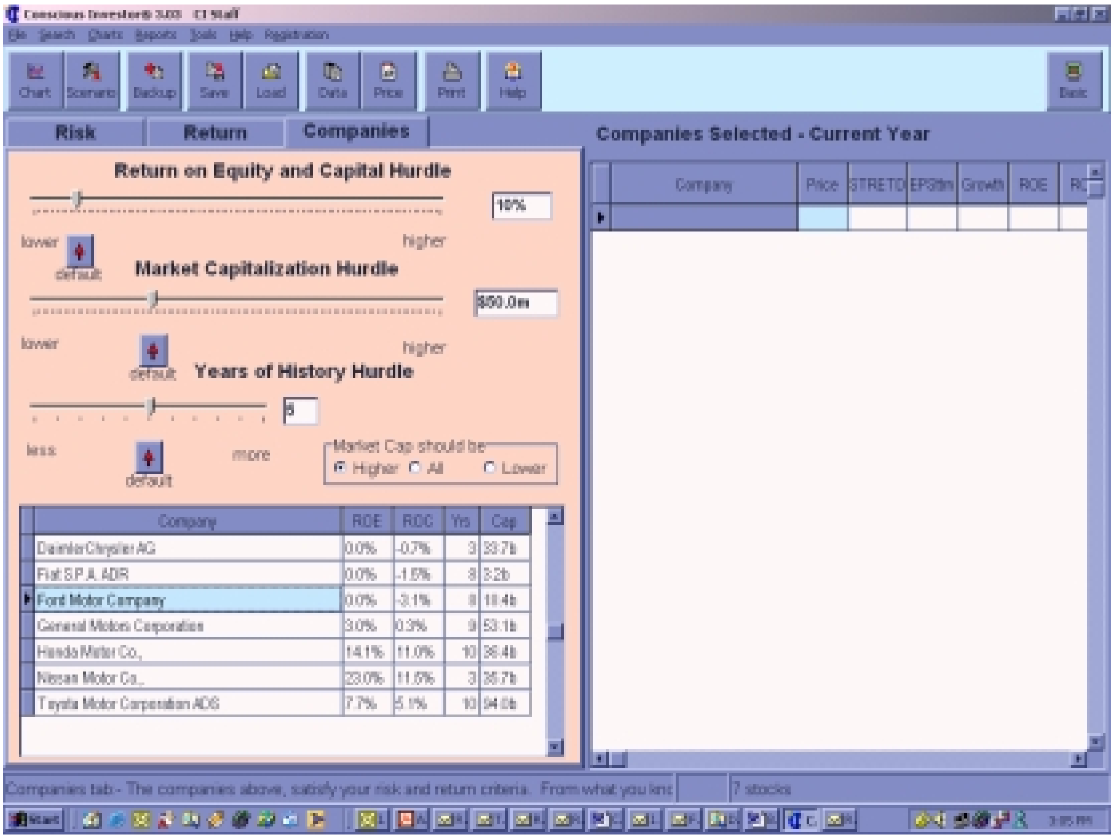
Henry Ford set a BHAG in 1907 when he proclaimed that his small company would:

> *"… democratise the automobile…The horse will have disappeared from our highways, the automobile will be taken for granted."*

At the time of making this BHAG, Ford was only one of countless players attempting to win a slice of the emerging automobile industry. This BHAG inspired the Ford team to propel the company to number one position within the industry.

Of course BHAGs are only of value while they have not been attained. Ironically once Ford had attained this ambitious BHAG it failed to set a new BHAG and complacency set in.

When we look at Ford in *Conscious Investor* we see that the returns to shareholders are currently extremely poor with Return on Equity (ROE) of 0% and Return on Capital (ROC) of –3.1%.



Is this a case of a visionary company encountering temporary adversity or is could Ford more accurately be described as a fallen star? To answer this an investor would need to look at present management's behaviour and determine whether the company has the ability to return to its core ideology and set new inspiring BHAGs that can propel the company into the future.

Interestingly, Collins and Porras discovered that most visionary companies have encountered periods of adversity during their history. What sets them apart however is their resiliency over time.

Why Become A "Conscious" Investor?

It's not just Ford that has been hit by troubled times. In fact many of the visionary companies included in the Collins and Porras study, when viewed through *Conscious Investor*, appear to be at cross-roads.

Investing in companies - whether they are visionary or not – therefore requires eternal vigilance.

At *Conscious Investing* our core purpose is to provide a means for individuals to become *conscious* in their investment decision-making. Afterall, we believe that *consciousness* is the ultimate tool for *risk reduction* and attaining *superior returns* over time.

So returning now to my original question - is successful investing just about maximising your returns? Could it be that successful investing is actually about *maximising your returns* AND identifying and supporting companies that are aligned with your *values and beliefs*?

Put another way, if the existence of *profit* AND *purpose* is important for companies to outperform over time, then surely it make sense that this co-existence may also be one of the most important keys to extraordinary wealth for investors.

If you have any thoughts on this question, I would be interested to hear your views and experiences. Feel free to email me anytime at Margie.Baldock@conscious-investor.com.

Table 1: Companies Participating in the "Built to Last" study

Visionary Companies	Comparison Companies
3M	Norton
American Express	Wells Fargo
Boeing	McDonald Douglas
Citicorp	Chase Manhattan
Ford	GM
General Electric	Westinghouse
Hewlett-Packard	Texas Instruments
IBM	Burroughs
Johnson and Johnson	Bristol-Myers Squibb
Marriott	Howard Johnson
Merck	Pfizer
Motorola	Zenith
Nordstrom	Melville
Philip Morris	RJR Nabisco
Proctor and Gamble	Colgate
Sony	Kenwood
Wal-Mart	Ames
Walt Disney	Columbia

Table 2: Other visionary and potentially visionary companies identified by Collins and Porras but excluded from the study:

Coca-Cola	LL Bean	Levi Strauss
McDonald's	McKinsey	State Farm
Nike	Cargill	Edward D Kpmes
Fannie Mae	Granite Rock	Molex
Telecare	Bonneville International	Cypress
Landmark Communications	MBNA Corporation	GSD andM
Manco	Taylor Corporation	Sunrise Medical