The Pursuit of Happiness

When trying to find the best option makes us miserable.

About 50 years ago, the political scientist and wide-ranging thinker Herbert Simon proposed a theory to explain how people make choices. Satisficers, he said, look for an option that is good enough and then end their search. Maximizers try to find the option that is the very best. For example, satisficers channel surf until they find the first show they like. Maximizers don’t make a decision until they have scrolled through every one of their 400 cable options, often not leaving themselves enough time to watch a show.

In more complicated situations when the range of choices is infinite, maximizers sometimes find it difficult to make any decision at all. As Simon concluded, the limited capacity of the human brain makes determining the absolute best option in almost any scenario impossible.

Professor Sheena Iyengar, working with doctoral student Rachael Wells and Barry Schwartz of Swarthmore College, examined how maximizers and satisficers approach a particular scenario where the choices are seemingly infinite: finding a job. Their subjects were graduating seniors at 11 colleges and universities across the United States.

First, the researchers asked the students how they felt about the notion of choice—Did they enjoy the choosing process in their everyday life, or go with the first acceptable option that presented itself—to determine which students were satisficers and which were maximizers. The satisficers were looking for a job that paid the bills, the researchers found, and the maximizers were looking for the ideal job.

Over the course of the year, the researchers tracked the students’ job searches. The maximizers, who tend to be very competitive and frequently compare themselves to others, applied for twice as many jobs, on average, as the satisficers. But this average doesn’t completely capture the difference in behavior, Iyengar says. “We had to remove quite a few maximizers from the data set,” she says, “because they would have skewed the mean. There were maximizers who applied for hundreds of jobs, even a thousand jobs.”

The study began during the fall 2001 semester, when the job market was...
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what should we seek to maximize—
material welfare or psychological welfare?

Throughout the year, the preferences of both the maximizers and satisficers changed, the researchers found. Satisficers, however, were less aware of the change—and were happier for it.

For that reason, Iyengar says that job seekers shouldn’t worry (as many do) if their goals change over the course of their search. “All preferences are malleable, particularly if you’re a young student just graduating from college,” she says. “How would you really know what you want? We’re better off accepting the fact that our preferences change, since it’s inevitable that they will and it doesn’t cause any harm.”

When it comes to the broader issue of whether maximizers or satisficers are better off, Iyengar offers no advice. “It’s a very hard call, because maximizers do better on a material level, but they are less happy,” she says. “That brings up an ethical question: What should we seek to maximize—peoples’ material welfare or their psychological welfare?”

Iyengar’s previous research uncovered the adverse effects of having too many choices. In her research, consumers were unprepared for the dilemma they would face. But in a job search, the job seeker alone decides how much he or she can handle. Presumably, if the number of choices becomes overwhelming, the job seeker would end the search.

However, Iyengar found that for many maximizers the love of choice was too strong to resist. “Even when job seekers could stop the process, and even when they didn’t have a lot of job offers to deal with, choice still got in the way,” Iyengar says. “They just couldn’t stop thinking about it. They still imagined choices. And it interfered with their happiness.”

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Sheena Iyengar is associate professor of management at Columbia Business School.

Psychological welfare? material welfare or
Satisficers, however, were less aware of the change—and were happier for it.

The researchers found that the maximizers’ strategy did, at least in one sense, pay off. Maximizers received more offers than satisficers received—the average maximizer received 2 or 3 options, compared to a range of 0 to 1.5 for satisficers—and their starting salaries were about 20 percent higher. However, the maximizers were less satisfied with the job they accepted, and they were more likely to want to find another job within a year.

The maximizers were less satisfied with their choices because they continued to think about other options even after their job searches had ended, Iyengar and her coresearchers found. “The maximizers were constantly fixated on alternatives,” Iyengar says. “They would wonder about jobs they hadn’t applied for and conjure up idealized jobs that didn’t even exist.”

The researchers had also quizzed the students about their preferences to discover what they were looking for in a job, such as a high salary, security, independence, the ability to be creative and working with people they liked.

When it comes to the broader issue of whether maximizers or satisficers are better off, Iyengar offers no advice. “It’s a very hard call, because maximizers do better on a material level, but they are less happy,” she says. “That brings up an ethical question: What should we seek to maximize—peoples’ material welfare or their psychological welfare?”

Iyengar’s previous research uncovered the adverse effects of having too many choices in different contexts, such as contemplating the chocolate displays at Godiva, choosing financial investments and finding a date from speed-dating. In this study, she wanted to see if people would still suffer if they were able to control the number of choices they would face. In the case of a chocolate display, for example, one could argue that marketers had determined the number of choices and that consumers were unprepared for the dilemma they would face. But in a job search, the job seeker alone decides how much he or she can handle.

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Sheena Iyengar is associate professor of management at Columbia Business School.
THE IDEA: Web retailers can tailor their ads according to consumers’ histories of making unintended purchases.

THE RESEARCH
When people search for a product online, they are often tempted by items they didn’t intend to buy. Consumers who visit Amazon.com to buy a textbook for a class might get recommendations for other books or see ads promoting a new CD that’s being offered at a deep discount. They might give in to temptation and add the CD to their baskets. Or they might click on the CD, possibly even put it on a wish list, and then click away, having resisted.

Gita Johar and Anirban Mukhopadhyay investigated the emotional consequences of these two scenarios. Consumers who make an impulse purchase tend to feel happy that they bought something they wanted but guilty for spending money unnecessarily. Consumers who held back even though they were tempted by the product will feel regret for denying themselves something they desired but feel proud that they were able to resist.

In the short term, these emotional states affect consumers’ responses to the subsequent ads they see while shopping online, the researchers found. Consumers who made the unintended purchase respond better to ads that appeal to their happiness, whereas consumers who resisted respond better to ads that appeal to their sense of pride. This is because they misattribute their feelings of happiness or pride to the ad.

These emotional responses are tied to a key issue in consumer psychology: how consumers manage conflicting goals. Most consumers have a long-term goal of saving money but want to buy items that they didn’t intend to purchase. One goal must be sacrificed to further the other. Johar and Mukhopadhyay’s research identifies the specific emotions people feel when they are forced to make this choice.

PRACTICAL APPLICATIONS
Web marketers
You can tailor your ads to appeal to a customer’s emotional state. Most search engines and Web retailers monitor click-stream behavior, making it easy to tell if customers were tempted enough by a product to put it on a wish list or get more information but didn’t click to buy it. In that case, you’ll want to have your site show these customers, who are in the proud state, ads that enhance their sense of pride—such as an ad for a charity designed to appeal to their sense of worth, an ad for clothing that appeals to their pride in looking good or an ad for a book that appeals to their sense of self-esteem. For customers who made the purchase, you’ll want to have your site display ads that appeal to their sense of happiness.

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Gita Johar is the Meyer Feldberg Professor of Business in the Marketing Division at Columbia Business School.
Emotional Accounting

Our feelings about the ways we get money influence how—and sometimes even when—we spend it.

In purely rational economic terms, money is fungible. It shouldn’t matter where the $20 in your wallet came from, whether you earned it at a job or found it on the street. But people act as if it does, and in the 1980s the concept of *mental accounting* emerged. According to this concept, people categorize money they receive by its source and deposit it in different mental accounts. Money received from a windfall such as winning the lottery or coming into an inheritance would go into one account, for example, whereas money received as income from a job would go into another.

Mental accounting explains why investment bankers tend to spend their bonuses on plasma TVs and exotic vacations but save money from their salaries to buy homes. Over the past few years, Professor Jonathan Levav, working with A. Peter McGraw of the Leeds School of Business at the University of Colorado at Boulder, pursued this idea further and found that in addition to mental accounting people tend to categorize money according to the feelings they associate with it, a process he calls *emotional accounting*.

To illustrate how we engage in emotional accounting, Levav compares two scenarios: receiving $200 as an unexpected gift from an aunt and receiving $200 as an inheritance from an aunt who just died. Although the money is from the same source, in the first case it triggers positive feelings, while in the second it produces what Levav terms a “negative affective tag.”

The way people evaluate money becomes more complicated when mixed emotions are involved. Suppose an investment banker received a bonus but knows that a colleague who didn’t work as hard got more money. In this case, the banker is glad he got a bonus but also angry because he feels he was treated unfairly. Meanwhile, a banker who received a bigger bonus than one of his close friends may feel more guilt than happiness.

To assuage such negative emotions, Levav says, people employ various cleansing and avoidance strategies. “If I have negative feelings about money, then I’ll launder it of its negativity,” he says. “This can mean spending it in ways that are virtuous or utilitarian. So I don’t buy the plasma TV for myself, but I might buy one for an orphanage. It’s not just about the product; it’s really about the use.”

Levav and his coresearcher conducted several studies that tested how university students spent money they received under different circumstances. In one experiment, students who completed a market research survey were given a choice afterward of different $2 coupons. They could spend the coupons either on ice cream in the cafeteria or on books in the university bookstore. Half of the students were told that the grant for the coupons came from computer firm Dell, which had positive or neutral associations within the student population. The other half were told the grant came from tobacco company Philip Morris. About 44 percent of the students who were told the coupons were paid for by Dell chose the utilitarian textbook coupons, double the percentage of those who were told the coupons came from Dell.

“In essence, people tell themselves, ‘Let me do something good with the money so I don’t feel bad about it anymore,’” Levav says. When people are angry—such as the banker who feels he was cheated on his bonus—they tend to set the money aside and give their anger a chance to dissipate.

People who feel guilty are more likely to donate the money to charity. When teachers at an affluent Chapel Hill, N.C., high school received bonuses based on their students’ standardized test scores, they donated the money to a rural school and said their students’ performance was partly the result of the community’s wealth. Levav and his coresearcher hypothesize that the teachers’ donation was a way to cleanse themselves of the negative emotions they associated with the money.

“When we make the decision to spend money virtuously—paying off a chunk of our college tuition, rather than paying off debt racked up on a weekend in Vegas—we can erase any bad feelings associated with it,” says Levav. “It may not be rational, but it makes us feel a lot better.”

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Jonathan Levav is assistant professor of marketing at Columbia Business School.
THE IDEA: Index options aren’t mispriced, and the huge returns from writing options come with huge risks.

THE RESEARCH
Put options on aggregate stock indices are essentially insurance contracts on market crashes: they pay out after large market declines. Like any other insurance contract that is linked to catastrophes or rare events, the realized returns on these contracts appear to be quite attractive. In normal time periods, the returns are 100 percent if no large declines occur. Seeing this, and noting that stock market crashes are rare, many hedge fund managers regularly write index put options. In the process, they have earned enormous returns. However, the risks associated with insuring these events are quite large, as was experienced during the stock market crash of 1987 and the dot-com bust from 2000 to 2002.

The main problem in analyzing the pricing of index put options is quantitative: How often do large market declines occur, and how large are they when they occur? The index option market has existed for only 20 years, making it difficult to assess these questions using historical data. Therefore, hedge fund managers who use historical option-return data may be unaware of the true risks of writing index options.

Rather than analyzing the risks on the basis of historical option returns, Mark Broadie, Mikhail Chernov and Michael Johannes proposed a new approach to evaluating option returns. Using a number of widely accepted models, they simulated returns over longer time periods to get a better sense of the risk-and-reward profile of writing put options.

Surprisingly, the researchers found that the predicted option returns were quite close to the historical returns, a finding that suggests that there isn’t mispricing—or opportunities for arbitrage—in the index option market. Rather, the observed returns accurately reflect the risk premia, or compensation, that investors receive for taking the risks associated with insuring against the size and frequency of market crashes.

PRACTICAL APPLICATIONS
Hedge-fund and asset managers and traders
The returns from writing index options appear to be commensurate with the risks involved, even if these risks aren’t always apparent in historical returns. If you are an arbitrageur, this may not be an appropriate market in which to invest, since the evidence does not suggest any mispricing. If you write index options, you should be aware of the considerable crash and price-jump risks. In the end, the index put option market is just like hurricane insurance: although in most years hurricanes are few and mild, it does not take many hurricanes like Katrina to bankrupt an insurance company—or in the case of a stock market crash, a hedge fund.

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Superstar Cities

As high salaries soar even higher, housing prices in the most attractive cities have tested their limits.

In the late 1980s and early 1990s, residents of Boston lamented the loss of the city’s computer industry. For more than a decade, the Boston metropolitan area had been a center for manufacturing minicomputers—word processors built by the likes of Wang and DEC—which vanished when the market turned in favor of personal computers.

Many people thought Boston wouldn’t recover. Instead, a new wave of businesses came to the city, including many financial services firms and biotech software companies. These businesses chose Boston because it already had a highly skilled workforce. “Oddly enough, it wasn’t industry that drove the growth,” says Professor Chris Mayer, who worked at the Boston Fed during this time of transition. “It was the people who attracted the industries.”

Boston is what Mayer calls a “superstar city.” A superstar city, by Mayer’s definition, has two key qualities: it is in high demand as a place to live, and its housing is supply constrained. These factors push its housing prices higher than in the rest of the country, and at a far faster pace. New York, Los Angeles and Seattle are superstars; the sprawling metropolises of Houston and Dallas are not. When more people move to Atlanta, one of the fastest-expanding metropolitan areas in the nation, developers simply build more apartment complexes and McMansions.

Most superstar cities are on the coasts, where supply is most limited. The prototypical example is San Francisco, where zoning laws since the 1980s have restricted new construction. As building slowed in the city, its housing prices soared, but the city remained extremely attractive to high-income, high-skilled workers, who bid up housing prices.

In contrast is Las Vegas, a city that has experienced remarkable growth but could seemingly expand to the desert horizon. The percentage of rich, poor and middle-class families who lived in the city remained relatively stable even as it grew. “If there’s only a small number of projects that can be built, builders will cater to the highest end of the market,” Mayer explains. “But if builders can satisfy demand at the high end of the market, they will produce ever more affordable housing.”

Mayer traces the superstar city phenomenon to population growth and the skewing of the income distribution. In recent years, many economists have noted that high-skill workers are earning higher and higher wages, relative to the typical worker in the U.S. population. Some argue that the middle class is going the way of Wang minicomputers as the incomes of the wealthy continue to climb. Mayer, working with Joseph Gyourko and Todd Sinai of Wharton, researched what this socioeconomic shift means for the housing market.

The researchers studied the differences in housing prices and income growth from 1950 to 2000. The surge in wealthy households and their desire to live in a small number of attractive cities has driven up prices at a relatively fast pace. And as more people are priced out of these attractive cities, high-income households have accounted for an increasingly greater share of their populations. “Over the years, a smaller and smaller percentage of the population can afford to live in superstar cities,” Mayer says.

This can quickly restyle the character of a city, Mayer notes. He cites changes in New York as an example. “It means luxury restaurants and shops, rather than neighborhood diners and dollar stores,” he says. “The Yankees used to be a blue-collar baseball team. Blue-collar workers can’t afford to go to Yankees games on a regular basis now.”

When Michael Bloomberg ran for mayor in 2001, he called living in Manhattan a luxury, a description Mayer sees as apt. “The idea that living in New York is the equivalent to driving a luxury car instead of a Ford or a Chrysler is hard for people to think about, because they’re used to thinking they can live wherever they want,” Mayer says. “You can also choose to buy whatever car you want, but there’s a price to pay. In that sense, living in New York is like driving a Lexus, and it’s moving into the Rolls Royce range.”

Some superstar cities appear at risk of pricing out everyone but the very rich. As prior studies by economists have shown, the rise in high-income salaries in cities tends to lift middle-class salaries over time. Hospitals need not just doctors but nurses. Firefighters and teachers need to be paid enough so that they can afford to live in superstar cities. In New York, the wages of people who
provide support services to Wall Street bankers have climbed as bankers’ salaries rocketed higher, although obviously not to the same extent.

However, the slight lift in the salaries of nurses and Wall Street administrative assistants doesn’t entirely compensate for the jump in housing prices. “People end up commuting farther,” Mayer says. “It becomes very difficult to live without two wage earners in a household. People who want to live in superstar cities are willing to live in small apartments and forgo other things they might want. That’s the tradeoff that superstar cities force people to make.”

There is a natural limit, Mayer says, to how far housing costs in superstar cities can climb, and that is determined by the wages and productivity of the people who choose to live there. As long as there is demand, housing prices in superstar cities will continue to rise. In New York, a penthouse apartment at the Hotel Pierre was listed for a record $70 million in December, just a few months after a mansion on East 75th Street sold for $53 million.

“It seems like there should be a limit to what even the wealthiest will pay, but we still might not be there yet in the highest-priced places,” Mayer says. “If high-skill workers keep earning more and more money, it’s conceivable that the run-up in prices in superstar cities could continue to go on for a long time to come.”

San Francisco vs. Las Vegas
San Francisco is the prototypical superstar city. Las Vegas experienced extraordinary demand but isn’t supply constrained, which allowed population growth from families across the income spectrum.
the tendency to focus on one individual and miss problems and possible solutions in the larger organization.

The Exxon Valdez oil spill, for example, was widely viewed as the fault of the captain of the oil tanker, a known alcoholic who had consumed more than a dozen shots of vodka within hours of embarking. His erratic navigation wasn’t corrected by his second-in-command, who was working a shift far exceeding federal fatigue standards. “Our public reaction focused on this individual rather than on the corporation’s standards and procedures, which allowed a drunk and exhausted crew to embark on a challenging route through an ecologically sensitive area,” Morris says.

Conversely, in East Asian cultures, corporations, divisions, teams and other collectivities are the salient units of society and are seen as causing outcomes. But how does the East Asian penchant for focusing on collectivities as actors ultimately result in a blaming of leaders? Corporations cannot apologize, receive punishment or atone for wrongdoing in the same tangible ways that a person can. Hence, before the public can move on and renew its trust in the corporation, a leader has to step forward as a symbol or personification of the corporation to accept blame.

In one case Morris studied, when it became known that the Japanese Health Ministry’s negligence caused some of the agency’s blood supply to become contaminated with HIV, the head of the agency took a 20 percent pay cut and apologized publicly, even though he had joined the agency after the acts of negligence had taken place.

Managers need to understand the implicit logic of their host country’s culture when confronted with a crisis, Morris says. If an accident occurs in a Japanese firm headed by an American, this leader should apologize, regardless of his or her involvement in the events. “A leader who fails to do so might be regarded as shirking his or her moral duties,” he says.

Conversely, Japanese managers in the United States should be wary of offering an apology for accidents they haven’t caused. If it was obvious that the manager hadn’t caused the accident, “the manager would be perceived as not seeing the world clearly,” Morris says. Even worse, “it could be interpreted as an admission of having caused the outcome.”

Morris found many cases in which leaders were held responsible by the Japanese public but would not have been by the American public. Morris and his co-researchers designed experiments, run in parallel in Japan and the United States, to test their hypotheses about the different assumptions and inferential steps that guide the assignment of responsibility in the two cultures.

Assigning responsibility begins with one’s perception of the agent who caused the accident. American cultural conceptions hold that individual persons are the only entities that have agency. “In the U.S., our first intuitive attribution for an aviation accident is almost always ‘pilot error,’” Morris says. The limitation of the American intuitive logic is the

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Michael Morris is the Chaikin-Chang Professor of Leadership in the Management Division at Columbia Business School.
THE IDEA: An anthropological approach reveals how trading floors can be designed to competitive advantage.

THE RESEARCH

Daniel Beunza and David Stark wanted to learn how traders—in this case, arbitrageurs—at the Wall Street headquarters of a large global bank communicated and used information. The researchers also wanted to learn how the arbitrageurs at this bank managed to consistently earn extraordinary profits. To do so, Beunza and Stark took an ethnographic approach, using direct observation and interviews to learn about the arbitrageurs.

The researchers spent almost three years observing 10 separate desks on the trading floor, visiting the floor roughly once every two weeks. They initially expected the arbitrageurs to be visibly stressed and screaming at one another. Instead, the researchers found the arbitrageurs to be quiet and relaxed: Throughout the day, they reclined at their desks, met for coffee in the hallway and had informal conversations at one another’s desks. Their manager sat, not in a grand office, but at a desk like all the others.

The arbitrageurs didn’t need to holler information at one another, the researchers learned; they got all the information they needed from their computer terminals, televisions and phone lines. Technology allowed them to obtain deep knowledge of their specialty. At the same time, the open arrangement of the trading floor allowed them to exchange information, creating a shared body of broad knowledge.

On this particular trading floor, each desk focused on a different type of arbitrage, such as mergers, options or convertible bonds. The desks shared their insights, creating a portrait of an entire company. Their manager encouraged different perspectives, even when desks took opposing positions. This, the researchers found, benefited the bank as a whole, because it encouraged the flourishing of creativity.

PRACTICAL APPLICATIONS

Trading floor managers

You can design your trading floors in a way that uses space and technology to competitive advantage. First, provide the technological tools that allow trading desks to become experts in their target areas. Encourage frequent and open communication among these desks, and welcome diverse perspectives, even when trading desks take positions that seem contradictory on a firm level; consider this a form of hedging. You can also foster a collaborative atmosphere by emphasizing trust and team incentives, rather than individual incentives.

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Daniel Beunza is assistant professor of management at Columbia Business School.
What inspired you to look at the plight of middle managers? I was looking at companies that were struggling to innovate, and I wanted to understand why. What I found is that a lot of the work on new ventures involves making connections across the company and finding resources that may not be formally available—particularly when it comes to an innovation that isn’t a direct fit with the current strategy of the company.

So why don’t middle managers get credit for the part they play in getting new ventures off the ground? Often, this work isn’t part of their official responsibilities and gets taken for granted. And that’s part of the problem. If you look at a middle manager’s job description, it will have items like “increase operational efficiency” or “decrease costs by 5 percent.” But where does it say to elbow people out of the way so that your venture gets protected; beg to get assets moved over to the production line that you need; negotiate with universities to get the intellectual property; and protect your people from undue interference by senior managers? These specific activities that middle managers do to make innovations happen are not part of the discussion.

When you look at the innovation literature, there are some suggestions that middle managers should take this role. But relative to all the writings about what senior leaders or managers of a specific venture have to do to make it successful, there isn’t much attention being paid to middle managers. Middle managers aren’t necessarily the ones who come up with the idea, but once the idea is identified, they’re the ones who know what to do within the organization to get it moving.

How can companies encourage middle managers and make their roles easier? When you look at how you structure your budget, you want to leave some slack to the discretion of the people in the middle. They need to have resources available. Very tightly run organizations often don’t do that, so they end up with very little for middle managers to work with. That’s the first step.

The next step is creating the right context and communication between the senior manager and the executive level, and the middle. For example, when Alan Lafley, the CEO of Procter & Gamble, says he wants 50 percent or more of the innovations the company works on to come from outside, that gives his middle managers permission to search for ideas that are not necessarily traditional P&G ideas. If he hadn’t done that, they couldn’t have done their jobs.

Essentially, he created a context that allowed him to get out of the way and empowered middle managers to pursue innovations. This doesn’t mean telling middle managers to do whatever they want. This is about having a different kind of discipline and a different kind of communication. It’s empowering, while setting limits.

Is driving innovation something that middle managers really want to do? Many do, but some feel that it’s a career risk, for good reason. Innovation is a process that unfolds unpredictably over time. Imagine three managers. Manager A has a brilliant idea and launches a venture, and it fails. B observes what A did and sees that now A is disappointed.

A lot of organizations took a meat-ax to their middle management ranks. They wound up with a lot of top-tier managers staring at one another in the executive suites.

I examined when innovation broke down and when it worked well. When it did work, it was usually because a middle manager was making the connections, finding the resources, providing a shield for people working on the venture so they didn’t get interfered with by senior management and doing the political work to say, “Hey, this is a legitimate activity.” And this was systematic across almost all of the companies I studied.

Rita McGrath calls for empowering middle managers, who—with their inside company knowledge, political savvy and talent for getting things done—make innovation possible.

Middle managers aren’t necessarily the ones who come up with the idea, but they’re the ones who know how to get it moving.

— Rita McGrath
and bitter, because the culture of the company condemns failure of that nature. B thinks A had a good idea but carried it out the wrong way, so B starts a venture to pursue a new take on the idea. This also fails. C looks at the trials of A and B and realizes that their efforts taught him something about this market. C launches a venture, and it succeeds beyond anybody's dreams.

Who's really responsible for the success? A, who had the idea, B, who tested the market in new ways, or C, who actually made the thing work? Companies aren’t good at figuring that out. C ends up a hero and rises in the hierarchy, and A and B are regarded as failures, or at least as less successful. The incentives are very skewed. Even worse, A and B will often leave and use what they have learned to start a new venture in competition with their original employer.

I just finished a study of success and failure in a portfolio of ventures at a big corporation. Out of 37 ventures, we found that 21 were shut down completely, but pieces of them were used in other ventures or carried over to the core business. There’s an awful lot of activity generated by the ventures, but they can’t be measured simply as successes or failures.

More broadly, this is one of the biggest problems with innovation programs. Companies are simplistic in how they judge ventures, and they don’t allow for the multiperiod, multisequence activities that are really what innovation is all about.

Why do so many people flinch at the term middle managers? Even middle managers themselves don’t seem to regard it as a desirable job description.

In the 1980s, middle management got a really bad name. People thought that companies with large middle management ranks were bloated, bureaucratic and inefficient. So a lot of organizations took a meat-ax to their middle management ranks. They delayed and downsized and empowered their low-level employees. What they wound up with was a lot of top-tier managers staring at one another in the executive suites, wondering what happened to the innovations. What happened was that all the managers who had the network connections, who knew where the technology was, who understood how the company worked were gone.

Maybe middle managers need a new image?

I think it’s time for an extreme make-over. The problem is middle managers don’t get a lot of recognition for their role in innovation, which is one reason why I wanted to write about this topic. A lot of what they do is behind-the-scenes work. It’s vital, but it’s not visible. When it’s time for the ribbon cutting, the CEO is there. When it comes to who’s regarded as the innovator or inventor, that’s the venture manager. The people who made it all happen are nowhere in the picture.

Companies should also recognize that innovation doesn’t need to be a scary process. There are tools and insights out there that are readily available if you’re willing to reach for them. Companies often make the same mistakes over and over again, primarily by applying practices that work well in the existing business to innovations.

For instance, one key principle we found is to recognize when you are operating on the basis of assumptions and to reward people for making better assumptions, not necessarily for coming up with the right answer. Another is to worry a lot more about the cost of failing than the rate of failing when you are investing in innovation—you can afford a lot of mistakes if they are inexpensive, and making small mistakes is often the only way to learn.

Innovation is different from running a conventional business, but it doesn’t have to be mysterious.

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Rita McGrath is associate professor of management at Columbia Business School and a faculty member of Columbia Business School Executive Education.
Regulating Through Rivalry
When testing competitors’ products results in greener products—and a better bottom line.

Every new cell phone, laptop or MP3 player eventually makes way for even more upgrades. Because electronic goods contain hazardous materials, the flow of new products onto the market prompts an important question: How should environmental standards for new products be monitored and enforced?

Efforts to monitor and limit hazardous materials have typically been enforced by government regulators, who test products for compliance and sanction firms when violations are found. But comprehensive regulation of new products is impossible since there are so many kinds of electronic products on the market and testing for compliance with environmental laws is expensive.

When California and the European Union recently implemented new restrictions on the kinds of materials that can be included in electronic goods sold in their markets, they took a novel approach to monitoring: regulators sought to engage manufacturers in the testing process by relying on electronics firms to police other firms. “Think of it as the firms whistle-blowing on one another,” says Professor Terry Taylor, who worked with Erica Plambeck of Stanford University to examine this new approach.

Taylor and his coresearcher used preliminary results from the California and EU initiatives to create a mathematical model that suggests having companies test their competitors—a tactic known as competitive testing—can improve manufacturers’ adherence to environmental standards and lead companies to put greener products on the market.

Investing time and money to test a competitor’s product can produce big returns. If a firm tips off regulators about a competitor’s noncompliance and the regulator confirms the report, the competitor will be blocked from the market until it can demonstrate that its product is no longer in violation. This gives other companies a chance to capture bigger shares of the market.

Taylor offers a key example: “Dutch authorities had a tip from an external party that said Sony’s PlayStations had too much cadmium. Regulators followed up and found that PlayStations were in violation. Sony was blocked from the market and lost an estimated $110 million in revenue during that time.”

There are good reasons for firms to embrace both competitive and regulatory testing. “Firms might be even better off if the regulator tested their products directly,” says Taylor. That’s because when a competitor fails testing conducted by regulators, other firms still reap the benefit of that competitor’s banned status, without having had to invest time or money in testing.

Competitive testing also increases the incentive for firms to comply with regulations so that they don’t get knocked out of the market themselves. To prevent firms from making agreements not to test one another, and to avoid creating an “If you tell on me, I’ll tell on you” dynamic, regulators make anonymous reporting a feature of these programs.

Taylor points out the paradox of competitive testing: it works best in noncompetitive markets, in which there are only a few players. “In a market with lots of little players, like the commodity consumer electronics market,” he says, “what are the incentives to test competitors?” Firms gain very little by knocking a small, low-end firm with no brand recognition out of the market. Thus, small, lesser-known electronics manufacturers—anticipating that they will not draw much scrutiny or testing—will have little reason to invest in compliance. In fact, relying on competitive testing can have the perverse effect of drawing these “white-box” manufacturers that have little interest in environmental compliance into the market.

Industries that produce goods that are subject to environmental, health or safety standards, and in which there are a small number of large firms, have the greatest potential to benefit from competitive testing and reduce the environmental hazards associated with their products. “Competitive testing,” Taylor says, “is like asking a kid to turn in his little brother for breaking the rules.”

Read More

Terry Taylor is the Barbara and Meyer Feldberg Associate Professor of Business in the Decision, Risk and Operations Division at Columbia Business School.
How Halting Deforestation Can Reduce the Impact of Climate Change

Geoffrey Heal is a cofounder of the Coalition for Rainforest Nations, which is seeking to provide financial incentives for forest conservation.

Imagine a project that does the following: It stops the logging of tropical forests, thereby preventing the extinction of the myriad species that depend on them; it takes a major step toward halting climate change; and it raises the living standard of some of the poorest people on the planet. Columbia Business School faculty members and alumni have developed just such a project.

Sir Michael Somare, the prime minister of Papua New Guinea, and Oscar Arias, the Nobel Peace Prize–winning president of Costa Rica, lead the Coalition for Rainforest Nations, an alliance of forested tropical countries that is widely regarded as one of the most important initiatives on the international political scene. The coalition’s aim is to modify the Kyoto Protocol to provide financial incentives for forest conservation, thus avoiding the two gigatons of carbon that deforestation contributes annually to the Earth’s atmosphere. The coalition is administered, and its strategy developed, at Columbia Business School.

Deforestation contributes between 20 and 25 percent of all greenhouse gas emissions annually—by comparison, the U.S. economy emits 27 percent—and is a major driver of climate change. Stop tropical deforestation and you make a big dent in climate change, almost as big as stopping all emissions from the United States. In addition, you conserve the many rare and beautiful species of animals, plants and insects that live in these forests, and you protect the livelihoods of the people around the globe who depend on forests for their existence.

I advocated seizing this opportunity in my 2000 book Nature and the Marketplace, but I never had the chance to put this idea into practice until I met Kevin Conrad ’05 (EMBA), an investment banker who grew up in Papua New Guinea and is a confidant of Prime Minister Somare. At the prime minister’s instigation, we hatched a plan to bring together a coalition of countries threatened with deforestation, which became the Coalition for Rainforest Nations. We then presented a proposal at the December 2005 Montreal meeting of the United Nations Framework Convention on Climate Change (UNFCCC), the body governing the Kyoto Protocol.

The wording of the proposal was unspecific and even bland: “Papua New Guinea and Costa Rica, on behalf of many supportive nations, call upon the parties to the UNFCCC and the Kyoto Protocol to take note of the present rates of deforestation within developing nations, acknowledge the resulting carbon emissions and consequently open dialogue to develop scientific, technical policy and capacity responses to address such emissions resulting from tropical deforestation.” Despite a clear lack of enthusiasm from the United States, the minutes of the meeting reflect a consensus in support of developing “policy approaches and positive incentives” for reducing emissions from deforestation.

“Positive incentives” is UN-speak for the use of market mechanisms. The UNFCCC agreed to consider detailed proposals for offering financial incentives for reducing emissions from deforestation in developing countries. Kevin and I were delegates of Papua New Guinea at the Montreal meeting; he is now the executive director of the coalition and has been joined by Federica Bietta ’05 (EMBA) as finance director.

Since December 2005 the coalition has been working with the Secretariat of the UNFCCC to develop detailed proposals for implementing incentives for reducing deforestation. The main idea is to introduce credits for reduced emissions from deforestation, or CREDs, that would be tradable on the emissions trading market to be established in 2008 under the Kyoto Protocol and also in the existing EU Emissions Trading Scheme.

The European Union—in particular the leaders of the UK, German and Italian governments—has been extremely supportive of the coalition’s initiative and has provided financial support to the Secretariat through Columbia Business School, as has the World Bank, which recently announced the creation of a $250 million forest carbon facility to prime transactions in this area.

The coalition plans to take a detailed proposal for the establishment and trading of CREDs to the December 2007 UNFCCC meeting in Bali. There are several economic details we have to resolve first, and to be successful we will need support not only from the coalition members and the EU but also from India and China, where deforestation is less rampant. The challenge is to create a scheme from which everyone can benefit, even those developing countries with little or no deforestation. Many international leaders are aware that approving this plan would lead to stable forests and greater income for forest dwellers. Approval in Bali would also mean reduced climate change for all.

Geoffrey Heal is the Paul Garrett Professor of Public Policy and Business Responsibility and a faculty leader of the Sanford C. Bernstein & Co. Center for Leadership and Ethics at Columbia Business School.
Reassessing Robert Moses and His Vision for New York

Ray Horton, who for 15 years was president of the Citizens Budget Commission, a nonprofit organization that promotes good government in New York City and New York State, discusses the recent nostalgia for the master builder.

Lately there’s been a lot of nostalgia for Robert Moses, that bête noire of 20th-century New York. A new exhibit at the Museum of the City of New York and an accompanying book by Hilary Ballon and Kenneth Jackson (both professors at Columbia University), offers a revisionist view of Moses, pointing out that without his many achievements—the development of bridges, roads, parks, playgrounds, swimming pools and public beaches—New York City would not be what it is today.

Ever since the publication of Robert Caro’s biography *The Power Broker: Robert Moses and the Fall of New York* in 1974, Moses has been seen as an evil man who demolished neighborhoods and blemished Jane Jacobs’s vision of a perfect New York. I had a somewhat different read of *The Power Broker*. It is certainly a critical biography, but it is the study of a man over the course of his career.

The first half of Caro’s book tells us about Moses the idealist, Moses the reformer, Moses the good guy. And the second half shows us the dark side of Moses—the Moses who bulldozed the South Bronx to make room for the Cross Bronx Expressway, the Moses who cared only about car culture, the man who didn’t care about the people affected by his projects.

The latter part of the book had an enormous impact, and the lasting impression of Moses that Caro left is different from the complete picture he presented. For more than 30 years, the collective wisdom has been that the city would have been better off without Moses.

In the last few months, news stories about the exhibit have described warm feelings for Moses that would have been unthinkable just a few years ago. Many of these stories say the nostalgia is for the way Moses got things done. It’s true that Moses did more spectacular development projects than anyone before or after. He was able to do this in a very complicated, fractious and divided city (though in many ways a less fractious and divided city than it is today).

And that has appeal when, after more than five years, the site of the World Trade Center is still an awful hole in the ground. It’s a tremendous embarrassment to the city, and it’s sacrilegious, in a sense, that the city, the state and the private sector have not been able to come to terms about how to rededicate that space.

Maybe Moses, if he were around, could have forced something to happen by now. But nobody today holds the number of positions that Moses had, and most people would agree that we wouldn’t want to give one person a near-monopoly on development, even if it meant we’d have a September 11 memorial.

To me, this nostalgia for Moses seems a bit misplaced. Moses is not relevant because he was able to get things done. He is relevant—and remarkable—because he was able to view the city as a whole, and he had a vision for it over time.

Whatever the short-term costs of a neighborhood dislocation, Moses would do it if there were long-term advantages for the city as a whole. This had devastating consequences at times, as it did in the South Bronx. But Moses was also the person who gave us Jones Beach, which was also devastating on a narrow neighborhood level. Except in that case, the families who controlled access to the ocean were members of the privileged class, and there are not many people who would argue that it was bad to take that land away in exchange for the long-term advantages.

Moses was a flawed individual who made many mistakes, as Caro’s biography and the new exhibit show. He was often described as seeing the city from a distance of 35,000 feet, and this was sometimes meant as a criticism of how he viewed New York only as it appeared on maps. But by taking the long view, Moses was able to overcome the not-in-my-backyard phenomenon in a way that very few people have been able to do since, which is why development is such a major problem in New York today.

Ray Horton is the Frank R. Lautenberg Professor of Ethics and Corporate Governance and director of the Social Enterprise Program at Columbia Business School.
Is the Price of Money Managers Too Low?

Gur Huberman examines why competition hasn’t eliminated profits for money managers, and why mutual funds are still priced well below the value of their profits.

There are hundreds of mutual fund families. Barriers to entry are low. And little capital is tied up in the business. These factors suggest that the industry is competitive and that its producers should therefore have low if not zero profits. But how does the market set the price of these expected future profits? In other words, how does the market price the equity of established money-management firms?

Consider a firm that manages a short-term-bond mutual fund, or even a riskier stock fund, and charges a fee at the end of each year equal to a fraction $c$ of the assets under management. The firm’s revenues pay for asset gathering, servicing and portfolio management, and for income taxes on profits. The rest goes to the firm’s owners. Simple back-of-the-envelope calculations show the pretax and after-tax profit margins are 35 percent and 20 percent, respectively, and money-management firms should be priced accordingly. (See box for details of the calculations.) Such profitability seems difficult to reconcile with an industry that is highly competitive.

In fact, money-management firms are priced at 1 to 4 percent of assets under management. It is tempting to explain away the discrepancy between the theoretical and actual price by citing the risk that any money manager may lose most or all of the assets under management for a variety of reasons, such as abysmal performance. But the formula also applies to incumbent money managers collectively, not just to individual money managers. Their collective risk appears negligible.

Other explanations suggest that current fees and profit margins are not sustainable in the long run and that competition will shrink them. Since prices reflect expectations of future profits, these explanations cannot be ruled out, but they entail ominous predictions for the money-management industry. And they beg the question: Why hasn’t competition eliminated these profits by now?

Money managers’ profits are derived from the fees they charge. In the absence of compelling evidence that money managers deliver excess returns, their clients should pay close attention to these fees. Indeed, straightforward calculations show that typical fees and performance are likely to result in substantial wealth dissipation, especially for long-term, buy-and-hold clients.

This issue is somewhat different for retail and institutional products. On the retail level, customers may pay little attention to fees because they seem small. It may even be the case that cutting fees to bolster performance is a money-losing proposition for a money manager. But, at least formally, each fund has trustees who are supposed to look after the interests of customers, not the interests of the firm that manages the assets. Why do these trustees not cut the fees and thereby also the managers’ profits? Probably because they owe their positions to the fund managers, and tend to act in accordance with the managers’ interests.

In defined contribution retirement plans like 401(k)s, plan sponsors contract with fund families to offer their funds to participants. Incentives for individuals to participate are strong, thanks to their preferential income tax treatment and often also to the sponsor’s matching contributions. One might think that sponsors would negotiate the fees down to (almost) eliminate the profits of the money managers, but the fees charged to fund holders in 401(k) plans are often the same as those charged to other retail customers. The overlooking of the seemingly small fees by retail customers offers at least a partial explanation of the profitability of funds that cater to retail customers.

However, such arguments should be less relevant for institutional money management, which is often performed by the same organizations that manage money for retail customers. Presumably, institutional clients are savvier than retail customers and, negotiating from a strong position, can bargain down the management fees to their competitive levels—the point at which institutional money management will earn (almost) no profit. However, they don’t; even with institutional clients, money managers seem to charge fees at higher than the competitive rate.

Even so, the market prices the business of money management well below what it appears to be worth—a price that would reflect the rich fees and high profit margins of the money managers.

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Calculations
Consider a firm that manages a mutual fund and charges a fee at the end of each year equal to a fraction $c$ of the assets under management. Assuming that it initially manages $A$, that the annual rate of interest is fixed at $R$ and that clients neither add nor withdraw money from the fund, the stream of income that the management company will receive is:

$$A(1 + R)(1 - c)c$$

at the end of the first year, $A(1 + R)^2(1 - c)c$ at the end of the second year, $A(1 + R)^3(1 - c)c$ at the end of the third, etc. At the discount rate $R$, the present value of this stream is $A$ minus the value of the assets under management.
Sometimes, trying to make the best choice makes us miserable. In this issue, Sheena Iyengar explains how satisficers and maximizers pursue the elusive goal of happiness. Chris Mayer examines the phenomenon of superstar cities, and Michael Morris describes how cultural differences affect the perception of responsibility. Other features take a look at emotional accounting and the unsung heroes of corporate growth. Research briefs show the benefits of tailoring Web ads to consumers’ purchasing histories, the risks of writing index options and how trading floors can be designed to competitive advantage.

To read more about the ideas covered in this issue—and to explore research findings on other business topics—visit the Columbia Ideas at Work Web site.

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