

VALUE CREATION THINKING VIDEO COURSE

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Introduction to a Three-part Video Course

A three-part video course has been developed that summarizes key ideas from my research journey that began in 1970. That research is focused on two foundational questions. First, how do firms succeed or fail in creating long-term value? Second, how best to connect a firm's long-term performance to its market value and shareholder returns? My work in answering these questions evolved into the Pragmatic Theory of the Firm.

Don't be turned off by the word 'theory.' A viable theory is a way of thinking that helps us see the world more clearly, clarify problems and approaches to solutions, and improve our decision-making. By understanding the value creation process, we gain a bottom-up view of how firms are the engine of economic prosperity.

The Pragmatic Theory of the Firm clarifies the firm's purpose and positions maximizing shareholder value not as the purpose of the firm but as the result of a firm successfully achieving its purpose. One result of this way of thinking is confidence in knowing what it takes for firms to create long-term value and in supporting a commitment to live the life of a value creator. That understanding sees through the seemingly never-ending debates about shareholder capitalism versus stakeholder capitalism and socialism versus capitalism.

I was fortunate to develop and promote this course in partnership with Principled Business, a 501 c (3) organization. Their mission is to enhance the understanding of free-market capitalism by business leaders; assist them in applying the foundational principles of capitalism in their firms; and energize people to engage with their local communities and to effectively communicate the widespread benefits delivered by firms that create long-term value. Principled Business delivers the course by way of a comprehensive educational package (resembling a classroom experience with discussion) www.PrincipledBusiness.org. The videos are also accessible via my website, www.LearningWhatWorks.com.

The Part 1 video lays out the Pragmatic Theory of the Firm that views the firm as a holistic system and explains the key components of the purpose for the firm. The firm's knowledge-building culture is the critical determinant of a firm's long-term value creation success. The life-cycle framework is presented and serves as much-needed tool to connect firms' financial performance to stock market valuations and shareholder returns. Parts 2 and 3 focus on analyzing the long-term life-cycle track records for a group of well-known firms, including Amazon, Walmart, and Nvidia. Expect to gain insights about the deeper causes of firms' long-term performance and, in general, experience the benefits of viewing the firm as a holistic system via the Pragmatic Theory of the Firm. The Part 3 video focuses on three firms in analyzing the growing trend to transition from command-and-control organizational structures to flatter structures. This topic should be a high priority for boards of directors and management since it can lead to significant benefits to all of the firm's stakeholders.

Bottom-up Understanding of a Flourishing Society

There is a prerequisite to firms being the engine of economic prosperity. And that is a society that facilitates both the startup of new businesses and their ongoing operations; plus, safeguarding the voluntary exchange and ownership of private property; and maintaining sound money and a tax system supportive of long-term value creation. In other words, economic freedom. Its importance is reflected in the empirical observation that people in the freest quartile of countries live about 17 years longer than those in the least-free quartile.¹

An important takeaway from this course is an appreciation for how firms create long-term value dependent upon a culture that enables freedom for employees to experiment and continually build up their problem-solving skills while solving problems that matter. Consequently, employees contribute to the firm's success and, in so doing, make the world a better place. When a firm's culture is right, work becomes meaningful. Work becomes more than a paycheck. This is the heart of a flourishing society. Viktor Frankl made a relevant point when he noted that people are pushed by drivers (e.g., monetary incentives) but pulled by meaning.² The Pragmatic Theory of the Firm facilitates the nurturing and sustaining of the right culture.

One of the firms analyzed in the course is the preeminent steel manufacturer Nucor. Ken Iverson was CEO for 30 years and orchestrated Nucor's culture. In his autobiography, Iverson noted: "We anticipate that roughly half our investments in new ideas will fail. ...we built Nucor under the assumption that most of the genius in our firm is found among the people doing the work. ...we focus on shaping an environment that frees employees to determine what they can do and should do, to the benefit of themselves and Nucor."³

Capitalism

I use the term 'capitalism' as synonymous with 'free-market capitalism' as distinct from crony capitalism that enables those with political connections to promote laws and regulations that advantage their firms at the expense of competitors and puts roadblocks in front of potential future competitors. As to inequality, a strong case can be made that people feel more strongly about fairness than inequality.⁴

Crony capitalism is piloted by exceedingly rich and powerful people, including entrepreneurs who built businesses from the startup stage. Their influence on the political process is immense. Laws and regulations that cement the status quo silently operate providing an unfair competitive playing field inconsistent with an opportunity rich society. Ask yourself if the laws and regulations that followed the 2008 financial crisis favored big banks to the detriment of smaller competitors?

The philosopher David Schmidtz provides an insightful view:

Society is not a race. In a race, people need to start on an equal footing. Why? Because a race's purpose is to measure relative performance. By contrast, a *society's* purpose is not to measure relative performance but to be a good place to live. To be a good place to live, a society needs to be a place where people do not face arbitrary bias or exclusion. In liberal society at its best, women, men, blacks, whites, and people of all religions have a real chance to live well, as free and responsible individuals. People need a good footing, not an equal footing.⁵

Digging deeper, the argument for socialism is based on a mechanistic view of the economy (and the firm) that ignores systems thinking, knowledge-building, and long-term value creation. Proponents of socialism fail to understand how we benefit from free-market capitalism. That this is important is noted by Eric Beinhocker and Nick Hanauer:

Markets are evolutionary systems that each day carry out millions of simultaneous experiments on ways to make our lives better. In other words, *the essential role of capitalism is not allocation—it is creation*. Life isn't drastically better for billions of people today than it was in 1800 because we are allocating the resources of the 19th-century economy more efficiently. Rather, it is better because we have life-saving antibiotics, indoor plumbing, motorized transport, access to vast amounts of information, and an enormous number of technical and social innovations that have become available to much (if not yet all) of the world's population. The genius of capitalism is that it both creates incentives for solving human problems and makes those solutions widely available. And it is solutions to human problems that define prosperity, not money.⁶

Widespread adoption of the Pragmatic Theory of the Firm, as explained in this three-part video course, would be a major step forward to transcend the polarization epitomized by capitalism versus socialism or Republican versus Democrat. In so doing, we can build a more civil society where we seek to build knowledge, to create value for others, and to ensure that everyone has a good footing.

The remainder of this paper is a transcript of the Parts 1, 2, and 3 videos, including related figures that I used in recording the videos.

Transcript Part 1 The Pragmatic Theory of the Firm

By way of background, during the 1960s, I began my career as an engineer then subsequently spent time in the army during the Vietnam War. In seeking a career change that I could be passionate about, I attended the University of California, Berkeley business school. That led to two research questions that have guided my lifelong journey: What causes firms to succeed or fail in creating value over the long term? How best to connect a firm's long-term financial performance to its market valuation? My research in answering these questions has evolved into the Pragmatic Theory of the Firm—the focal point of this course.

In 1970, I co-founded Callard, Madden & Associates, a research firm with institutional money manager clients. That provided an opportunity for me to develop the life-cycle valuation framework and a more accurate accounting return metric, the CFROI (cash-flow-return-on-investment). Today, most large money management organizations utilize this framework by way of a global database provided by UBS HOLT. That work effectively dealt with the task of connecting a firm's financial performance to market valuations and explaining excess shareholder returns.

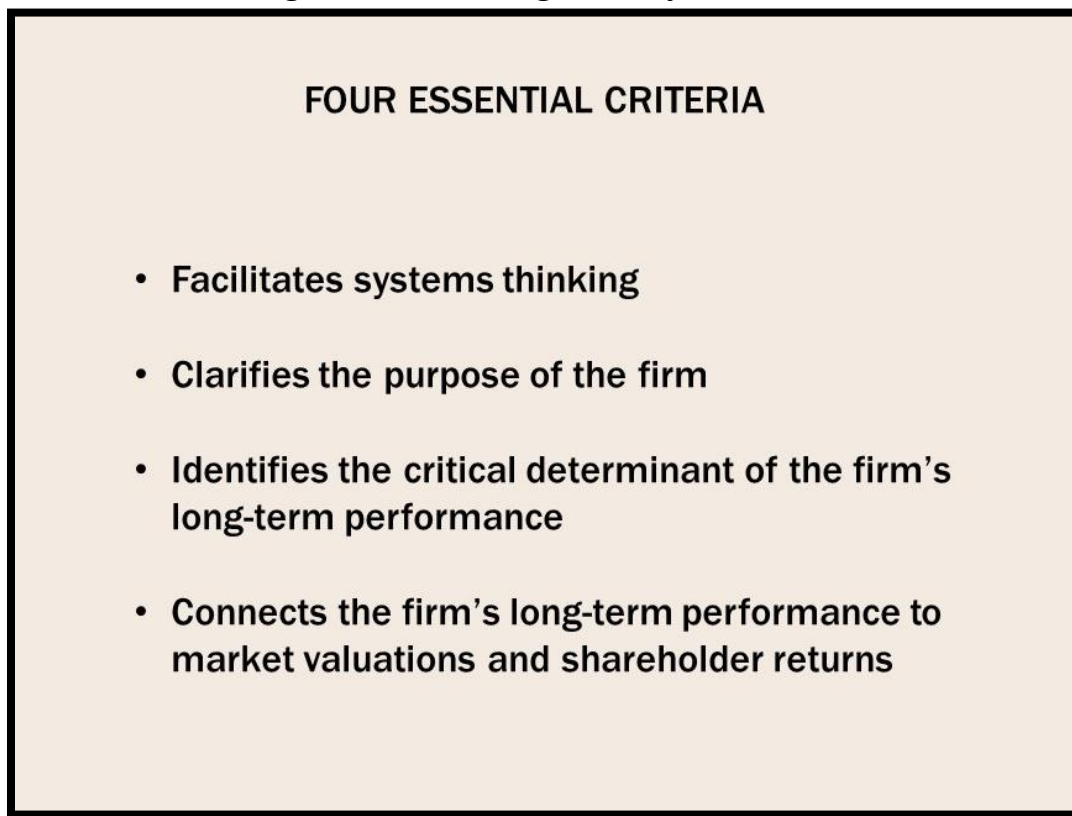
I learned that systems thinking is essential to grapple with interrelationships and to treat the firm in a holistic manner. A systems perspective facilitates alternative ways of framing problems and seeing how the root cause of a problem may be at a higher level in the organization. Moreover, in

today's economy the firm's connectedness often entails membership in an ecosystem that requires systems thinking for analysis, not linear cause-and-effect thinking.

Another takeaway is that knowledge building and value creation are opposite sides of the same coin. A highly proficient knowledge-building culture is the source of many of the components of competitive advantage, such as effective strategies, essential capabilities, etc.

Let's begin by addressing four plausible criteria for judging if a theory of the firm is viable for practical decision-making.

Figure 1.1 Evaluating a Theory of the Firm



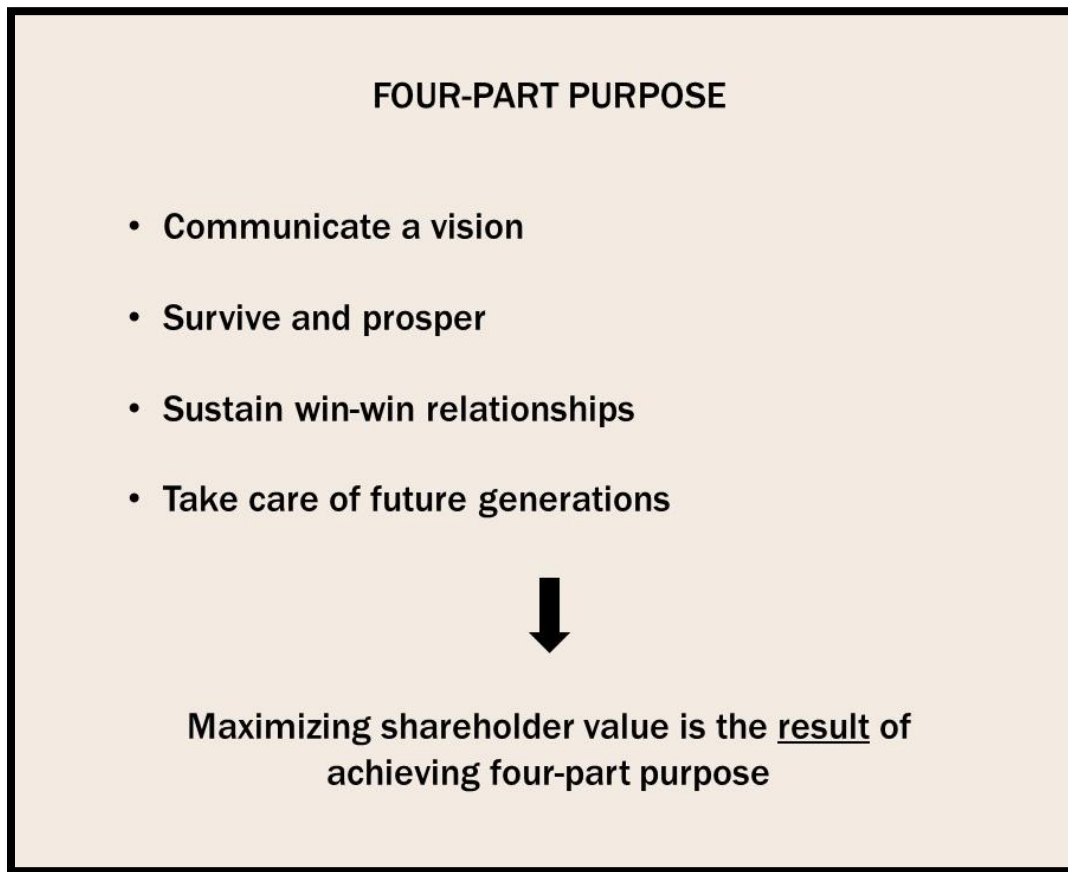
The academic literature dealing with the theory of the firm has been hyper-focused on either highly abstract questions such as why do firms exist or a singular focus on specific issues such as corporate governance. These research programs do not provide practical insights for a wide range of decision-making by management, boards, and investors.

I suggest four plausible criteria for evaluating a theory of the firm. First, it needs to facilitate systems thinking so essential for analyzing complex problems and for avoiding the pitfalls from excessive reliance on linear cause-and-effect thinking. Second, any analysis of a system, such as a firm, requires clarity about the purpose of the system. Lack of clarity has resulted, for example, in never-ending debates about shareholder capitalism versus stakeholder capitalism. Third, a

theory should specify the critical determinant of the firm's long-term performance. Fourth, it is remarkable that theories of value creation by firms so often are silent as to insights about the market value of the firm. A viable theory of the firm needs to connect the firm's long-term performance to market valuations and shareholder returns.

Let's now apply these criteria to the Pragmatic Theory of the Firm beginning with the firm's purpose.

Figure 1.2 Starting point—the firm's purpose



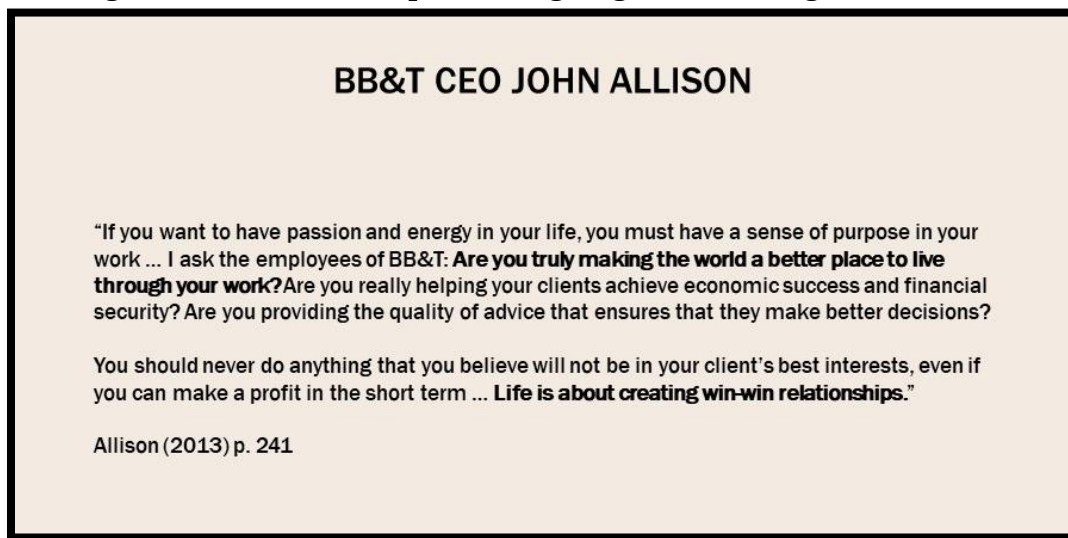
The Pragmatic Theory of the Firm views the firm as a system of complex and interrelated activities steeped in nonlinear relationships, feedback loops, and time-lagged effects driven by multiple causes. Step one in understanding the firm as a system is to clearly specify its purpose. The following four mutually reinforcing objectives constitute the firm's purpose:

- Communicate a *vision* that is inspirational and motivates employees to join the firm's commitment to behave ethically and make the world a better place.
- *Survive and prosper* through continuous gains in efficiency and sustained innovation, which depend upon a firm's knowledge-building proficiency. Nothing works long term if the firm steadfastly fails to earn its cost of capital.

- Work continuously to build trust and *win-win relationships* with all the firm's stakeholders.
- *Take care of future generations* with a commitment to ensure environmental sustainability that starts with the design stage of a firm's products and services to minimize subsequent waste and pollution.

Importantly, maximizing shareholder value is best positioned not as the purpose of the firm, but as the result of a firm successfully achieving its four-part purpose. Let's discuss how purpose can be a reliable guidepost during changing environments.

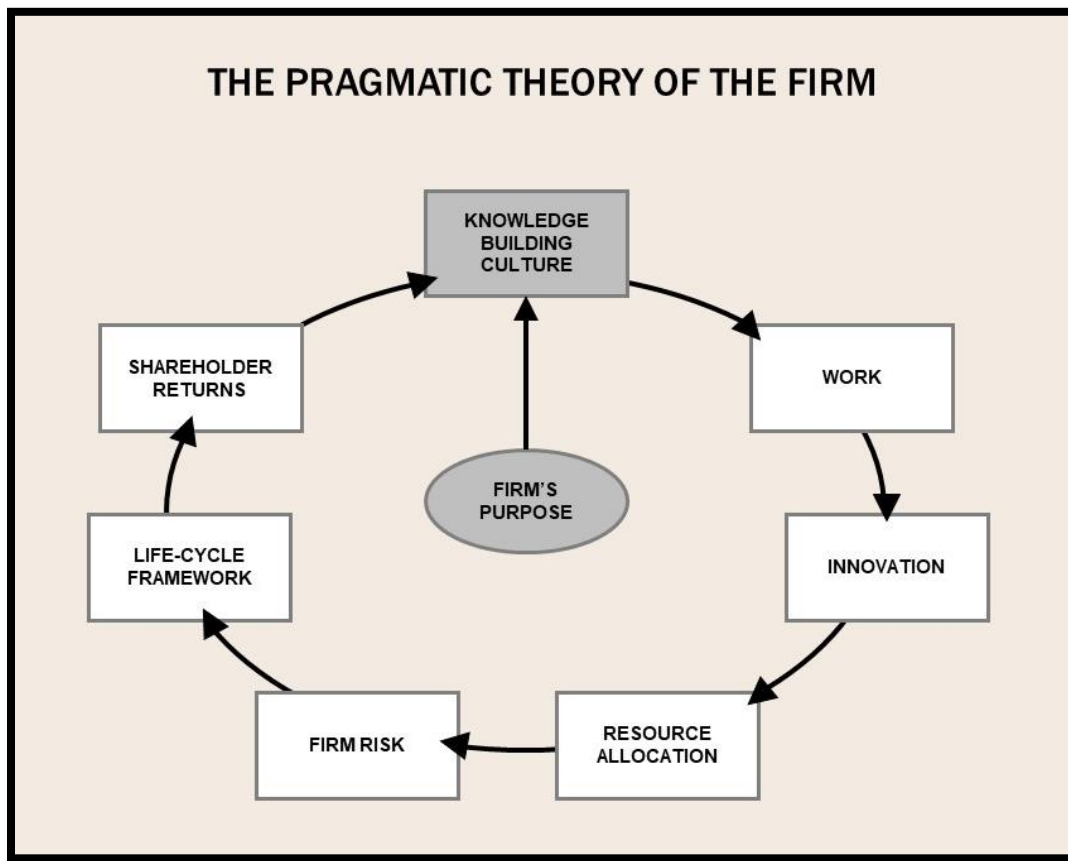
Figure 1.3 BB&T—best performing large bank during the 2008 crisis



During the 2008 financial crisis, many large banks boosted quarterly earnings by selling toxic products to their customers, such as negative amortization loans. With these loans customers made miniscule payments in the early years although the principal owed kept increasing. Many customers suffered severe financial losses. BB&T never sold any toxic loans since their culture was so clear as to the purpose of the firm, as explained by BB&T's long-term CEO John Allison.

“If you want to have passion and energy in your life, you must have a sense of purpose in your work ... I ask the employees of BB&T: Are you truly making the world a better place to live through your work? Are you really helping your clients achieve economic success and financial security? Are you providing the quality of advice that ensures that they make better decisions? You should never do anything that you believe will not be in your client's best interests, even if you can make a profit in the short term ... Life is about creating win-win relationships.”

Figure 1.4 Components of the Pragmatic Theory of the Firm



The Pragmatic Theory of the Firm is illustrated beginning with the firm's four-part purpose tied to a knowledge-building culture and ending with shareholder returns. Viewing the firm as a holistic system, the Pragmatic Theory of the Firm emphasizes the interrelationships of the firm's major activities that include *work*, *innovation*, *resource allocation*, plus *firm risk* and the connection between long-term financial performance and market valuation via the *life-cycle framework* and *shareholder returns*. Importantly, the Pragmatic Theory of the Firm positions the firm's knowledge-building proficiency as the critical determinant of its long-term financial performance. We will analyze the knowledge-building process later in this presentation.

Work: The objective of work is to deliver value to the customer while simultaneously reducing waste. Value is delivered to customers when their total experience in buying and using the product or service results in them saying: "This is a good deal." Keep in mind that accounting controls promote the separation of functions in the firm whereas the Pragmatic Theory of the Firm emphasizes a systems view and connectedness. For example, accounting-based cost controls can lead to optimization of local efficiencies to the detriment of overall system performance.

Innovation: In the new economy, opportunities for innovation are ubiquitous. Identifying and seizing upon these opportunities, however, depends on the firm's knowledge-building culture and its organizational structure. A pro-innovation culture questions what we think we know and the related assumptions at all levels of the firm, thereby encouraging experimentation, accepting

failures as part of building useful knowledge, helping others solve problems, mentoring to improve employees' problem-solving skills, and designing performance measurement and incentives to assist and motivate those doing the work.

Resource Allocation: Resource allocation is influenced by the extent of command-and-control organizational structure—the fewer the layers, the flatter the organizational structure and typically the faster information flows from front-line employees to top management. Resource allocation is also influenced by distortions in measuring accounting-based return-on-assets and the tradeoff between investment to improve the efficiency of existing assets and investment to develop new businesses that might even compete with existing businesses.

Firm Risk: The Pragmatic Theory of the Firm views firm risk as obstacles to achieving the firm's purpose. Consequently, firm risk increases with changes that degrade the likelihood of the firm achieving its purpose. There is a myriad of management actions that benefit near-term earnings but degrade the likelihood of the firm achieving its purpose in the long run.

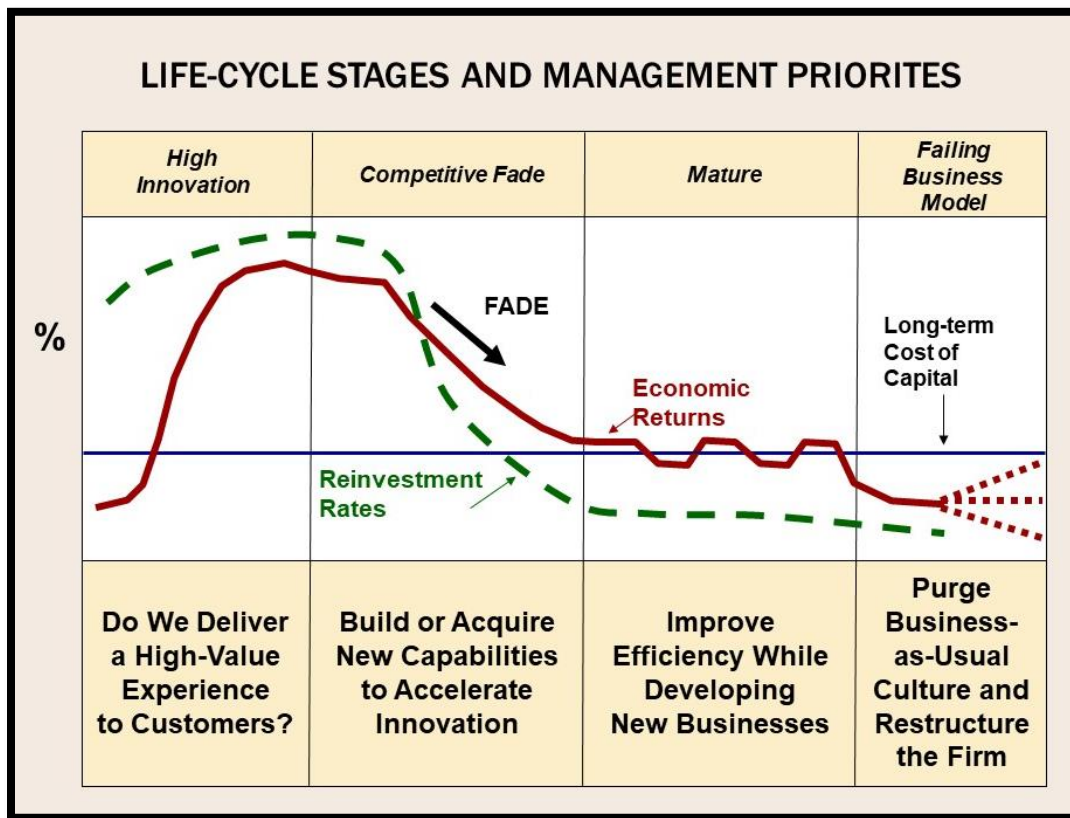
The Life-cycle Framework: The life-cycle framework enables one to gain insights from past performance that are relevant to future performance. You will experience through the many examples of firms in this course that the life-cycle valuation language is far more useful than earnings per share growth rates and economic value added or EVA.

Shareholder Returns: Shareholder returns for a specific time period are explained by comparing expected life-cycle performance at the beginning of the period versus actual performance delivered.

In my opinion, the path for management to purge short-termism and walk away from dancing to Wall Street's tune for meeting or exceeding their quarterly earnings expectations is to adopt the Pragmatic Theory of the Firm and its life-cycle language.

Let's review the life-cycle components and then utilize this way of thinking to analyze a well-known firm, Eastman Kodak.

Figure 1.5 Life-cycle framework

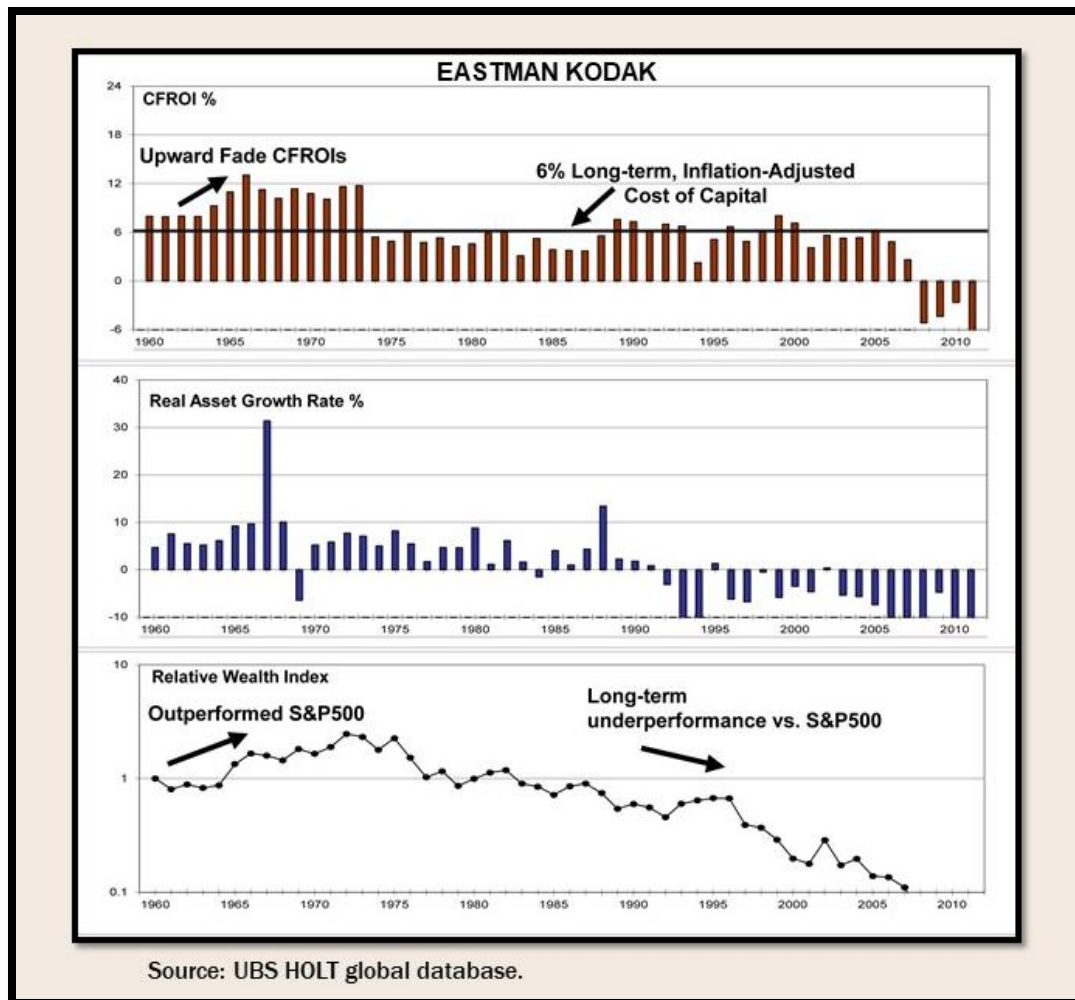


In a market-based economy, a firm's economic returns regress towards the average cost-of-capital return over time. Economic returns refer to cash-out/cash-in achieved returns on investment (ROIs). Further, a firm's reinvestment rate typically slows as the firm grows and faces more competition.

Note the relationship between a firm's economic returns and reinvestment rates over the firm's life cycle. At the *high innovation stage*, management's critical task is to confirm or refute key business model assumptions and, if necessary, pivot to a more viable approach to deliver value to targeted customers. Competitors are also attracted to this opportunity, however, and strive to duplicate and possibly improve upon the value experience offered by the successful startup. Consequently, firms eventually enter the *competitive fade stage*. Portfolio managers well versed in the life-cycle framework frequently debate buy/sell opportunities in terms of a firm's ability to "beat the (expected) fade." To achieve a favorable fade, management needs to build or acquire needed capabilities to expand beyond the comfort zone of their existing technologies, products, and services. At the *mature stage*, economic returns approximate the cost of capital and there is a tendency for management to myopically focus on the efficiency of existing businesses. Through experimentation with emergent opportunities, however, management can potentially achieve economic returns on new investments substantially more than the cost of capital. The hallmark of the *failing business model stage* is a business-as-usual culture that fails to adapt to fundamental change. Purging this dysfunctional culture is the top priority.

Summarized at the bottom of this figure are management's top priorities that are shown dependent upon a firm's life-cycle stage. These priorities are especially useful guideposts for management, boards of directors, and investors.

Figure 1.6 Eastman Kodak 1960-2011



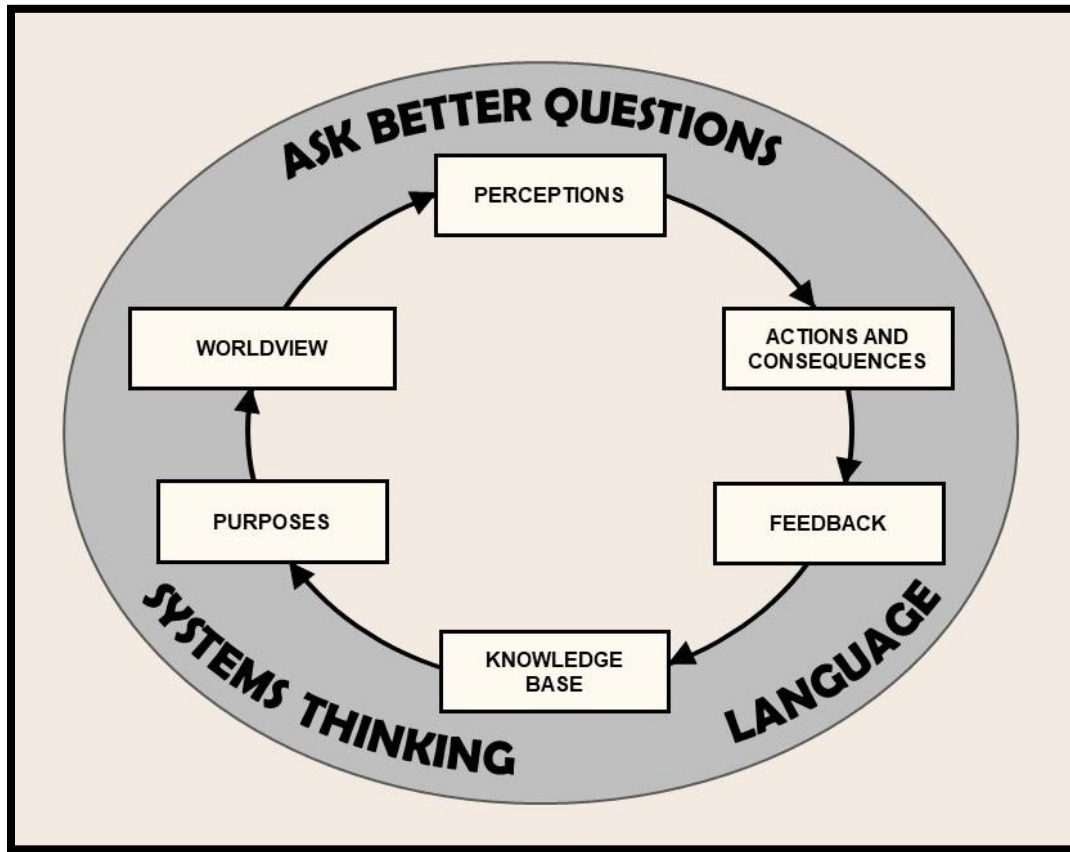
Let's consider the history of Eastman Kodak in life-cycle terms beginning with 1960 and ending in 2011, one year before its bankruptcy. The top panel plots economic returns as CFROI (cash-flow-return-on-investment), which is an inflation-adjusted accounting return with a considerable number of adjustments to minimize accounting biases, such as capitalization and amortization of R&D expenditures. The cost of capital is the red line in the top panel. The middle panel displays real asset growth rates that approximate reinvestment rates. The bottom panel tracks the firm's total shareholder returns net of the S&P 500 Index total return. As reflected in the top panel, Kodak's introduction of the Instamatic cartridge in the early 1960s contributed to earning CFROIs well above the 6% real (inflation-adjusted) long-term cost of capital coupled with significant asset growth rates. This unexpected surge in performance exceeded investor expectations leading to outperformance of the S&P 500 during the 1960s and the early 1970s.

However, since the early 1970s, as shown in the top panel, CFROIs faded to the cost of capital level—the red horizontal line. Most large firms can sustain cost-of-capital returns for long periods of time. Not so for Kodak, as CFROIs then rapidly faded to below-cost-of-capital returns. Management failed to adapt to a changing world in which digital photography replaced most of the uses for cameras and film that was Kodak's core business. As shown in the bottom panel, investors continually underestimated Kodak's rapid fade and its stock price substantially underperformed the S&P500 on the road to bankruptcy in 2012.

Firms like Kodak that quickly fade to the mature, cost-of-capital stage followed by the failing-business-model stage typically follow a similar pattern. This begins with a business-as-usual, dysfunctional board of directors who do not appreciate the top priorities for management dependent upon the firm's current life-cycle stage. The pattern often includes a revolving door of CEOs who unveil a new strategy and focus on short-term improvements in financial performance. The more entrenched the firm's bureaucratic culture due to excessive layers constituting a command-and-control organizational structure, the more difficult to achieve meaningful improvement.

Note that Kodak hired a young engineer, Steve Sasson, who promptly invented digital photography. When asked about how management responded during meetings in which he explained his invention, he replied that management showed little interest and emphasized that Kodak is a film company. This is a clear-cut example of a significant decline in the proficiency of Kodak's knowledge-building culture that included management's inability to question their strongly held beliefs about the future of its core film business. Let's now dig deeper into the knowledge building process that is foundational to identifying obsolete assumptions and boosting value-creating innovation.

Figure 1.7 The Knowledge Building Loop



We go through life traversing a Knowledge Building Loop while continuously learning which actions help best to achieve our purposes. The components of the Knowledge Building Loop serve as guideposts that help audit how we know what we think we know. The knowledge base contains assumptions of varying degrees of reliability. One's worldview represents ideas and beliefs through which we interpret and interact with the world. A worldview that favors a deeper understanding of causality and nonlinear system complexities improves one's knowledge base, leading to more effective actions that produce desired consequences. Neuroscientists affirm that our perceptions are based on memories that facilitate predictions via analogy to the past. We see what our brains tell us to see. Especially important is orchestrating feedback that can overcome our automatic reliance on the past and reveal obsolete assumptions earlier than otherwise.

The Knowledge Building Loop highlights three useful habits. First, systems thinking has myriad benefits, including viewing employee behavior as a structure of the system. Second, asking better questions is the path to innovation that matters. And third, attention to language opens the door to discovering hidden and possibly obsolete assumptions. A particularly insightful example of this way of thinking is offered by the remarkable knowledge-building journey of the Wright brothers in teaching the world how to fly.

Figure 1.8 Fast and effective traversing of the Knowledge Building Loop

**ORVILLE AND WILBUR WRIGHT, 1903,
TAUGHT THE WORLD HOW TO FLY**



The components of the Knowledge Building Loop serve especially well as guideposts for analyzing the successes and failures of innovation projects. For example, Orville and Wilbur Wright taught the world how to fly as demonstrated on December 17, 1903 in the Wright Flyer, which was built for about \$35,000 in today's dollars.

The Wright brothers extensively documented their four-year journey which can be summarized as fast and effective traversing of the Knowledge Building Loop. Here are key highlights. Their existing **knowledge base** benefitted from operating a bicycle repair shop that influenced a core belief that substantially differed from their well-funded competitors who believed the key was a powerful engine coupled to a stable aircraft. In contrast, the Wright brothers believed that pilot control was the key to flight. Note that a bicycle is inherently unstable until the rider masters how to control it.

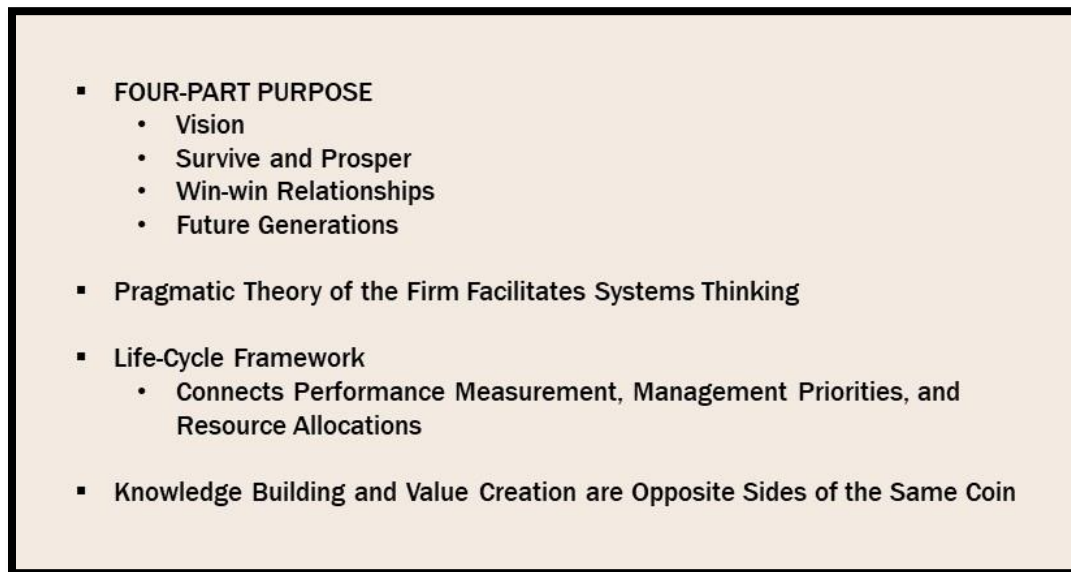
The Wright brothers, in general, were skeptical of what others accepted as proven knowledge. As to **purposes**, their competitors typically wanted to showcase the “big idea” and hired pilots to fly these experimental planes which often led to fatal crashes. The Wright brothers differed as to purposes as they were intent on systematically building up their knowledge base and not dying from a plane crash. Early on, they performed extensive experiments with kites and then gliders.

As to **worldview**, they framed problems in terms of control, which inextricably led to systems thinking. And their **perceptions** were shaped by an overriding concern for pilot control. Their reliance on experiments to provide critical **feedback as to actions and consequences** overturned

much of conventional thinking and systematically led to improved performance of the overall system. For example, they constructed a small-scale wind tunnel from a wooden box and fan that enabled experiments demonstrating serious errors in conventional knowledge. Specifically, their improved measurements of lift and drag coefficients greatly helped their design of wings and a propeller.

Let's summarize important takeaways from Part 1 of this course

Figure 1.9 Important Takeaways

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- **FOUR-PART PURPOSE**
 - Vision
 - Survive and Prosper
 - Win-win Relationships
 - Future Generations
 - **Pragmatic Theory of the Firm Facilitates Systems Thinking**
 - **Life-Cycle Framework**
 - Connects Performance Measurement, Management Priorities, and Resource Allocations
 - **Knowledge Building and Value Creation are Opposite Sides of the Same Coin**

The Pragmatic Theory of the Firm was developed over decades of researching the details of firms' long-term performance. In terms of important benefits to users, I would include the firm's four-part purpose that addresses all stakeholders in an economically sensible way; the implementation of systems thinking and the life-cycle framework; and the awareness that knowledge building and value creation are opposite sides of the same coin.

This completes Part 1 of the course. Parts 2 and 3 illustrate an important use of the Pragmatic Theory of the Firm in facilitating practical insights through a deeper analysis of firms' long-term performance. Part 2 analyzes the consumer finance software firm Intuit, Amazon, Nivida, and Walmart. Part 3 discusses Deere and Microsoft; in addition, issues concerning organizational structure are addressed through analyses of Nucor Steel, the Chinese firm Haier Group, and the German firm Bayer.

Transcript Part 2 Knowledge Building and Value Creation

When a firm has a history of success, management, the board, and employees can easily become risk averse and give top priority to stability, predictability, and control. However, the external environment and ways to create value as perceived by customers are in a state of continual change. What is needed is

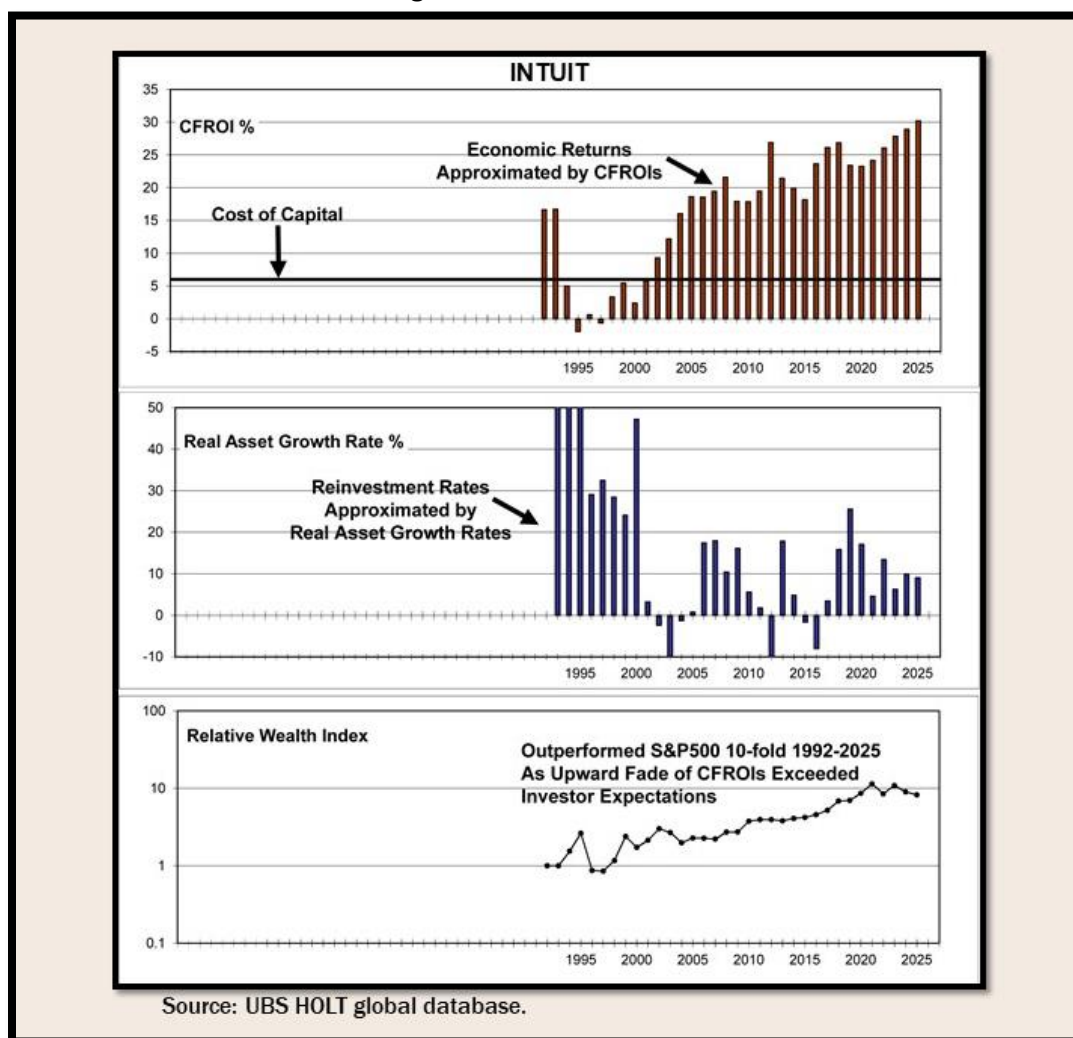
a proficient knowledge-building culture that operates at all levels of the firm and instills confidence in dealing with uncertainty.

Change and uncertainty represent opportunities to experiment, to identify obsolete assumptions, to accept failure as part of knowledge building, and to avoid a narrow and fixed mindset by embracing systems thinking and asking better questions. In this manner, the firm adapts early to change. This is the path to sustained, long-term value creation.

A relentless focus on knowledge building by management and supported by the board of directors makes sense because the resulting culture is the foundational source of long-term performance. Absent such a culture the result is often an excessive focus on quarterly earnings to the detriment of investing for the long term.

We can gain insights about a knowledge-building culture through analyzing the life-cycle track records of firms. We begin with Intuit, a consumer financial software firm known for their Quick Books product for small business.

Figure 2.1 Intuit 1992-2025



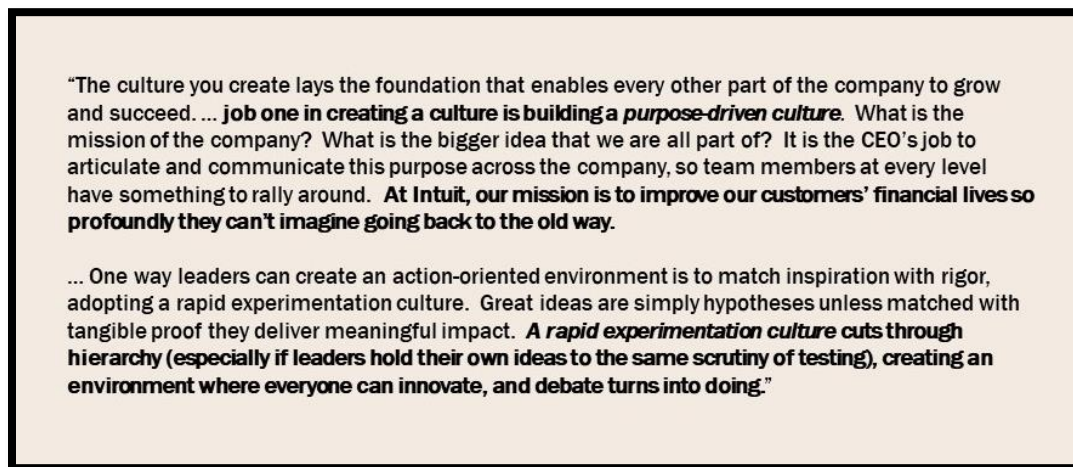
The life-cycle track record for Intuit, 1992-2025, shows in the top panel exceptionally high CFROIs versus the cost of capital shown as the red line. The middle panel shows very high reinvestment rates, calculated as asset growth rates, in the early startup years. The lower panel shows long-term outperformance of the S&P 500 as the firm's financial performance continually exceeded investor expectations.

Consider the early years when Intuit's Quicken software product for personal finances competed against Microsoft Money. How did Intuit's Quicken win the competitive battle against a huge, financially strong Microsoft that most likely employed higher skilled programmers versus Intuit? The answer to this question returns us to the firm's knowledge-building culture as the critical determinant of long-term performance.

Intuit's founding CEO Scott Cook instilled an almost religious fervor in Intuit's employees to observe in minute detail how customers used their software. Programmers would visit customers in their homes. In contrast, Microsoft programmers stayed in their offices and did not experience the feedback that could have enabled them to purge faulty assumptions as did Intuit's programmers.

As to their business software Quick Books, Intuit developers learned that customers wanted to avoid learning details concerning accounting principles whereas competitors were guided by CPAs who insisted on incorporating capabilities important to them but not to customers. Quick Books avoided increased capabilities, bet on simplicity that customers wanted, and dominated the market.

Figure 2.2 Brad Smith on Intuit's culture



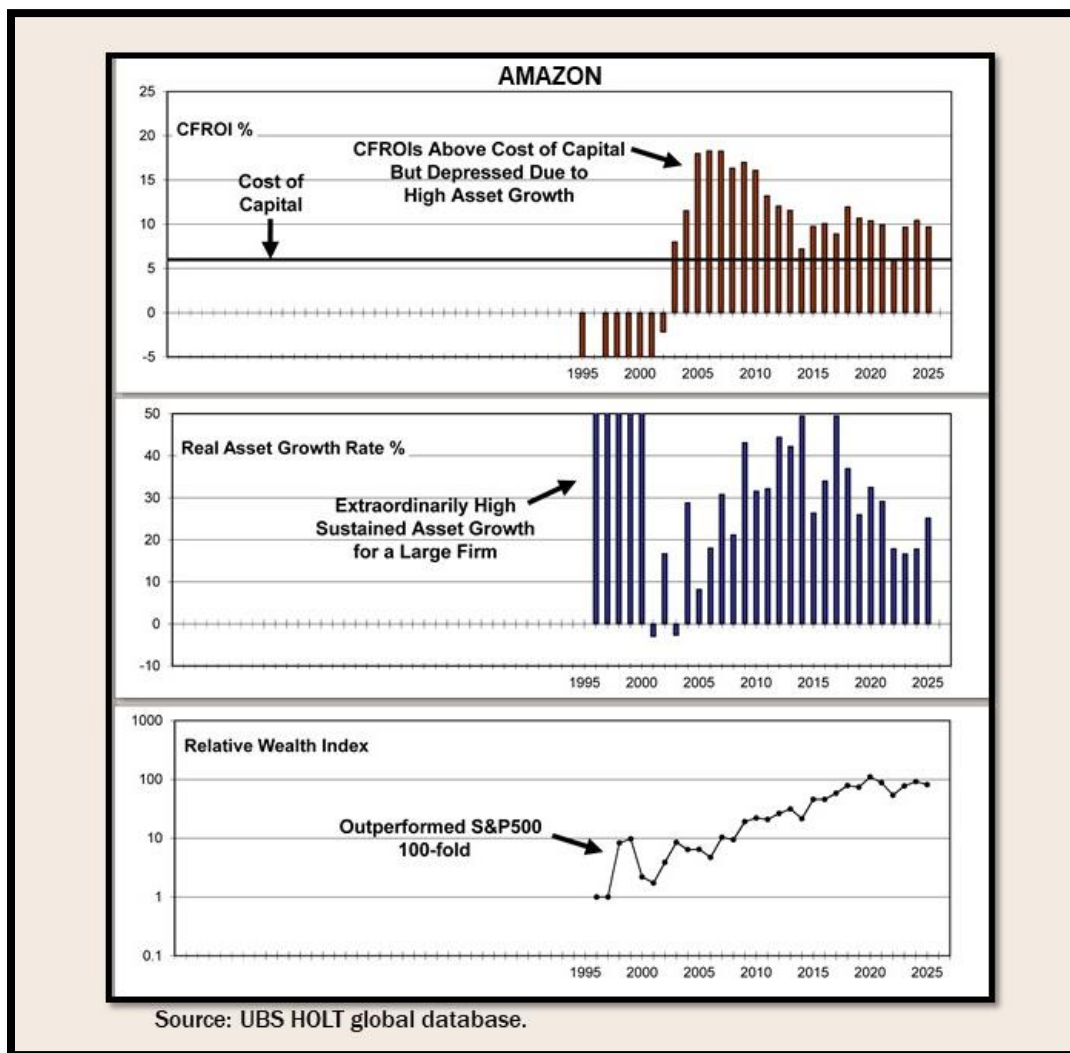
Brad Smith later became CEO and, in the spirit of the Pragmatic Theory of the Firm, summarized Intuit's culture as follows: "The culture you create lays the foundation that enables every other part of the company to grow and succeed ... job one in creating a culture is building a purpose-driven culture. What is the mission of the company? What is the bigger idea we are all part of? It is the CEO's job to articulate and communicate this purpose across the company, so team members at every level have something to rally around. At Intuit, our mission is to improve our customers' financial lives so profoundly they can't imagine going back to the old way.

One way leaders can create an action-oriented environment is to match inspiration with rigor, adopting a rapid experimentation culture. Great ideas are simply hypotheses unless matched with tangible proof they deliver meaningful impact. A rapid experimentation culture cuts through hierarchy (especially if leaders hold their own ideas to the same scrutiny of testing), creating an environment where everyone can innovate, and debate turns into doing.”

The resulting organizational structure was described by Scott Cook in an interview as “focused on information, not rank in which the senior executives are not at the top of a pyramid, but rather at the center of a circle.”

A key point is that although the context changes when studying different firms, the benefits from the way of thinking promoted by the Pragmatic Theory of the Firm apply to all firms. Moreover, an insightful analysis of the past equips you to make better decisions in the future. Let’s examine Amazon’s history.

Figure 2.3 Amazon 1995-2025

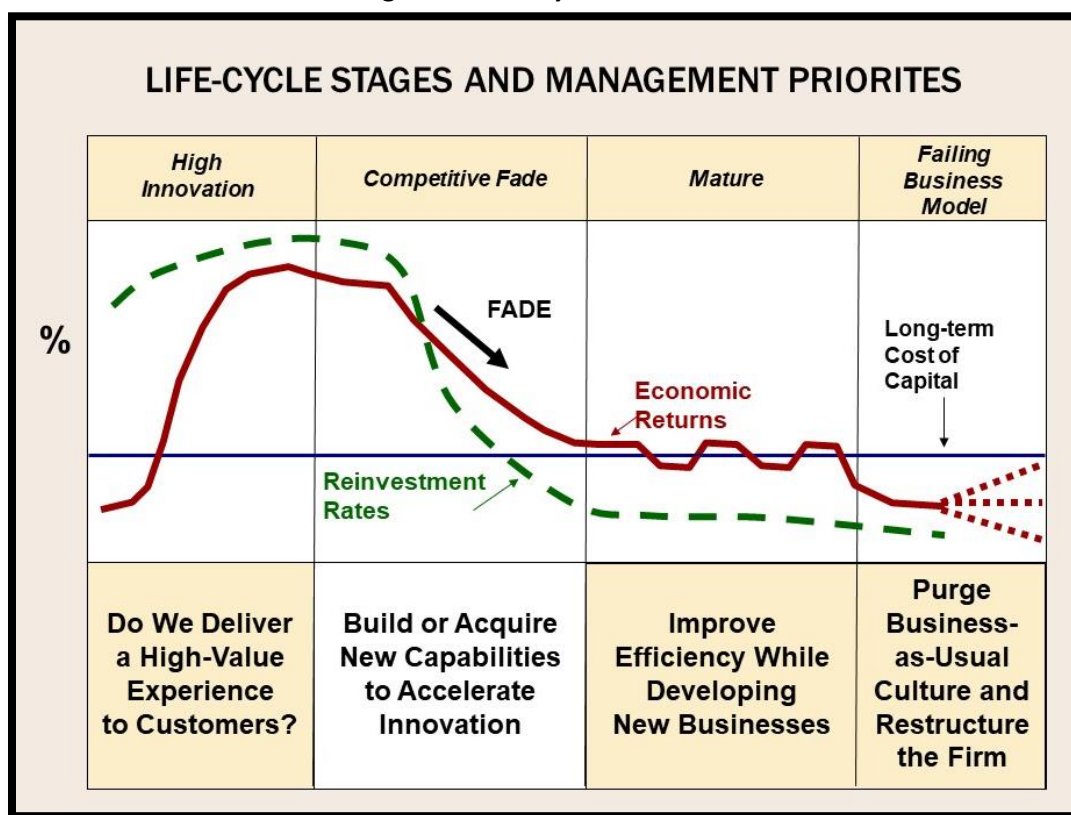


The top panel of Amazon’s life-cycle track record 1995 to 2025 displays CFROIs substantially above the cost of capital shown as the red horizontal line. Amazon is in the competitive fade stage of the life cycle

as explained in Part 1. The asset growth rates, plotted in the middle panel reveal the key reason why Amazon has outperformed the S&P 500 100-fold over the last 30 years as shown in the bottom panel. Investors were continually surprised by Amazon's extraordinarily high reinvestment rates which normally regress to much slower rates as a firm gets larger.

Three characteristics of Amazon are especially noteworthy. These were shaped by Amazon's founder Jeff Bezos. First, make long-term investments and not be deterred by related short-term negative impacts on financial performance. Note that in his 1997 shareholder letter, Bezos asserted: "We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term considerations or short-term Wall Street reactions." Second, promote systems thinking that overcomes excessive reliance on linear cause-and-effect thinking and stresses connectedness. Third, sustain a culture of knowledge-building proficiency.

Figure 2.4 Life-cycle framework



Recall, as shown in this figure, that the top priority for management in the competitive fade stage of the life cycle is to build or acquire new capabilities to accelerate innovation.

Figure 2.5 Jeff Bezos and competitive fade

Companies get skills-focused, instead of customer-needs focused. When [companies] think about extending their business into some new area, the first question is 'why should we do that—we don't have any skills in that area.' That approach puts a finite lifetime on a company, because the world changes, and what used to be cutting-edge skills have turned into something your customers may not need anymore. A much more stable strategy is to start with 'what do my customers need?' Then do an inventory of the gaps in your skills. Kindle is a great example. If we set our strategy by what our skills happen to be rather than by what our customers need, we never would have done it. We had to go out and hire people who know how to build hardware devices and create a whole new competency for the company.

Jeff Bezos, 2008

In an interview, Jeff Bezos summarized how Amazon deals with this situation:

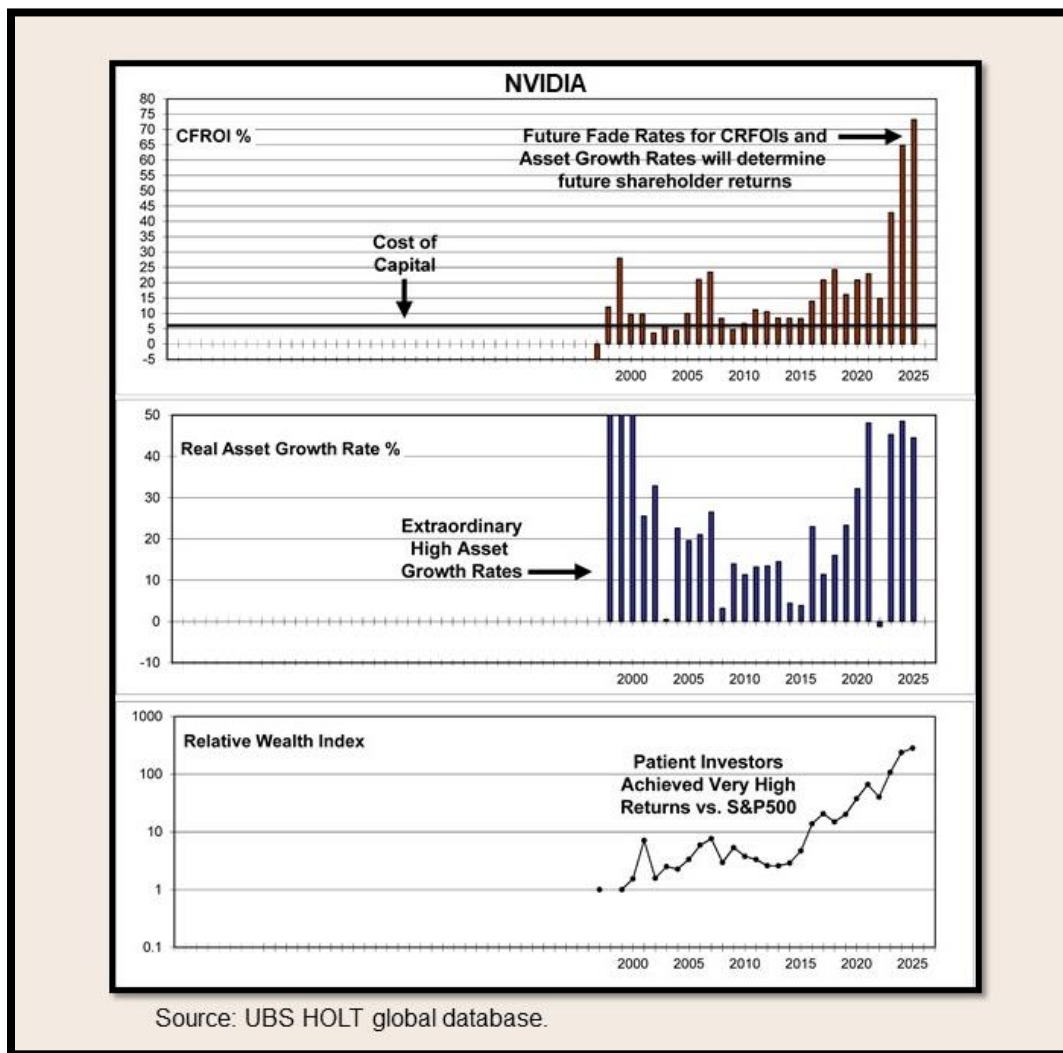
“Companies get skills-focused, instead of customer-needs focused. When companies think about extending their business into some new area, the first question is 'why should we do that—we don't have any skills in that area.' That approach puts a finite lifetime on a company, because the world changes, and what used to be cutting-edge skills have turned into something your customers may not need anymore. A much more stable strategy is to start with 'what do my customers need?' Then do an inventory of the gaps in your skills. Kindle is a great example. If we set our strategy by what our skills happen to be rather than by what our customers need, we never would have done it. We had to go out and hire people who know how to build hardware devices and create a whole new competency for the company.”

In the spirit of the Knowledge Building Loop, Bezos banned PowerPoints from meetings for new products and new businesses. The replacement is a six-page narrative that is carefully read at the start of the meetings. Bezos explained: “The narrative structure of a good memo forces better thought and better understanding of what's more important and how things are related. PowerPoint style presentations somehow give permission to gloss over ideas, flatten out any sense of relative importance, and ignore the interconnectedness of ideas.”

Another creative Amazon practice is their Working Backwards process for major new products and initiatives. The important idea here is to start with the target customer experience, then work backwards by writing a press release announcing the product including anticipated tough questions and answers. Working Backwards is a knowledge-building process addressing a detailed understanding of the opportunity and the constraints. So simple, yet highly effective—and a way to avoid early commitment to the 'great idea' that may be clever but is incapable of leading to the desired customer experience.

Let's discuss another firm in which the founding CEO was especially instrumental in sustaining a culture of knowledge-building proficiency. Everyone in Nvidia refers to CEO Jensen Huang as simply Jensen. Nvidia is an extreme outlier in terms of a culture rooted in speed, autonomy, and the absence of internal politics. Jensen's direct involvement with so many employees not only avoids bureaucracy but also positions himself on the leading edge of information flow about change. Nvidia's knowledge-building culture enabled ultra-fast design/produce cycles for their chips.

Figure 2.6 Nvidia 1997-2025



Note the top panel in the life-cycle track record for Nvidia 1997 to 2025. For most years prior to 2015, the firm earned approximately cost of capital returns—the red horizontal line. The decade beginning 2015 shows a remarkable surge in CFROIs coupled to huge reinvestment rates displayed in the middle panel. Investors did not forecast such performance and the continual revaluation of the firm generated substantial outperformance of the S&P 500 illustrated in the bottom panel.

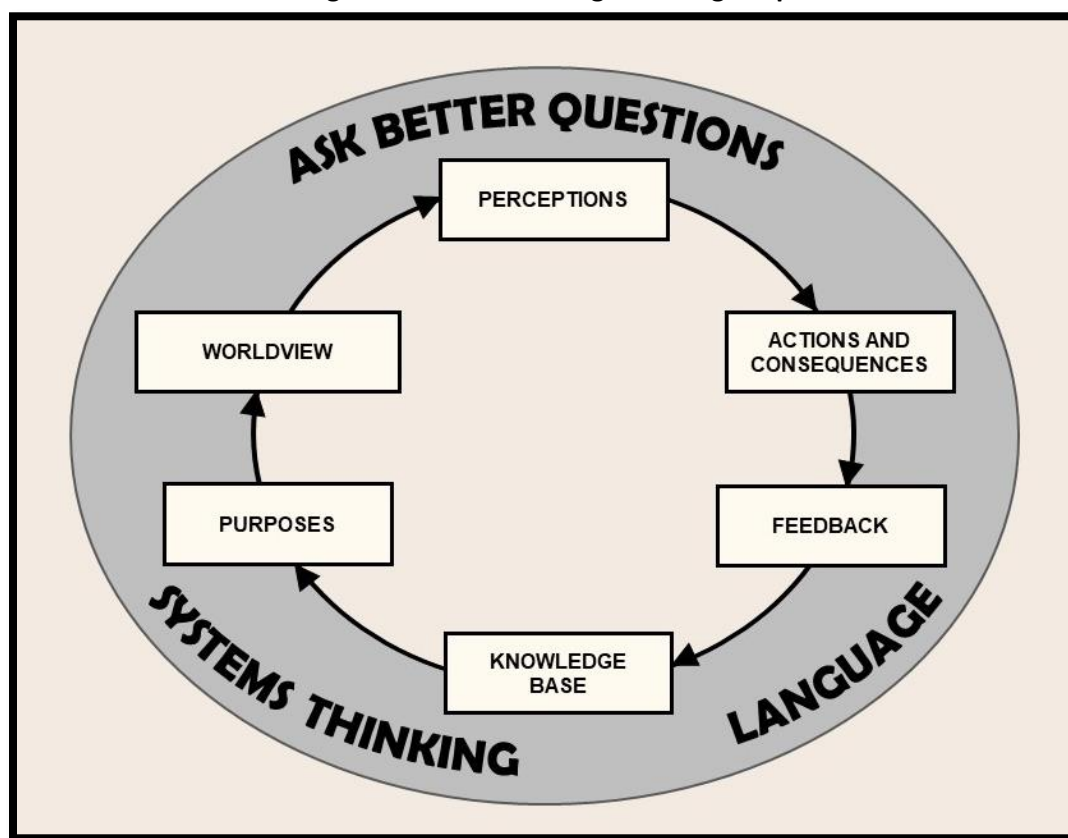
Briefly, the Nvidia innovation story began with its chips for PCs that were exceptionally well-received by video gamers. Scientists learned that Nvidia's GPUs could facilitate simulations of complex natural phenomena. Nvidia's CUDA software facilitated large scale acceleration in computing power while

making it easy for developers to focus solely on Nvidia’s hardware and software—the essence of competitive advantage. When AI emerged at scale in the early 2020s, developers were hooked on Nvidia’s products for building AI applications.

Jensen’s concern for knowledge-building proficiency led to extensive use of whiteboards to facilitate constructive skepticism of thinking—his thinking and others. Jensen’s whiteboarding orchestrates meetings focused on solving problems, not reviewing things that have already been accomplished. Whiteboarding forces people to examine assumptions that otherwise would go unquestioned.

Both Amazon and Nvidia spotlight the critical importance of the knowledge building process that can be productively analyzed with the components of the Knowledge Building Loop, which was introduced in Part 1.

Figure 2.7 The Knowledge Building Loop

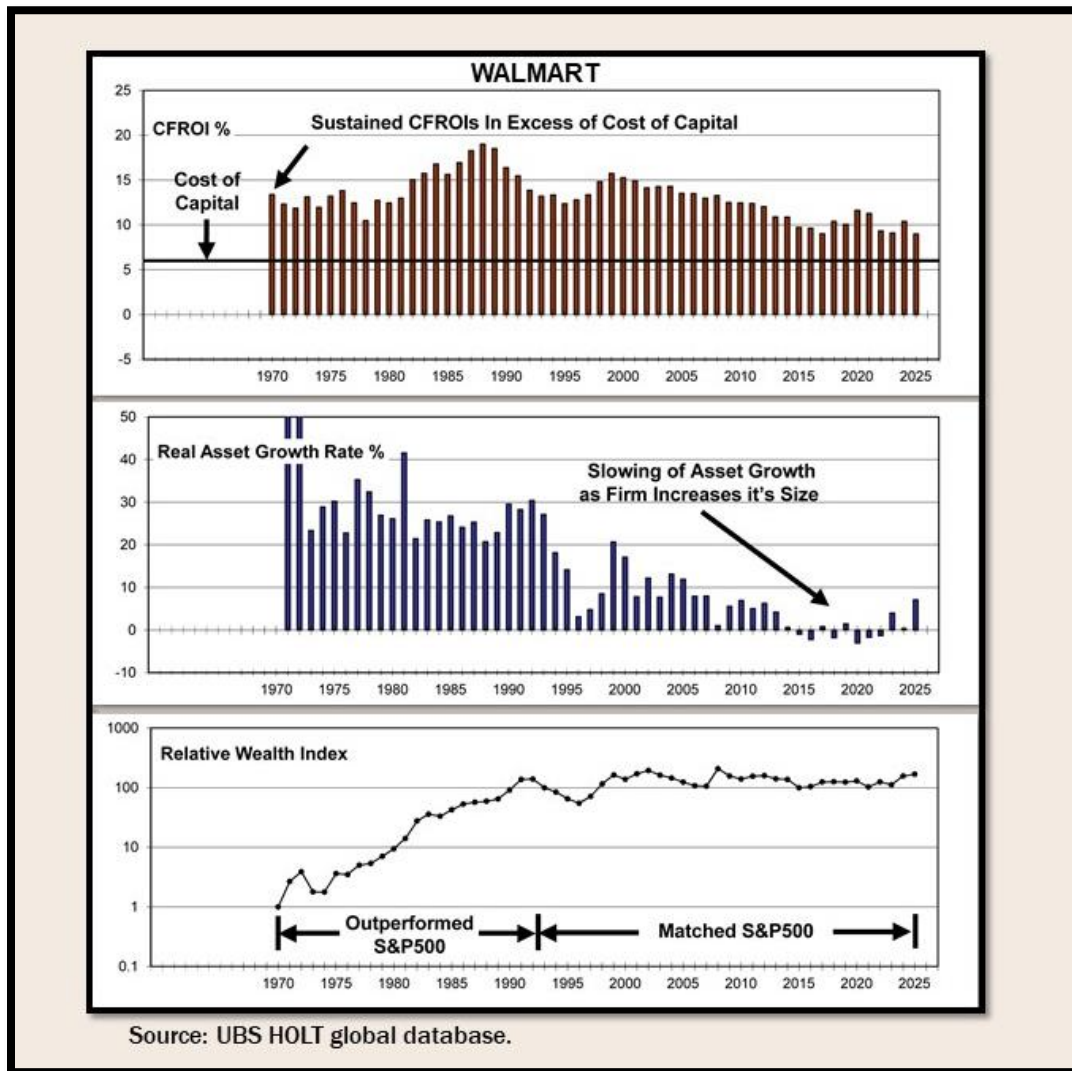


The Knowledge Building Loop in this figure provides a roadmap to better understand the rationale for Amazon’s replacing PowerPoints with narratives and analyzing proposed projects by working backwards from the product introduction and for Nvidia orchestrating meetings by having participants argue the logic of their proposals on whiteboards. Both firms have developed routines that, at a foundational level, facilitate fast and effective traversing of the Knowledge Building Loop.

Recall the highlighted useful habits of system thinking, analyzing language to reveal obsolete assumptions, and asking better questions. Can these seemingly simple, yet often ignored, habits lead to large-scale, sustained value creation by firms? Yes.

A revealing example is how Sam Walton developed the core business model for Walmart.

Figure 2.8 Walmart 1970-2025

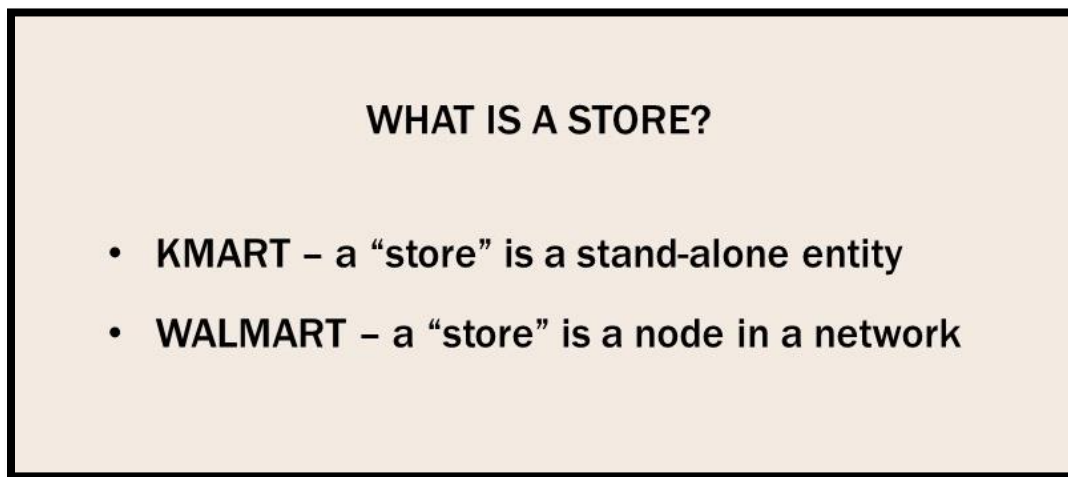


Walmart's life-cycle track record, 1970 to 2025, shows in the top panel, sustained CFROIs well above the cost of capital. The middle panel displays exceptionally high reinvestment rates calculated as real asset growth rates, 1970 to 1990, followed by a slowing of asset growth as the firm grew increasingly larger. As illustrated in the bottom panel, Walmart outperformed the S&P 100-fold 1970 to 1990 and subsequently matched the S&P 500 through 2025.

Walmart replaced Kmart as the dominant retailer and the conventional explanation is that Kmart was unable to match Walmart's efficiency in serving customers driven by the fast pace of Walmart's implementation of technological innovations such as bar codes, satellite communications, and the like. Kmart eventually filed for bankruptcy in 2002.

For the foundational cause of Walmart's success and Kmart's failure, let's consider management worldviews. It is apparent from reading the CEO shareholder letters in Kmart's annual reports in the 1970s that Kmart's top management had a worldview that their past success using a decentralized organization with store managers who are close to customers making critical decisions such as inventory ordering would deliver similar successes in the future. Sam Walton's worldview radically differed and can be distilled into his answer to the question: What is a store?

Figure 2.9 Language hides assumptions



Sam Walton purged the obsolete assumption that efficiency required decentralization and embraced systems thinking. He viewed a store as a node in a network. Everything changes. The location of stores and distribution centers are viewed as interconnected components of a holistic system—the firm. Also interrelated are the managerial tasks of dealing with how work is organized, innovations pursued, and resource allocations made. Walton was instrumental in sustaining a culture of knowledge-building proficiency that perceived opportunities for implementing technological innovations far in advance of competitors. The firm has delivered on its mission of saving customers money so they can live better and, in so doing, benefitted all of its stakeholders.

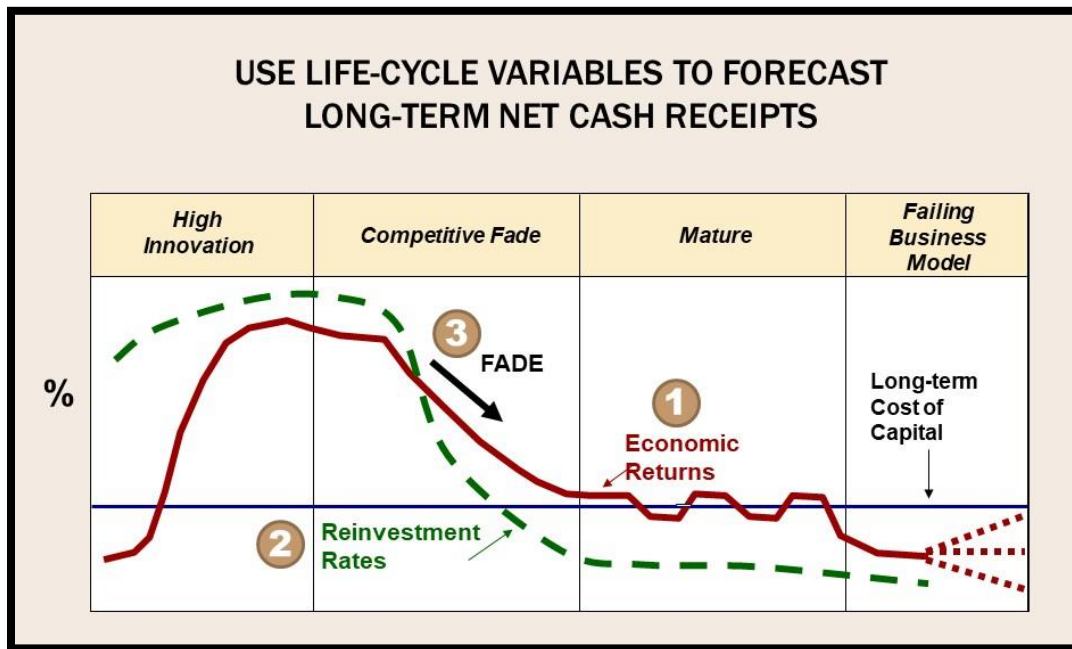
Note that the way of thinking being utilized is grounded in long-term value creation. In contrast Wall Street's extreme focus on earnings per share growth rates and valuation analysis using historical ranges of P/E multiples is an especially crude instrument for understanding long-term levels and changes in stock prices. Let's apply life-cycle thinking to the question: Why did Walmart outperform the S&P 500 13-fold from 1980 to 1990?

Figure 2.10 Walmart stock price 1980-1990



In analyzing long-term levels and changes in stock prices, it helps to adopt an economically sound perspective that a price is the present value of anticipated net cash receipts, i.e., cash inflows less cash outflows. Technical issues such as the assignment of a discount rate to calculate present values are covered in my 2020 Wiley book, *Value Creation Principles: The Pragmatic Theory of the Firm Begins with Purpose and Ends with Sustainable Capitalism*. Most importantly, conventional spreadsheet analyses of valuation are not helpful for judging the plausibility of the forecasts. However, the life-cycle framework offers an alternative. The forecast of net cash receipts can be generated by forecasts of three life-cycle variables—economic returns expressed as accounting return on assets, reinvestment rates, and the related fade rates.

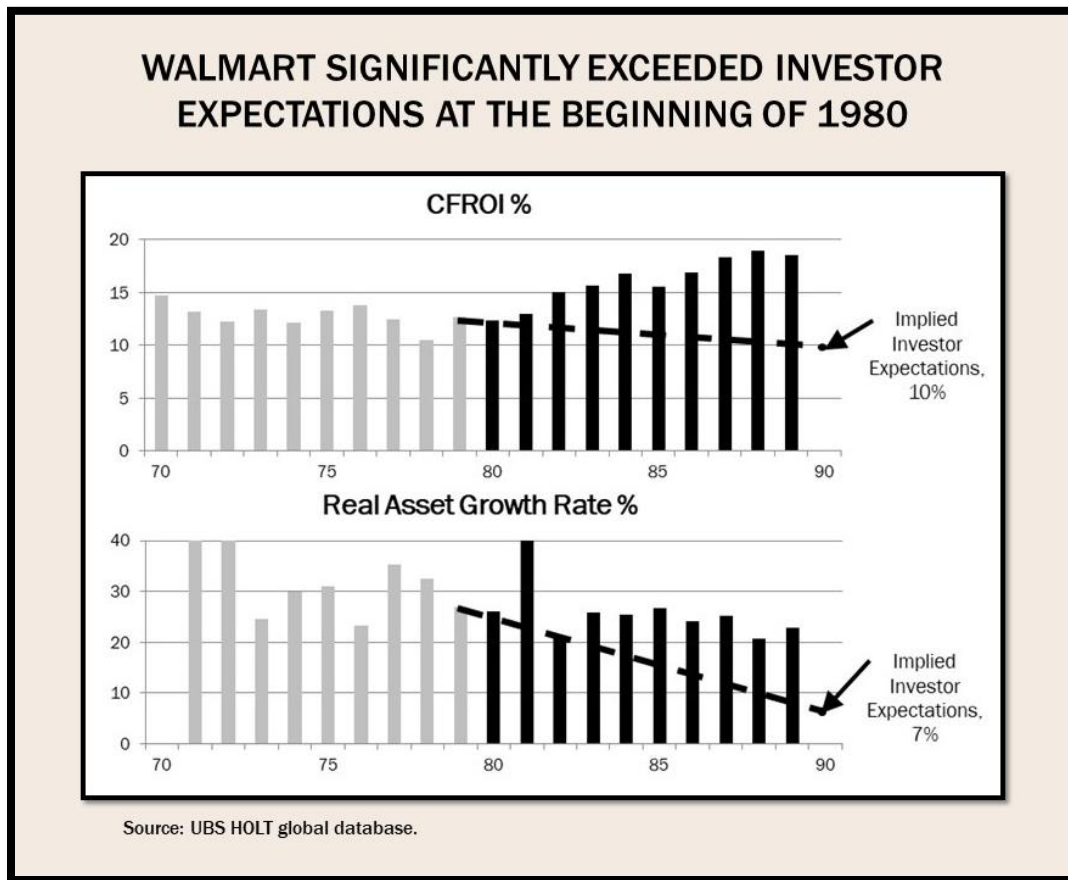
Figure 2.11 Long-term net cash receipts



The important benefit is that a forecast in life-cycle terms can be judged for plausibility versus a firm's past life-cycle track record and those of competitors. The same logic applies to a firm's financial performance measurement of its business units, which heavily influences resource allocation decisions.

Let's go back in time to the beginning of 1980 and use the life-cycle approach that begins with a known value for Walmart's stock price and derives a reasonable combination of future fade rates for CFROIs and asset growth rates for Walmart that reproduce the known market value.

Figure 2.12 Walmart actual vs. expected performance 1980-1990



We label this forecast “implied investor expectations” as shown in this figure. Note that the shaded columns on the left reflect past CFROIs and asset growth rates. Investor expectations for future CFROIs and asset growth rates over the next ten years are shown as fade rates via the dashed line. Walmart’s actual performance is displayed by the black columns on the right.

Clearly, Walmart outperformed original expectations. The most notable observation that is not easily revealed from earnings per share growth rates is that high CFROIs were combined with extraordinarily high reinvestment or asset growth rates sustained even as the firm grew to substantial size. That is the ideal combination to generate very substantial future net cash receipts. The bottom line is that Walmart outperformed the S&P 500 13-fold over this ten-year period. As noted earlier, earnings per share growth rates and P/E multiples are crude instruments ill-suited to understanding long-term value creation and shareholder returns.

In the next video, Part 3 of this course, we begin by analyzing what management has to get right in order to sustain a culture of knowledge-building proficiency.

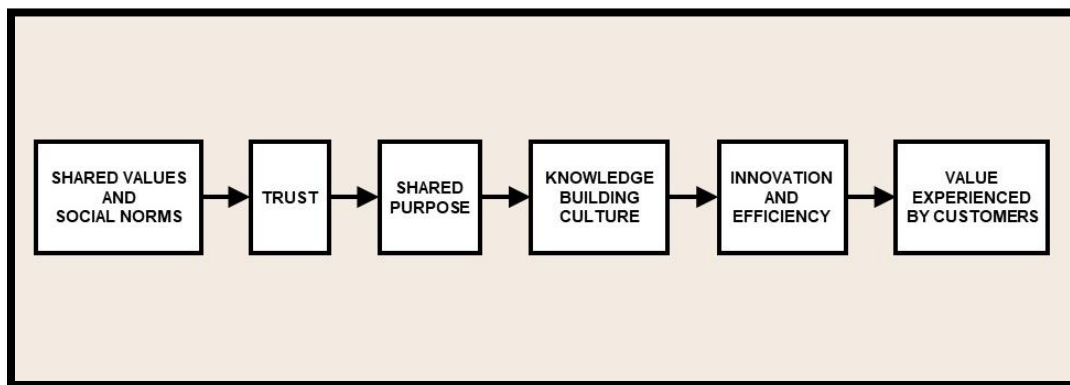
Transcript Part 3 Culture and Organizational Structure

Part 1 of this course made the case that the critical determinant of a firm’s long-term performance is the proficiency of its knowledge-building culture. Such a culture gets shaped not solely by words spoken by top management but management-employee experiences that cement shared values and social norms.

While values are the ideals employees strive to fulfill, norms reflect whether employees “walk the talk” by actually living out these values.

For example, integrity is a value to live up to, while fostering a widespread commitment in a pharmaceutical firm to report all adverse side effects in a clinical trial is a social norm woven into employee behavior.

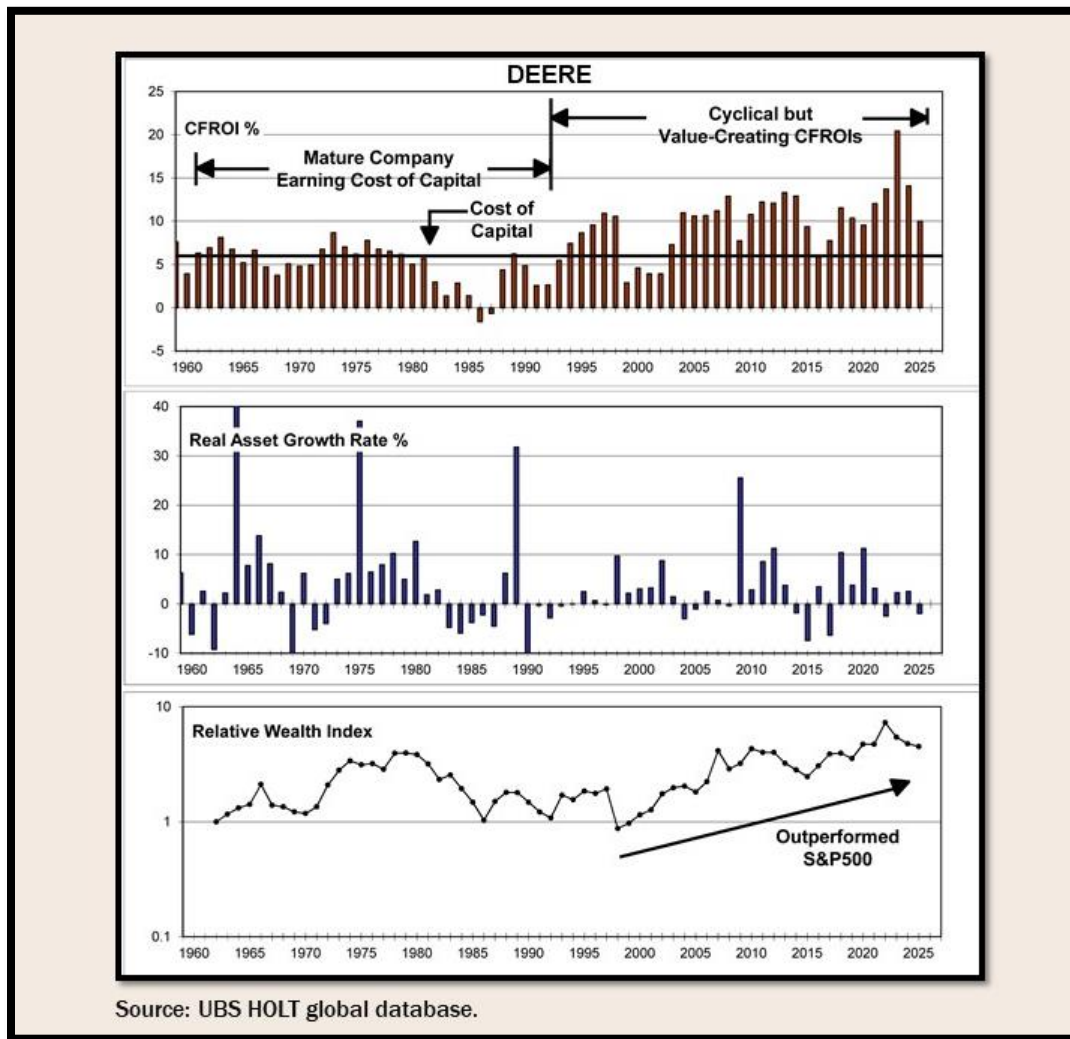
Figure 3.1 Prerequisites for sustained value creation



This figure highlights the prerequisites for sustaining a knowledge-building culture. Consider the right-hand side of this figure, value experienced by customers. The preceding cause of this value is the firm’s skill with innovation and efficiency. Both are needed for the firm to survive and prosper and earn at least the cost of capital. Note that a purpose-driven culture—well articulated by John Allison in Part 1 describing BB&T’s culture—ideally incorporates the four components of the Pragmatic Theory of the Firm’s purpose. That is the path to benefitting people, profit, and planet. As shown in the figure, the needed ingredient for all employees to embrace the firm’s purpose is trust. And for trust to flourish the prerequisite is behavior by both management and employees grounded in shared values and social norms.

The challenge of quantifying shared values and social norms, trust, purpose, and culture can lead to their neglect. However, their importance is undeniable as seen in our discussion of Deere followed by Microsoft.

Figure 3.2 Deere 1960-2025



The life-cycle track record for Deere, 1960 to 2025, depicts Deere's journey to currently having 75,000 employees and being a leading innovator in agriculture, forestry, and roadbuilding equipment and well known for its farm tractors. From 1960 to the early 2000s, Deere was in the mature life-cycle stage earning CFROIs approximating the cost of capital as illustrated in the top panel of this figure. Over the next two decades, Deere substantially improved its financial performance achieving cyclical but mostly value-creating CFROIs well above the cost of capital.

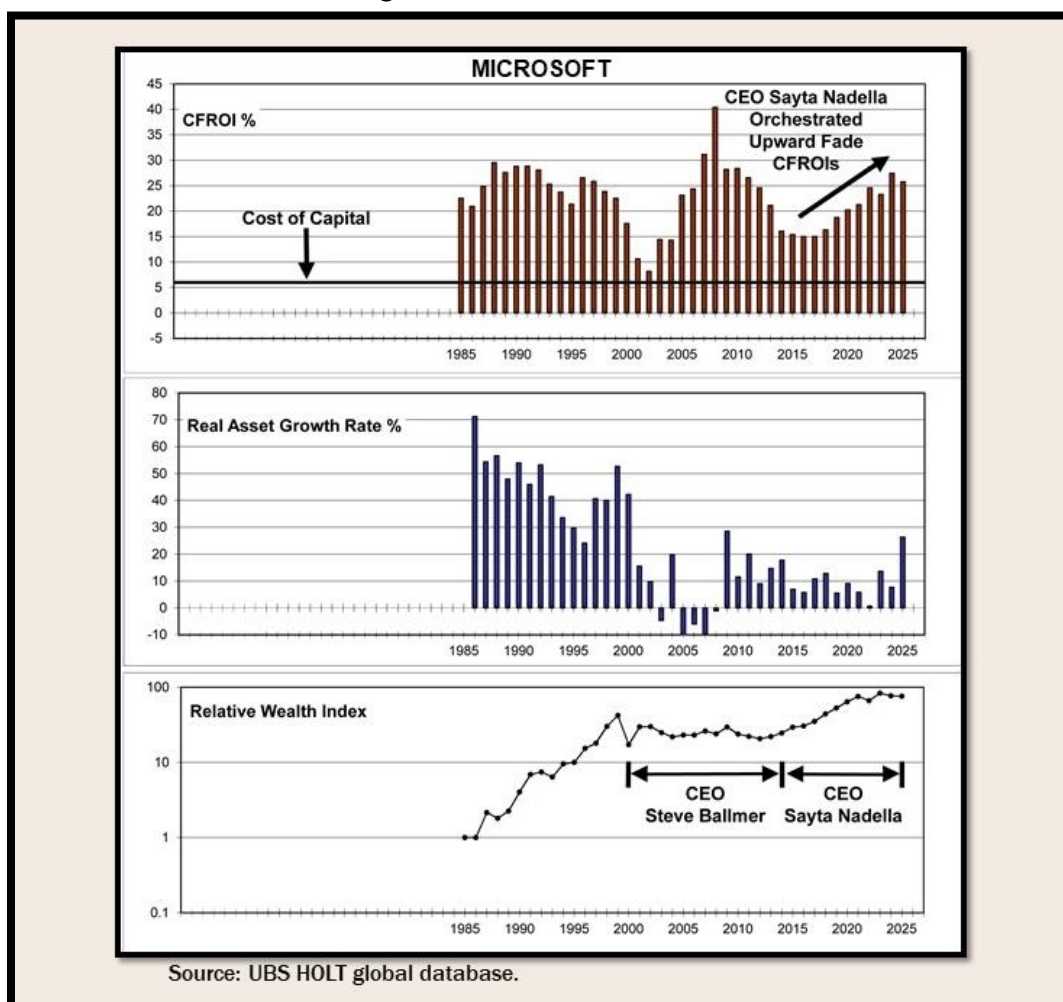
Since 2000, Deere has mostly outperformed the S&P 500 as shown in the rising relative wealth index in the bottom panel. Investors did not expect Deere to generate a favorable upward fade of CFROIs. Deere successfully transitioned from a product-centric mature business to a financially strong, solidly profitable, platform-centric, information-based firm focused on precision agriculture services utilizing sensors and probes in the soil combined with specialized software. Farmers experienced value creation by way of increased yields and decreased costs. What is the foundational cause of this successful transition?

Robert Lane became CEO in 2000 and clearly understood the immediate challenges facing Deere: (1) avoid the failing business model life-cycle stage, (2) fix the lack of discipline for allocating resources, and (3) change the existing adversarial culture between unionized employees and management. The intensity of this adversarial culture was displayed on a big sign near the entrance to every Deere factory. It listed shop rules for wage employees, including “You will not assault a member of management.”

A uniquely skilled manager, Dick Klein, was given the responsibility to change Deere’s adversarial culture. Klein was adamant that without trust culture will not change. He systematically, plant-by-plant successfully orchestrated change—in Klein’s words: “Labor and management coming together to utilize the knowledge and skills of all employees by involving them continually in problem solving and decision making.”

From a systems perspective, this change was a prerequisite to implementing a lean, Toyota-style, manufacturing process that upgraded the firm’s knowledge-building proficiency and enabled remarkable improvements in manufacturing efficiency. The significantly more profitable Deere was then able to become the leader in precision agriculture to the benefit of all of its stakeholders.

Figure 3.3 Microsoft 1985-2025



The top panel of Microsoft's life-cycle track record shows a stellar record of earning CFROIs substantially greater than the cost of capital. From 1985 to 2000, extraordinarily high asset growth rates, shown in the middle panel, continually exceeded investor expectations resulting in Microsoft's stock substantially outperforming the S&P 500.

The bottom panel shows when Steve Ballmer was CEO followed by Satya Nadella. The outperformance under Nadella's leadership suggest that he addressed core value creation issues. Nadella orchestrated a significant change to Ballmer's command-and-control bureaucratic culture. His tenure as CEO is an affirmation of the previously discussed prerequisites to sustained value creation—shared values and social norms facilitating trust, combined with a shared purpose, enabling a knowledge-building culture to flourish thereby boosting long-term value creation.

Nadella's approach to leading Microsoft is a hand-in-glove fit with the Pragmatic Theory of the Firm's four-part purpose; in particular, a vision that inspires and motivates employees to work for a firm committed to behaving ethically and making the world a better place coupled to an extreme focus on a knowledge-building culture.

Figure 3.4 Microsoft's culture

"I encouraged Microsoft to become mobile-first and cloud-first, not PC first. We needed to envision a world where the mobility of the human experience across all devices was what mattered, and the cloud made that mobile possible, enabling the new generation of intelligent experiences. The transformation we would undertake across all parts of our businesses would help Microsoft and our customers thrive in the new world.

It would be easy to be motivated to change through envy. But envy is negative and outer-directed, not driven from within, and so I knew that it wouldn't carry us very far down the path to true renewal.

We could also motivate ourselves through competitive zeal. Microsoft is known for rallying the troops with competitive fire. The press loves that, but it's not me. My approach is to lead with a sense of purpose and pride in what we do, not envy or combativeness.

I like to think the C in CEO stands for culture. The CEO is the curator of an organization's culture. As I told employees, anything is possible for a company when its culture is about listening, learning, and harnessing individual passions and talents to the company's mission. I plan to use every opportunity at my disposal to encourage our team to live this culture of dynamic learning."

Satya Nadella

Here is a quote from his book, *Hit Refresh*:

"I encouraged Microsoft to become mobile-first and cloud-first, not PC first. We needed to envision a world where the mobility of the human experience across all devices was what mattered, and the cloud made that mobile possible, enabling the new generation of intelligent experiences. The transformation we would undertake across all parts of our businesses would help Microsoft and our customers thrive in the new world.

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Let's now use three company histories in analyzing the accelerating trend to replace command-and-control organizational structures with flatter structures. The firm's organizational structure should be shaped to facilitate the nurturing and sustaining of a knowledge-building culture at all levels of the firm. Today's command-and-control organizational structure originated on three beliefs. First, important knowledge about running a business is generated by top management. Second, budgets and targets are needed to incentivize lower levels of the firm to do what top management wants. Third, employees at low levels are not to be trusted.

All three beliefs are obsolete in today's fast-changing world where superior results depend upon employee-created intangible assets and not merely scaling up tangible assets. The alternative is a much flatter structure.

The lifeblood of command-and-control hierarchies is the budget that sets in motion the target marching orders for those at lower levels. Of course, budgets invariably lead to gamesmanship in setting lower forecasts of future performance which are then easier to beat thereby earning a performance bonus.

A leader in the movement to flatter organizations in Europe is Bjarte Bogsnes. Here is a relevant quote from his 2023 book, *This Is Beyond Budgeting: A Guide to More Adaptive and Human Organizations*:

Figure 3.5 Beyond Budgeting

THIS IS BEYOND BUDGETING: A GUIDE TO MORE ADAPTIVE AND HUMAN ORGANIZATIONS

"The three purposes [of the budget] should be separated and then solved in three different processes because they are about different things. A target is an aspiration, what we want to happen. A forecast is an expectation, what we think will happen, whether we like what we see or not. And resource allocation is about optimization of resources.

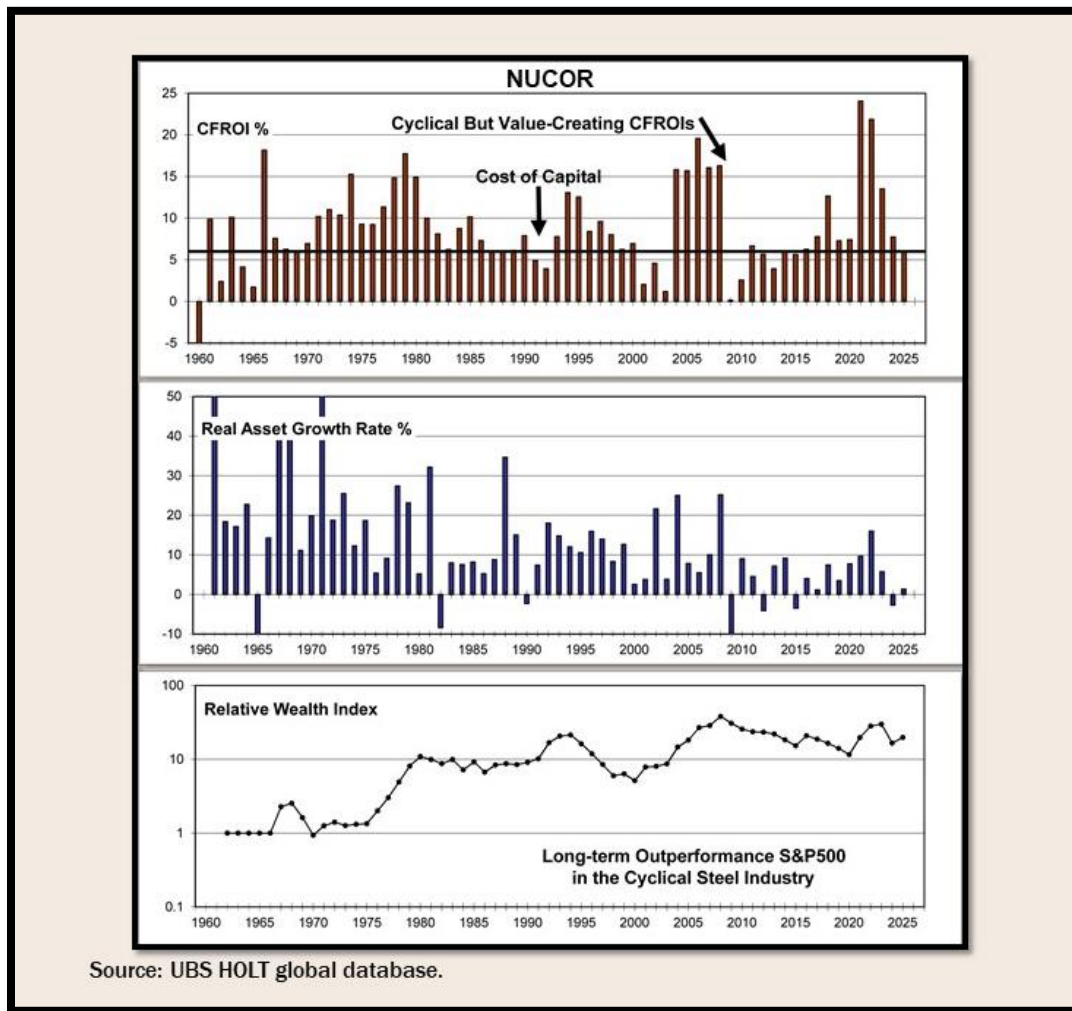
... Some tell me it is impossible to operate without a budget. My response is that this separation lets us do everything the budget tried to do for us, but now in much better ways: better targets, better forecasts, and a more effective resource allocation. It also improves how we measure, evaluate, reward, and coordinate. How impossible and how scary is that?"

Bjarte Bogsnes

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Figure 3.6 Nucor 1960-2025



Let's review Nucor, the preeminent steel producer with the highest productivity and highest paid employees that produce high-quality steel and is the leader in producing steel that minimizes greenhouse gas emissions. Ken Iverson became CEO in 1965. He nurtured and sustained a flat organizational structure with only four layers of management from the CEO to the employees on the steel plant floor. This was coupled with an unusually high degree of freedom for employees.

Keep in mind that historically the steel industry has generated low and cyclical returns on capital. The top panel of Nucor's life-cycle track record from 1960 to 2025 displays CFROIs distinctly higher than its main competitors. The middle panel shows significant asset growth as Nucor earned a higher share of the steel market. The relative wealth index in the bottom panel records outperformance of the S&P 500 during Iverson's tenure as CEO from 1965 to 1995.

Figure 3.7 Ken Iverson and Nucor's Culture

PLAIN TALK: LESSONS FROM A BUSINESS MAVERICK

- We anticipate that roughly half our investments in new ideas will fail.
- Management has been able to get employees to identify their own interests fundamentally with management, i.e., win-win partnerships.
- We have no job descriptions. Employees become members of a team and define their own jobs in ways that optimize their team's productivity.
- If your success requires uniformity and consistency like McDonalds and Walmart, centralized decision-making may be required. But if success relies more on innovation and flexibility, push decision-making lower.
- We built Nucor under the assumption that most of the genius in our firm is found among the people doing the work.
- We focus on shaping an environment that frees employees to determine what they can do and should do, to the benefit of themselves and Nucor.

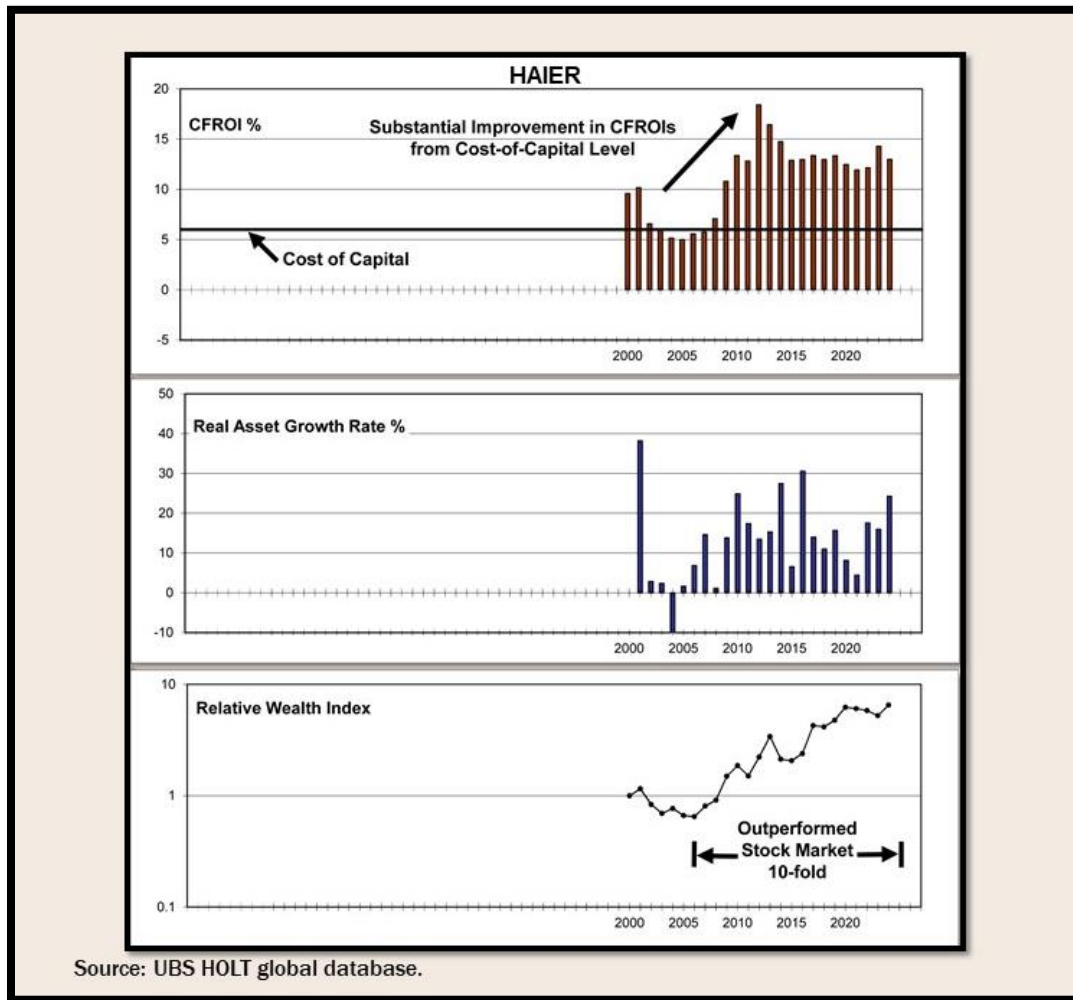
Ken Iverson

In his autobiography, *Plain Talk: Lessons from a Business Maverick*, Iverson describes how he shaped Nucor in a way that echoes the Pragmatic Theory of the Firm's four-part purpose and shows the importance given to a knowledge-building culture. Iverson's autobiography certainly contains plain talk on important value creation issues, including the following:

- We anticipate that roughly half our investments in new ideas will fail.
- Management has been able to get employees to identify their own interests fundamentally with management, i.e., win-win partnerships.
- We have no job descriptions. Employees become members of a team and define their own jobs in ways that optimize their team's productivity.
- If your success requires uniformity and consistency like McDonalds and Walmart, centralized decision-making may be required. But if success relies more on innovation and flexibility, push decision-making lower.
- We built Nucor under the assumption that most of the genius in our firm is found among the people doing the work.

- We focus on shaping an environment that frees employees to determine what they can do and should do, to the benefit of themselves and Nucor.

Figure 3.8 Haier Group 2000-2024



Let's discuss a remarkable Chinese firm, Haier Group, and begin with its life-cycle track record. The top panel shows CFROIs in the early years dipping below the cost of capital and Haier stock underperformed the market as shown in the bottom panel. The subsequent 10-fold outperformance of the market was driven by increasing investor expectations for sustaining much higher CFROIs coupled to high Asset growth rates shown in the middle panel.

A visitor to Haier's corporate headquarters in China will see a glass-enclosed sledge hammer mounted on the wall. This is a reminder of the beginning of a value creation journey for Zhang Ruimin when he became CEO in 1984 of a money-losing Chinese refrigerator manufacturer with 800 employees and clearly in the failing business model life-cycle stage. The level of employee morale was reflected in Ruimin's first rule: do not pee on the factory floor. As to product quality, Ruimin got employees' attention by using the sledge hammer on many defective refrigerators recently manufactured.

CEO Zhang Ruimin exemplifies a critical characteristic of leaders skilled in effective knowledge building; i.e., constructive skepticism of what they think they know as to how best to organize to create value. Ruimin radically changed Haier's organizational structure as the firm grew to 130,000 employees.

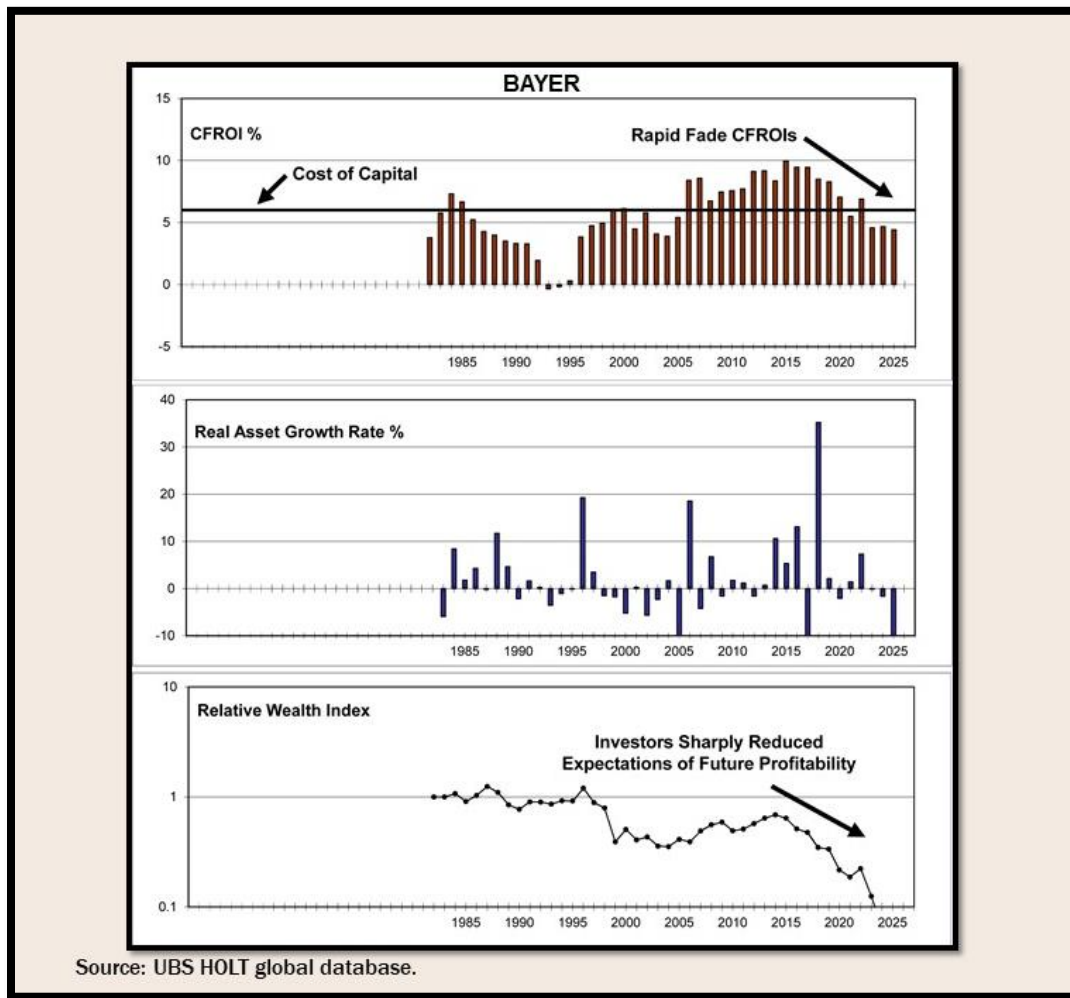
Haier became the global leader in white goods, such as refrigerators and ovens, by evolving to a flat organization with thousands of microenterprises that orchestrate design, manufacturing, and delivery of unique customer experiences as part of an ecosystem-driven organization. Haier's success is reflected in many microenterprises transitioning to independent firms, some publicly traded.

Haier strives for zero distance between the firm and its customers in order to effectively communicate customer problems and requests for ideas to hundreds of thousands of contributors. Successful contributors earn a share of profits, with some becoming leaders of new microenterprises. The result is an ecosystem focused on knowledge building, with Haier as the hub of a large multi-company network.

The study of individual firms using the Pragmatic Theory of the firm as a way of thinking provides a rich vein to mine for value creation ideas. Our last firm in this course to study is Bayer AG, a German firm whose two businesses were pharmaceuticals and consumer health when Werner Baumann became CEO in 2016. He immediately orchestrated a mega-acquisition to create a third major business, crop science. Bayer paid \$63 billion, a significant premium to acquire Monsanto. This sharply increased Bayer's debt load and also bought ownership of tens of thousands of ongoing and future lawsuits claiming that Monsanto's Roundup herbicide caused cancer.

Litigation costs skyrocketed and coupled with interest on the debt load; pharmaceutical R&D fell short of what was needed to replace Bayer's top drugs coming off patents. Meanwhile, Bayer grew beyond 100,000 employees, all managed with a bureaucratic command-and-control organizational structure. After intense shareholder pressure, Baumann resigned and Bill Anderson became CEO in mid-2022.

Figure 3.9 Bayer AG 1982-2025



In the top panel of Bayer's life-cycle track record we see a rapid fade of CFROIs since acquiring Monsanto. Recognizing the severity of Bayer's position, the board supported Anderson's multi-year radical reorganization which he named Dynamic Shared Ownership. Commenting on the extensive bureaucracy spawned by Bayer's command-and-control structure, Anderson noted that Bayer's manual for company rules covered 1,362 pages. In Anderson's 2023 Shareholder Letter, Anderson provides an insightful summary of the need for a highly proficient knowledge-building culture that minimizes bureaucracy and upgrades the speed and effectiveness of decision-making:

Figure 3.10 Dynamic Shared Ownership

BILL ANDERSON'S 2023 SHAREHOLDER LETTER

Bayer has huge potential. But, as in many large companies, we often make life difficult for ourselves. There is a whole lot of coordination, monitoring and supervision going on. In some areas, we have 12 hierarchy levels between the CEO and the customer.

Why is that a problem? Because this traditional approach of top-down management doesn't place products and customers at the heart of daily work. Decisions take far too long. Initiative and creativity are stifled by bureaucracy.

That's why we want to turn our system on its head. In the future, 95 percent of the decision-making will shift to the people actually doing the work. We are introducing a new operating model, which we call Dynamic Shared Ownership. This new system will reduce hierarchy levels, eliminate bureaucracy and significantly accelerate decision-making. We will primarily work in small, self-managed teams, totally focused on improving our products and the lives of our customers. This shift will enable us to unleash the entrepreneurial power of each individual and ensure that all of our efforts are focused on the needs of consumers, patients, and farmers.

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Now that we are close to the end of this course, let's consider how thought leaders in management and investment describe a critically important need for change. That is, change that purges short-termism, encourages investors to act like long-term owners, and enables a capitalism that benefits everyone, that lifts all economic boats. Change that the Pragmatic Theory of the Firm can facilitate.

Figure 3.11 Thought Leaders

“Until large asset owners radically change their approach, other key players (such as asset managers, corporate boards, and company executives) will probably remain trapped in value-destroying short-termism. But by accepting the opportunity and responsibility to be leaders who act in the best interests of individual savers, large asset owners can be a powerful force for instituting the kind of balanced, long-term capitalism that benefits everyone.”

Dominic Barton and Mark Wiseman, 2014
Harvard Business Review

Dominic Barton, former Global Managing Director of McKinsey, and Mark Wiseman who was instrumental as CEO in orchestrating the stellar performance of the Canadian Pension Plan, wrote in a 2014 Harvard Business Review article:

“Until large asset owners radically change their approach, other key players (such as asset managers, corporate boards, and company executives) will probably remain trapped in value-destroying short-termism. But by accepting the opportunity and responsibility to be leaders who act in the best interests of individual savers, large asset owners can be a powerful force for instituting the kind of balanced, long-term capitalism that benefits everyone.”

Note that Barton and Wiseman focus on large asset owners, like pension funds, to lead the charge in bringing change. Since large asset owners have the largest ownership positions in corporations worldwide, they are uniquely suited to implement the Pragmatic Theory of the Firm and convince boards of directors and top management to do the same.

Figure 3.12 Thought Leader

“The concept of ownership investing is where investors think of themselves as owners rather than traders. This shift raises a key question: How do the firms we own create value, and what is the role of owners in promoting and facilitating value creation? ... Madden provides a conceptual framework with his pragmatic theory of the firm. ... The broad adoption of the theory and practice of ownership investing would not just raise the investment returns of pension funds. It would also lift all economic boats around the globe through increased capital productivity and wealth creation.”

Keith Ambachtsheer, 2025
Journal of Portfolio Management

For 40 years, Keith Ambachtsheer has authored the monthly Ambachtsheer Letter that is must reading for large asset owners. He wrote in a 2025 article in the Journal of Portfolio Management:

“The concept of ownership investing is where investors think of themselves as owners rather than traders. This shift raises a key question: How do the firms we own create value, and what is the role of owners in promoting and facilitating value creation? ... Madden provides a conceptual framework with his pragmatic theory of the firm. ... The broad adoption of the theory and practice of ownership investing would not just raise the investment returns of pension funds. It would also lift all economic boats around the globe through increased capital productivity and wealth creation.”

Here are some concluding thoughts to this course. On my website, LearningWhatWorks.com, is considerable information about journal articles and books that I have written in developing the work summarized in this course.

This course is open access and freely available to students and others. The ideas have worked well in Executive Education courses and early classroom use in business school is encouraging.

I have worked with a team at Principled Business, which is a 501 c (3) organization founded by Alexander McCobin, in creating this course. During a long lunch I had with Luke Ripp, who heads up Development and Strategic Partnerships for Principled Business, it became apparent that the Pragmatic Theory of the Firm and Principled Business are addressing the same challenge from complementary directions.

The Pragmatic Theory of the Firm lays out the principles for understanding how firms can succeed in creating long-term value and provides a way of thinking that better explains the past performance of firms and provides guideposts for creating value in the future. A better way of thinking gives both investors and management an intellectual foundation to purge short-termism and behave like long-term owners

Principled Business engages, develops, and motivates business leaders to champion free enterprise as a moral force for human flourishing through leadership practices that reflect the values of free enterprise. Keep in mind that economic freedom is a prerequisite for business firms to be created that can drive innovation that benefits all of the firm’s stakeholders. However, it is up to leaders to demonstrate through the companies they build, the people they lead, and the public example they set that capitalism is the path to a flourishing society.

On a personal note, when I talk with young people, I distill the contents of this course into a very simple message. Commit to living the life of a value creator. That is, creating value for others is the primary means by which you create value for yourself. Keep in mind that living in an environment with the kind of capitalism described in this course provides an opportunity for people to rise as high as their skills and determination can take them.

¹ 2025 annual report by the Fraser Institute, “Economic Freedom of the World.”

² Viktor Frankl, 1959. *Man's Search for Meaning*. Boston: Beacon Press.

³ Ken Iverson. 1998. *Plain Talk: Lessons from a Business Maverick*. Hoboken, NJ: John Wiley & Sons.

⁴ Christina Starmans, Mark Sheskin, and Paul Bloom. 2017. "Why people prefer unequal societies." *Nature Human Behavior*. Vol. 1 article 82.

⁵ David Schmidtz. 2006. *Elements of Justice*. Cambridge: Cambridge University Press.

⁶ Eric Beinhocker and Nick Hanauer. 2014. "Redefining capitalism." *McKinsey Quarterly*. September.