

The Loyalty Effect

essays

on the
relationship
between
loyalty and
profits

the cost of
investor
disloyalty

essay # 6

BAIN & COMPANY

the cost of investor disloyalty

The foundation of customer loyalty—that great engine of long-term profit and cash flow—is customer value and the long-term investment that creates it. For this reason, customer loyalty is hard to find at companies owned by short-sighted, fickle investors. Unfortunately, this means that customer loyalty is hard to find at most public companies. The average rate of annual investor churn at firms listed on the New York Stock Exchange skyrocketed from 14% in 1960 to more than 50% in 1995. Or to put that another way, the average publicly owned company can expect to lose half its owners over the course of the next 11 months. It is ironic that so many investors should be so disloyal. After all, the stated purpose of most corporate management is to maximize shareholder value. But it's absurd to make shareholder value an overarching corporate objective when most of a company's investors will defect in less than a year and are obviously indifferent to the long-term health and well being of customers, employees, and shareholders more loyal than themselves. Aligning investor interests with

the interests of customers, employees, and management is largely a matter of timeframe. When average investors expect to own a company stock for five years or more, then the long-term investments that build long-term profits will strike them as appropriate and wise. But when the timescale for value creation shrinks to a year or less, the strategies that turn customers and employees into lasting assets no longer serve the interests of investors. On the contrary, the easiest way to boost short-term earnings is to use the tactics of asset exploitation—price increases and layoffs—and ignore their devastating effect on asset duration and long term value.

Most senior executives seem resigned to the fickleness and short-term focus of today's capital markets, but in taking this fatalistic attitude, they make two grave mistakes. First, they underestimate the damage done by asset exploitation. Second, they ignore or fail to recognize, a range of pragmatic alternatives—ways of stabilizing their investment base and creating the conditions for long-term investor partnerships and the implementation of long-term, value-creating strategies.

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If executives are serious about earning the benefits a loyal base of customers and employees can provide, they need to take control of their investor inventories. There are four principal ways of overcoming or sidestepping the disadvantages of public ownership:

- 1) **Educate investors** about the benefits and advantages of loyalty. Companies must explain the principles of loyalty-based economics, show how they work, and prove to investors that the companies with the highest loyalty earn the highest profits. Once investors believe loyalty is a rational goal leading to higher profits, they will want to see loyalty measures they can use to gauge the company's progress. These include calculations of customer net present value, customer duration, customer lifecycle profits, share of customer wallet, and measurements of the value delivered to customers, as well as statistics on new customer gain rates, customer retention, customer defections—to name a few. The company will need to develop similar loyalty measures for employees.

Many investors realize that short-term profit gives an inadequate picture of a business's health and future prospects, but few management teams have ever offered them a satisfactory alternative.

- 2) **Target low-churn institutional investors.**

While the average institutional investor churns its portfolio at a rate of 60% per year, there are institutions that prefer to buy and hold. By searching out loyal investors and persuading them to invest in your stock, companies can steadily enrich their investor mix.

One corporation that took this approach is Nike, whose managers decided they could not achieve their objectives without a core of stable long-term investors. But instead of complaining about the outrageous short-term speculative behavior of institutional investors, they took their own advice to *Just do it*. In 1989, Nike's management team began marketing its stock the way it markets its shoes: It segmented investors and tailored its marketing approach to the shareholders it wanted. What Nike did was to analyze the earnings growth and cash-flow patterns it could realistically deliver; sort through the universe of public companies to find those with similar results; and then identify the investors who owned significant positions in those firms. By marketing itself to those investors, Nike was able to shift almost 30% of its shares into their hands.

Among the 700 U.S. investment managers with more than \$100 million under management, turnover rates range from less than 5% to almost 400% per year. Average turnover for the group as a whole was 62%.

Nevertheless, about 20% of these investment managers hold their investments for an average of 5.7 years or longer. And some 4% of them hold their investments, on average, for 20 years or longer. Clearly not *all* loyal investors have gone the way of the dinosaurs.

One name that leaps from the list of the ten largest institutions with the lowest portfolio turnover rates is State Farm. The Good Neighbor holds more than \$18 billion in equities and turns them over at the neighborly rate of only 3.4% per year. The company's philosophy of long term loyalty and partnership extends all the way to its strategy for investing in public stocks. By sticking with its investments, State Farm has been able to outperform the S&P 500 over the long term, which places its performance solidly in the top quartile of all investment managers.

- 3) ***Attract stable core owners.*** The third approach, which pushes the second one step further, is to find an institutional or individual investor who will buy a controlling position in the company, which remains publicly owned. Needless to say, the things to look for are business philosophy, integrity, and a track record of long term, stable holdings.

The archetype is Warren Buffett. Portfolio turnover at Berkshire Hathaway runs at about 8.2%, and investment returns have been phenomenal. But there are others. Paul Desmarais, chairman of Power Corporation of Montreal, also pursues this

kind of investment strategy. Another is Alfred Lerner, MBNA's largest shareholder. Managers might also consider looking for loyal investors—individuals or institutions—overseas. In countries like Germany and Japan, investors are much more likely to stick with their investment for the long-term. In Japan, the average share of stock in a public company is held for seven years, compared to less than two years in the United States.

- 4) ***Taking the company private***—the final approach—frees managers from the volatility of public markets, the carping of securities analysts, and the short-term thinking of transient investors, but it has two substantial risks. The first is that most companies must take on additional debt in order to buy back their stock. The second and greater risk is the choice of a leveraged buyout firm to act as a partner. Luckily, there is a class of private investment firms, that make excellent partners, every bit as attractive as Warren Buffett. They're asset builders, and they recognize the value of long-term stability and loyalty. Rather than engineer a financial restructuring, they prefer to become long-term partners in the development of value-creating strategies that leave everyone—customers and employees as well as investors—better off. Experts estimate that the average holding period for private equity investments is four to six years—two to three times longer than the average for public markets.

One particularly successful example of such a private investment group is Bain Capital*, founded in 1984 by former management consultants. According to Mitt Romney, the group's managing partner, the strategy is "to buy companies only when we believe we can help build the business asset and increase its value. We search for growth opportunities, new markets, new outlets, new channels, or merger candidates that would strengthen a franchise. Slashing costs is not our business. We see people as the key asset we're acquiring."

Investment loyalty plays a central role in Bain Capital's value-creation strategy, and it has paid handsome dividends. Since its founding, the firm has invested in 80 companies with cumulative sales of approximately \$10 billion. While no LBO firm can succeed in every one of its deals, the group's asset-building strategy has been successful in all but a handful of cases. Returns from its investments have averaged better than 90% per year over the past decade.

** Bain Capital and Bain & Company are completely separate companies with no sharing of information or management between them.*

Control Your Own Destiny

All schemes to reduce the pressure on quarterly returns are open to the suspicion that managers just don't want their feet held so close to the fire of no-alibi performance. But if you think that getting rid of short-term investors is a way of reducing the pressure to perform, then think again. Loyal capital is more committed to your business, knows more about it, and therefore tends to demand *more* than the transient investors you never meet or hear from. Investors like Warren Buffett, Bain Capital, and State Farm insist on altogether exceptional performance. The difference is that they know what kind of performance is possible and understand the timeframe in which they can reasonably demand it.

It's not patient money companies need, but smart money. Smart investors know that the only way to maximize shareholder value is to earn the loyalty of customers and employees. This is increasingly true as businesses become more knowledge-based and service-intensive. Managers must take steps to find smart investors, educate the investors they already have, and avoid the high cost of disloyal capital.





By Frederick F. Reichheld

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Bain & Company serves clients through an 18-country network of 25 offices across six continents. Since 1973, Bain has worked with over 1500 major multinational and other corporations, from every economic sector, in every region of the world, to improve bottom-line results.

Through its diverse client assignments and research, Bain has developed an immense experience base, covering a broad range of critical business issues; together with original, proven methods and powerful tools to successfully address them. Bain is known for conceiving customized, creative and often breakthrough strategies wholly unique to each client's situation. Quantum leaps in performance are a frequent outcome.

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