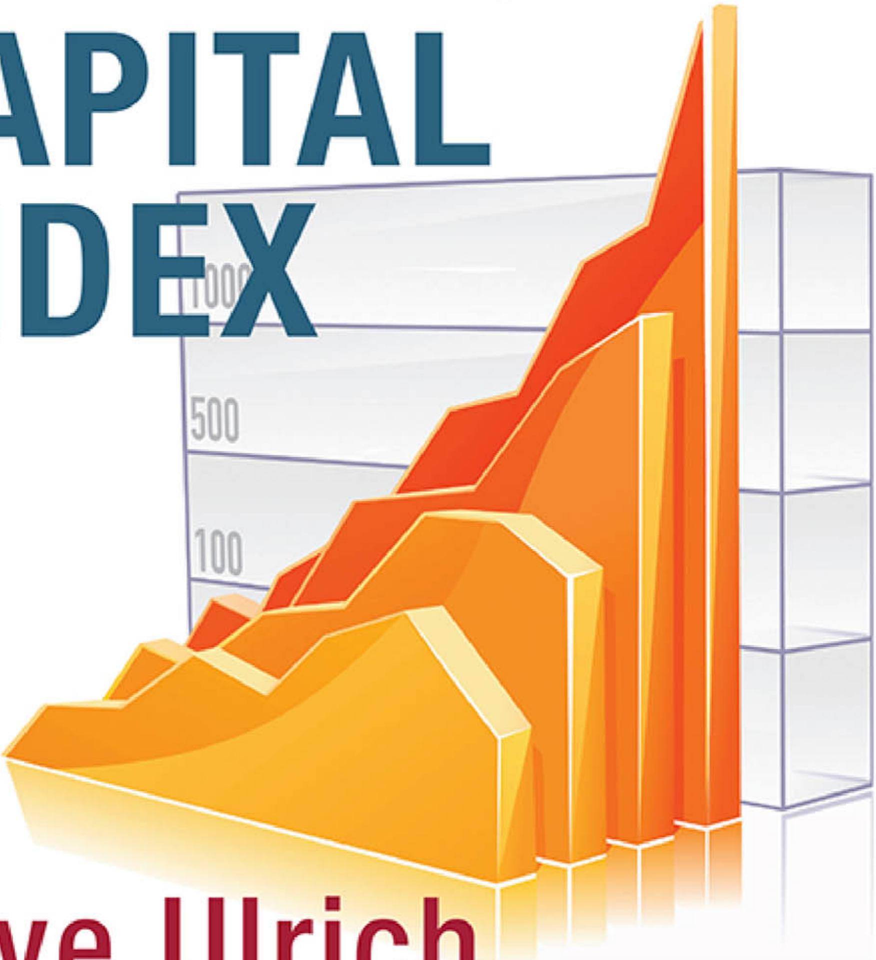
THE LEADERSHIP CAPITAL INDEX

Realizing the Market Value of Leadership



Dave Ulrich

Bestselling Author of *The Why of Work* and *Human Resource Champions*

Foreword by Mark Mobius

Executive Chairman, Templeton Emerging Markets Group

More Praise for *The Leadership Capital Index*

"Much needed! Leadership has always been the X factor in gauging the health of any organization—we know it's vitally important, but we haven't had a way to think about it objectively. Now we can compare apples to apples."

—Cheryl Bachelder, CEO, Popeyes Louisiana Kitchen, and author of *Dare to Serve*

"All investors who take their job seriously will want to read this book. Ulrich has closed a critical gap in risk mitigation with this comprehensive 360 for assessing leadership capability throughout an organization."

—Sandy Ogg, Operating Partner, The Blackstone Group

"Long-term-oriented investors understand that 'people lead, financial numbers lag.' Thanks to Dave Ulrich's leadership capital index, we now have a more rigorous way to evaluate the people who lead and can make much better investment decisions."

—Fred Trigueiro, founder and CEO, Archipelago Partners, Brazil

"It is a remarkably comprehensive model. *The Leadership Capital Index* will be an important and immensely useful book not only for investors but for anyone needing to better understand the nature of leadership."

—Hermann Hauser, cofounder and Partner, Amadeus Capital Partners

"Dave Ulrich has written a foundational book. He has introduced the concept of the leadership capital index and brought together eight key elements of the index. Each element is carefully developed and ultimately put into a format designed for practical usage. As the CIO of an investment management firm specializing in publicly traded stocks, I am tasked with making investment decisions based on publicly available data. This means my investment team and I have to carefully choose only a few critical items to discuss with each corporate management team. We also hold our stocks for long periods of time; our approach is significantly dependent upon superior corporate leadership. Dave's book will help us select the one or two key index elements for each potential investment and ask the pertinent questions. Refreshingly, Dave has left the door wide open for improvements in the index."

—Frederick K. Martin, CEO and CIO, Disciplined Growth Investors

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THE LEADERSHIP CAPITAL INDEX

Also by the Author

Dave Ulrich has written 30 books and more than 200 articles that shape managerial thinking and action in organizations, leadership, and human resources. Key books include:

ORGANIZATION INSIGHTS

Justin Allen and Dave Ulrich. 2013. *Talent Accelerator: Secrets for Driving Business Growth in Asia*. RBL Group and Ministry of Manpower (Singapore).

Dave Ulrich and Wendy Ulrich. 2010. *The Why of Work: How Great Leaders Build Abundant Organizations That Win*. New York: McGraw Hill.

Ron Ashkenas, Dave Ulrich, Todd Jick, and Steve Kerr. 1995. *The Boundaryless Organization: Breaking the Chains of Organization Structure*. San Francisco: Josey-Bass.

Dave Ulrich and Dale Lake. 1990. *Organizational Capability: Competing from the Inside/Out*. New York: Wiley.

LEADERSHIP INSIGHTS

Defining the Outcomes and Practices of Leadership

Dave Ulrich and Norm Smallwood. 2013. *Leadership Sustainability: Seven Disciplines to Achieve the Changes Great Leaders Know They Must Make*. New York: McGraw Hill.

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Dave Ulrich and Norm Smallwood. 2007. *Leadership Brand: Developing Customer Focused Leaders to Drive Performance and Building Lasting Value*. Boston: Harvard Business Press.

HUMAN RESOURCE INSIGHTS

Dave Ulrich, William Schiemann, and Libby Sartain. 2015. *The Rise of HR*. HR Certification Institute.

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Dave Ulrich

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The Leadership Capital Index

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To investors and leaders
who seek common ground

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FOREWORD

All of us in the investment world are continually challenged to find that single best share investment that will produce excellent profits and not result in losses for ourselves and our clients. More important, we strive to do that consistently not only for one company stock that we have purchased but for all of the shares in our portfolios. We therefore spend a great deal of time studying companies listed in stock markets all over the world. We pore over company audited accounts, examining the profit and loss figures as well as the balance sheets. The profit and loss numbers give us clues to the company's history of earnings and what kind of trends they may reveal. By calculating such ratios as return on assets, return on equity, net profit margin, and so forth, we also gain insight into the profitability of the company.

The company's balance sheet reveals how safe the company is in terms of any possible debts that could result in bankruptcy. Of course, those profit and loss figures as well as balance sheet accounts are not sufficient to really understand what is happening, since the business environment changes from one report date to another. There could be dramatic changes in the company's sales, the competition, the debts acquired, and so forth. For that reason we try to get updates regarding the company's activities by visiting the company and having follow-up calls.

Despite all of these efforts, however, our investments still are vulnerable to events both internal and external to the company. For this reason we need to depend on the company's management—the most important element on the firm's viability. Who is in charge and what are their capabilities? If we can identify those firms whose managements are capable of confronting the challenges facing the company and, more important, capable of making it grow, then our chances of good investment returns rise dramatically.

But how can we make this assessment of the company's management? Up to now it has been done on a very subjective basis without any systematic approach. This is a major challenge, since we are dealing with intangible variables such as strategy, brand, and operational capabilities. The key is to assess the firm's leadership. An interview with the firm's top management often is not comprehensive and is colored by personal biases.

The good news is that someone has finally developed a systematic and logical way to measure the elusive variable of company leadership that plays such a key role in determining company success and market value. Dave Ulrich has found a way to measure this variable, so critical to investment success. For investment professionals like me, this book is long overdue.

Anyone interested in improving investment performance should not only read but also carefully study this book. By realizing the market value of leadership through a leadership capital index, investors will be able to reduce their overall investment risk and improve their chances of investment success.

—Mark Mobius, Executive Chairman,
Templeton Emerging Markets Group

THE LEADERSHIP CAPITAL INDEX

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INTRODUCTION

The Market Value of Leadership

You're considering investing in a firm; how do you know what it's really worth? Helping investors answer this question has occupied a good part of my past decade. I've drawn ideas from the vast and multifaceted financial literature, the emerging and complex intangibles literature, and the broad literature of leadership. This book shifts investor attention from financial measures to intangibles (like strategy, brand, operations, and customer service) to leadership. This book integrates theory and research to address the question of how to add leadership to your view of firm valuation.

The results will be useful to many audiences. Looking at leadership through investors' eyes—the main thrust of the book—will of course benefit investors themselves, but it will also benefit the rating agencies who create indices to report value, the government monitoring bodies who work to ensure that business standards are maintained, the trade associations who promote the interests of their members, the boards of directors who steward and oversee value-creating firm behavior, the executive teams who succeed by delivering value, and the leadership development professionals and human resource professionals and others who build value through leadership and organization processes.

In much of my writing, I tackle large and messy problems, like defining how human resources can be adapted to deliver business performance (*HR Champions, HR Transformation, HR Value Proposition, HR from the Outside In, The Rise of HR*), how organizations can change their culture and create new capabilities (*Organization Capability, GE Workout, Boundaryless Organization, Learning Organization*), how leadership can be codified, improved, and tied to customers (*Results Based Leadership, Leadership Code, Leadership Brand, Leadership Sustainability*), and how employees can find more meaning from their work setting (*Why of Work*). My goal has been to shape future conversations that solve relevant business questions through integrating innovative and complex ideas in a simple way.

Leadership matters, and most acknowledge that leaders affect an organization's value. Almost every activist investor recognizes the importance of leadership for firm success and can point to iconic leaders who have created great value. However, just by observing that a particular leader is visionary or inspiring, by focusing only on the person at the top and ignoring the larger leadership team, or by failing to assess whose leadership capability is woven into the organization's DNA, investors make simplistic and intuitive assessments of leadership value. The main title of this book, *The Leadership Capital Index,* draws on a useful metaphor for how to include, conceive, and audit leadership in the assessment of firm value. A leadership capital index is like a financial confidence index—Moody's or Standard & Poor's. Rather than assessing a firm's likelihood of paying its debts, however, the leadership capital index offers a more thorough way to assess a firm's present and future leadership. The subtitle of this book, *Realizing the Market Value of Leadership,* promises a more comprehensive and rigorous way of evaluating leadership as part of a firm's overall value.

One reason this book has taken a decade to write is the difficulty of articulating a simple solution to the complex task of judging leadership quality as an outside debt or equity investor. I started by trying to help investors go from instinctive to rigorous leadership assessments. I wanted the leadership capital index in this book to take investors from a present 5% confidence in their assessment of leadership to a 90% confidence level, but I eventually concluded that this goal was naïve on my part.

Instead, I have chosen to write an MVP—minimum viable process—book, picking up a concept from software development. In software, innovators get started, go public, share ideas, receive critiques, experiment, and continually improve. In the same vein, my leadership capital index is not yet perfect—but it offers a simple and already helpful approach to the question of assessing genuine value. This MVP logic is like software version 1.0, knowing that 2.0 and 3.0 will follow. But 1.0 becomes the critical first draft that will define and shape the conversation. Creating this rigorous way to define and assess leadership through the eyes of investors is a significant step forward.

My hope is to frame a dialogue about something that investors and others will use in a disciplined way. The leadership capital index will be used to assess firm value, but it will also become part of conversations about risk, social responsibility, governance, mergers and acquisitions, and leadership selection or development. This is a lot to ask of one book, but the ideas presented will make real progress on this journey.

Most popular business books start with stories of beloved companies and try to uncover insights from those exemplars. These insights might come from in-depth narrative on a few companies or from research on many companies designed to discover what respected companies do. I have written a number of such books. The benefit of this approach is that the stories (and the research) are compelling and interesting, offering details that bring the insights alive. The downside is that the stories and research reflect a point in time. However excellent or great they are now, companies may not continue to be so in the years (or even months) to come. Starting with stories, either as individual cases or as research based on lots of cases, runs the risk that events will overtake the author's insights and lead readers to doubt the inferences the author has drawn.

While not focused on specific companies, we wanted to figure out how active investors can better assess leaders, so my colleagues and I wanted to get inside the investor's mind. Norm Smallwood and I interviewed dozens of thoughtful investors around the world; ran a number of focus groups with four to eight investors in Brazil, Singapore, Canada, Norway, Germany, the United Kingdom, the Middle East, and the United States; and surveyed more than four hundred investors (and published these results). We found that investors were intrigued with the concept of leadership, acknowledged it as a missing ingredient (some said the holy grail) of investment assessment, but were unsure how to approach it with more than casual observations.

I also looked at dozens of studies by consulting firms and experts who attempted to put substance behind the assessment of leadership. Very talented colleagues have approached the challenge of assessing how leaders can be more effective. In general, these studies offered deep insights on one piece of the leadership puzzle. Some focused on compensation practices, others on personal style, and still others on organization governance and design. None attempted to prepare a comprehensive approach to leadership capital as a whole.[1]

It's just as well that I abandoned the idea of starting with stories of investors' successfully assessing leadership—such stories are rare, and those that exist are often incomplete or even more transitory than the usual story of business excellence. Instead, my focus is on stimulating ideas that will deliver investor rigor in assessing leadership capital. Throughout the book, I refer to insights from investor interviews, focus groups, and surveys, but concentrate on the ideas and frameworks rather than the stories. I put myself in the place of an investor who has done financial and intangible analytics and is now seeking insights on leadership that will inform the final decision.

When I discuss this leadership capital index, people often demand, "Show me the measures on the existing balance sheet and income statement." I struggled for years to do this, but then the obvious hit me: current income statements and balance sheets were designed to give investors financial information to assess a firm's value—not information on leadership capital. Nonetheless, investors and others who are serious about long-term value creation will seek the additional insights that come from a thorough assessment of leadership—the sort of assessment this leadership capital index begins to provide. The measures of this index come from more in-depth observations, interviews, surveys, and other data about leadership. The value of this book is that it provides you with the right questions to ask and the right indicators to track.

So this is an ambitious and sweeping book. When you see leadership through the eyes of investors, you will build new insights into how you can better realize the full market value of a company. The proposed leadership capital index offers a rather simple (but not simplistic) approach, with ideas, tools, and diagnostic questions that can be used with increasing amounts of granularity (one could audit two domains of leadership, ten elements, or fifty-nine items). Using this leadership capital index, investors can hope to move from 5% to 30% or even 40% confidence in their assessment of leadership. By offering a leadership capital index, I will take a major step forward to shape the discussion to realize the market value of leadership.

The book is divided into four parts. Part 1 (Why and How Leadership Matters to Investors), in Chapters 1 and 2, provides the context for the leadership capital index. These chapters summarize previous work on firm valuation and leadership, present the rationale for leadership as an increasingly important part of market value, and define a leadership capital index to advance and assess quality of leadership with two domains: individual and organizational elements of leadership. Part 2 (The Individual Elements of the Leadership Capital Index), in Chapters 3 through 7, presents five elements of individual leader behavior that investors can monitor, then identifies specific competencies and indicators for these five elements. These five chapters will help investors determine the quality of individual leaders within an organization. Part 3 (The Organization Elements of the Leadership Capital Index), in Chapters 8 through 12, presents five elements of organizational systems that shape leadership that investors can monitor and identifies specific dimensions and indicators of these five human capital systems. These five chapters will help investors realize the value of the organization that creates leadership. Part 4 (Application and Action), in Chapters 13 and 14, pulls together all of the ideas and show how investors, regulatory agencies, boards of directors, C-suite executives, and leadership development professionals can apply these ideas to improve the quality of leadership of companies they assess or work in.

I am deeply indebted to many colleagues who have shaped the ideas in this book. My insights draw on exceptional thought leaders in diverse disciplines including finance, market valuation, organization systems, human capital, human resources, and leadership. I am particularly indebted to those who have worked to bring investment-level rigor to the assessment of traditionally "softer" organization issues. The list of these colleagues is too long to mention, but they are cited in Chapters 1 and 2. I have learned firsthand about the elements of leadership capital and organization capability from working with hundreds of clients over many decades. I am grateful to these clients for allowing me to observe and co-learn with them. My personal intellectual guides on this work include remarkable insights from cherished colleagues including Justin Allen, Dick Beatty, John Boudreau, Wayne Brockbank, Bob Eichinger, Allan Freed, Peter Goerke, Marshall Goldsmith, Lynda Gratton, Gordon Hewitt, Steve Kerr, Dale Lake, Ed Lawler, Mark Nyman, Jeff Pfeffer, CK Prahalad, Ray Reilly, Norm Smallwood, Pat Wright, and Jon Younger. Each has directly contributed to my understanding, and I clearly have assimilated their ideas.

I am indebted to Hilary Powers for her extraordinary assistance in developmental editing. She has an incredible gift for making abstract ideas accessible. None of my books would be the same without her remarkable editing. I am very grateful for Steve Piersanti and his amazingly talented team at Berrett-Koehler, who are not only professionally gifted but also show personal care. Clearly, this book and other work-related activities would not happen without the incredible support of Ginger Bitter, my assistant for over twenty-five years, who not only manages unwieldy logistics but is also a dear personal friend. Yet my most heartfelt appreciation and gratitude goes to my wife, Wendy, who continues with positive patience to support and shape my professional and personal lives in ways that I could not begin to imagine without her: *plus que hier, moins que demain.*

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PART ONE

Why and How Leadership Matters to Investors

Sometimes, new ideas completely disrupt traditional thinking. More often, new ideas emerge from synthesizing previous thinking, then evolving to fresh insights. This present work builds on outstanding work in the study of market value and leadership. Each of these separate disciplines has vast reservoirs of ideas, studies, and tools. In Chapter 1, I want to acknowledge this previous work but then show that by connecting market valuation and leadership, each discipline moves forward. Market valuation with leadership insights becomes more complete and accurate. Leadership through the lens of market valuation brings more discipline to the study of what effective leaders know and do. In Chapter 1, I also report on how the most prominent investor of our day (Warren Buffett) continually reflects on management as part of his decision making, and I report our research from investors about the importance of leadership in their decision making. Leadership matters to investors, but they can be comprehensive in their assessment.

In Chapter 2, I show that now is the time to propose a *leadership capital index* that offers investors a much more comprehensive way of assessing leadership as part of their firm valuation process. While investors recognize the importance of leadership, they often lack rigor in assessing it. The proposed leadership capital index identifies two domains of leadership (individual behavior and organization capabilities) and five elements in each domain that investors can access to move beyond superficial and casual leadership observations. This leadership capital index will also inform those interested in understanding governance, risk, social responsibility, and other organization processes. The domains and elements of this leadership capital index synthesize and extend multiple strands of excellent work into the next step of realizing the market value of leadership.

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CHAPTER 1

When Leadership Matters to Investors, It Matters More

"How much is that doggie in the window?" asked Patti Page in a 1952 novelty song. Investment analysts and others have asked essentially that same question since companies have been publicly traded: "How much is this company?" (With a strong subtext of "How much is this company worth to me?")

A dog's value comes from its recognizable traits (breed, age, health, temperament), but also from its personal value to the owner (relationship, history, companionship). Similarly, a company's value comes from its tangible assets like products, receivables, technology, and facilities—the assets that show up on the balance sheet and are as easy to see as the surface of a dog. Company value also includes intangibles such as strategy, brand, intellectual property, and reputation, which are more subjective and less likely to show up on the balance sheet but have been recognized as being just as essential to determining a company's desirability as an investment.

Underlying the intangibles, each organization has a level of leadership capital—an established pattern of both individual leader characteristics and organization and human capital processes—that can and should be included in determining firm value. Investors often have a strong feeling about the importance of a particular leadership trait, but their opinions tend to be superficial because they don't recognize or have ways to fully evaluate all the elements that underlie effective leadership. They make judgments with only one or two pieces of a leadership puzzle, not the entire puzzle.

The leadership capital index in this book will help investors and others improve their approach to firm valuation. When leadership capital becomes a factor in investor judgments, it will naturally receive more emphasis in day-to-day corporate life, to the benefit of many.

Audiences for Leadership Capital Insights

The insights from this book should prove useful for stakeholders committed to understanding leadership and value: investors, rating firms, proxy advisory firms, boards of directors, senior executives, and HR and leadership specialists.

INVESTORS

The primary audience for this book is investors looking to value the quality of a company's leadership. Interested investors include equity and debt investors, long-term and short-term investors, and relational and transactional investors. Investors who value and assess the quality of leadership will make more informed decisions about the future value of a company. Most thoughtful investors recognize that leadership matters, but they are not clear on how to rigorously assess leadership.

A major private equity group held an annual conference for the CEOs of companies it had acquired, where it would share advice on what these independent CEOs should focus on in the next year. In 2009, soon after the market collapse, this conference focused for two days on leadership. The group executives had discovered that it often took five to seven years to turn around a distressed company—and that in 60% to 70% of the cases, the biggest challenge was the quality of leadership. Often the leaders who'd gotten the company into a position where it was purchased by the private equity group were not able to make the bold changes needed to turn around and transform their company to prepare it to be repositioned in the marketplace. The group leaders felt that if they could prepare acquired-firm leaders to be more capable, they could turn the companies faster. The group decided to hire a talent czar, someone who could assess leadership talent in companies likely to be acquired and then develop leadership in acquired companies to be better able to transform their company and prepare it to be resold. These private equity investors recognized that leadership mattered—and that they were not in a position to perform thoughtful or thorough assessments of leadership. So they retained a specialist to do so.

As this private equity group recognized, valuing leadership comes from and extends the work on intangibles. Two firms in the same industry with the same financial results may have dramatically different market valuation. This differentiated market valuation is often attributed to intangibles, which show up in business by boosting—or undercutting—investors' confidence in a firm's performance. Leaders architect intangible value. When investors accurately assess leadership, they are indirectly but accurately assessing the future intangible value of a firm. Thus investing in leadership capital may result in a leadership premium or discount, depending on the outcome of the assessment.

RATING FIRMS

Standard & Poor's (S&P), Moody's, and Fitch issue about 95% of the creditworthiness ratings based on their view of a company's ability to pay back its debt. Credit rating has been a staple of measuring firm financial performance since the early 1900s, and a firm's credit rating influences both its cost of capital and its ability to access capital. While critics sometimes challenge the details of risk assessments, these ratings continue to have great influence.

Just as credit ratings reflect the likelihood of continued financial effectiveness, a leadership capital rating could be created to reflect the likelihood of leaders' making the right choices to drive firm performance. If universally accepted, a leadership capital index would have implications for numerous stakeholders. For example, in 2011, S&P very publicly downgraded U.S. securities from AAA to AA because of the budget deficit and rising debt burden. This downgrade influenced borrowing costs for the U.S. government, companies, and consumers. However, the underlying reason for this downgrade was not just the debt burden itself but the inability of leaders in Congress to collaborate well enough to face and solve the deficit problem. A leadership capital index that assesses the quality of leadership would complement a report on the symptom (debt burden and ability to repay), but go beyond it to assess the underlying problem (quality of leadership).

Likewise, in the 2008–2010 recession, many Western banks were "bailed out" by government support. The problem with this metaphor is that bailing water out of a boat only relieves the symptom. If the hole in the boat is not fixed, water will keep leaking in. The "hole in the boat" may be defined as poor leadership. Unless and until leaders behave differently, similar results will occur. Even after financial bailouts, leaders who spent excessively at executive retreats or on executive compensation continued to place their firms at risk. To avoid future bank risks, regulators formed bank stress tests that focused on risky assets, balance sheet quality, and the amount of capital on hold. Unfortunately, none of the bank stress tests in the United States (by the Federal Reserve Board), Asia (by the International Monetary Fund), or Europe (by the European Banking Authority) include an assessment of leadership. Perhaps this is why financial stress tests are somewhat discounted and do not receive the confidence they were intended to inspire.[1]

PROXY ADVISORY FIRMS

Proxy advisory firms, including Institutional Shareholder Services (ISS), Egan-Jones Proxy Services, Glass, Lewis & Co., and Institutional Investor Advisory Services (IIAS) in India offer shareholders advice on how to vote their shares. These firms issue reports on how a firm's governance practices relate to firm performance based on public financial data. For example, ISS reports four pillars of governance practices: board structure, executive compensation, shareholder rights, and audit-related activities. While all are related to leadership, none of these four pillars rates leadership capital directly. They report the alignment of total shareholder return over one, three, and five years with CEO pay and compare this to an industry peer group to measure pay for performance, but they do not offer further insights on leadership. Including more refined indicators of leadership would enable these proxy firms to offer more thorough recommendations.

BOARDS OF DIRECTORS

As trustees of a firm's assets and shareholder interests, boards of directors have fiduciary responsibility for its performance. To fulfill this responsibility, boards review strategic plans, financial performance, firm policies, and operating choices. A primary task of a board is to select a CEO who can make astute decisions to lead the firm. In addition, the board determines compensation for the CEO and other key executives. Through these actions, boards recognize the importance of leadership capital for firm success—especially in settings like government agencies, not-for-profits, privately held companies, or countries where market value may not be a dominant logic.

A leadership capital index could help the board manage succession against a set of criteria that informs and bolsters confidence from investors and others. Executive succession is not just about the person who moves into a key position—it is about how the individual qualities instill confidence in others, particularly investors. In addition, boards sometimes invite in financial advisers to help determine how to increase total shareholder return. Often these advisers examine industry trends (to see if the firm has a strategic advantage) and financial performance (to see if it meets financial expectations). Less often do boards invite in leadership advisers to examine intangible value to see if their firm trades at a premium or discount to the industry. Boards might use the leadership risk assessments proposed in this book to review their firm's quality of leadership, which in turn would give investors more confidence.

THE C-SUITE

C-suite executives and senior leaders want to demonstrate excellent leadership skills. Often leadership excellence is defined by the personal characteristics of the leader (authenticity, charisma, communicator, and so forth). But unless these personal leadership characteristics build confidence with investors, they are not contributing all they could to sustainable value. CEOs are also committed to building future human capital—their number one priority, according to a recent survey.[2] Having a leadership capital index would help senior leaders know what to expect of themselves and other leaders so that investors would be more likely to invest in the company because of what leaders know and do.

HR AND LEADERSHIP SPECIALISTS

HR and leadership development specialists who design and deliver leadership improvement efforts could also be well served by a leadership capital index. Recently, my colleagues and I were in a consortium of leading companies, most of which had teams or HR professionals in attendance. One question we asked these groups to consider was, "What would you like investors to know about your quality of leadership that would increase their confidence in your future earnings and market value?"

Almost none of these senior HR professionals had considered this question, even as they worked to improve leadership in their company. Indeed, one of the consortium teams happened to be investors from one of the large global sovereign wealth funds, and these investor participants talked about what they look for in leadership when they make significant investment choices. But as they were presenting their list of desired leadership attributes, I noticed that none of the HR participants in the workshop were paying much attention.

I stopped the discussion at that point. "Do you realize what you are hearing?" I asked. "Guys from one of the largest investors in the world are sharing what they are looking for in leadership in your companies—or your rivals in the investment market. No one is taking notes. What you should be doing is rigorously writing down what they say, then sharing this with your CEO and chief investment officer so that they can communicate these messages in conference calls and investor discussions. And you should be rethinking leadership investments to ensure that you have or develop these traits."

With some embarrassment, these HR professionals starting taking notes! And some later told me they could now engage in more business-oriented discussions with their business leaders.

Using a leadership capital index that focuses on how investors view leadership can help sharpen leadership improvement efforts. If nothing else, it will bring the concept to the table and allow it to be considered.

Logic of Leadership Capital Index

A leadership *index* differs from a leadership *standard*. Standards define what is expected; indices rate how well an activity performs. For example, consider the *Economist*'s Big Mac index, which measures the cost of a Big Mac in various countries in terms of its difference from the average Big Mac price in the United States. The index doesn't try to tell you how much a Big Mac should cost—rather, it is a crude but useful assessment of the cost of living around the world.

An index guides investors to make more informed choices. When a rating agency like Moody's or S&P downgrades a company, it is not saying the company did or did not meet financial reporting requirements. It is offering an opinion about the firm's ability to repay loans in the future. Likewise, a leadership capital index would inform investors and others about the readiness of the firm's leadership to meet business challenges.

I am not proposing some sort of leadership equivalent of generally accepted accounting principles (GAAP)—this is not an attempt to codify all leaders in the same way. Developing such a leadership standard would be nearly impossible because leadership is inevitably both personally subjective and contingent on the unique needs of the company. Defining a leadership standard would be like defining the perfect basketball player. Both Michael Jordan and Bill Russell were enormously successful, but they had very different skills, played in different eras, and had different roles on their teams. Likewise, it is silly to ask who was or is the best leader—Bill Gates, Richard Branson, Indra Nooyi, Ratan Tata, Carlos Ghosn, Warren Buffett, Zhang Ruixin, Steve Jobs, Larry Page, Oprah Winfrey, or Jack Welch? In fact, each was very successful using unique skills appropriate for the circumstance. In the near future, no uniform standard of leadership is at all likely, but an investor who recognized the quality of leadership in each of these leaders and thus invested in them early on would have been well served. A leadership capital index can give investors and other interested parties a set of guidelines to assess leadership.

When my colleagues and I share our aspiration to develop a leadership capital index, almost everyone agrees that this would be a marvelous resource. Some call it the holy grail for both firm valuation and leadership development, but most are skeptical that it can happen. However, the timing is now right, because both firm valuation and leadership improvement efforts have evolved to a stage where such an index can actually be created.

My current proposal for a leadership capital index follows the logic of the *minimum viable product* for innovation in high-tech.[3] According to this logic, web applications and lean start-ups continually experiment to learn how to improve. The product is not wholly defined in advance; it develops as it is tested, used, and improved. In valuation and leadership, a number of initial efforts have been made to establish an investor view of leadership. By combining these separate but thoughtful initiatives, we can now create a more rigorous and holistic leadership capital index. Leadership capital index 1.0 is to build the case for the index and establish a framework and baseline for the index, which is the purpose of this book.

Valuation Evolution: From Financial to Intangible to Leadership

The definition of an organization's value has changed over the years, and I believe it is still changing. Once it was mainly the physical stuff that could be removed and sold; then it expanded to include the intangible assets that made it a going concern. Leadership looks like the next step.

It's worth tracing the development in more detail. Historically, the accounting profession received a major challenge after the stock market crash of 1929. Many argued that stock prices misrepresented firm value because the public information available to investors did not accurately reflect the extent of a firm's assets. In 1934 the Securities and Exchange Commission was formed to create standards and regulate how public companies report their financial performance to investors. The large accounting and audit firms at the time (called the "Big Eight": Price Waterhouse & Co.; Haskins & Sells; Ernst & Ernst; Peat, Marwick, Mitchell & Co.; Arthur Young & Co.; Lybrand, Ross Bros. & Montgomery; Touche, Niven & Co.; and Arthur Andersen & Co.) established a set of standards and principles through the Financial Accounting Standards Board (FASB). The rules define uniform standards in an effort to communicate accurate information to investors so they can better measure firm value (generally accepted accounting principles—GAAP—in the United States, or international accounting standards—IAS—outside the United States).

The intent of these accounting standards is to offer investors comparable, public, and transparent data that will enable them to make accurate valuation decisions. The ingredients, or financial data, from the accounting standards can then be combined to define a firm's value. An entire industry has been created and evolved to define approaches to the increasingly complex task of measuring a firm's value.[4] Income approaches to valuation focus on capitalization of current net income or cash flows and discounting of future cash flows. Cost approaches to valuation emphasize the cost of replacement of an asset to determine its value. Market approaches value assets because of their current value based on competitive pricing. Again, each of these broad approaches to valuation combines the ingredients from the accounting standards data to determine a value of the firm.

IMPORTANCE OF INTANGIBLES FOR VALUATION

In recent years, due to changes and uncertainty in markets, information, and globalization—and despite the constant attention reported in the preceding section—the financial data publicly reported by firms has not reflected their value accurately.[5] Earnings reported in a variety of forms (net income, operating earnings, core earnings, and more) have become ever more suspect.[6] As a result, efforts at firm valuation have turned from financial results toward a deeper understanding of the intangibles that influence these results.

Baruch Lev, an accounting professor who is a thought leader of the intangibles movement, has shown the importance of intangibles as indicated through *market to book value*—suggesting that for every $6 of market value, only $1 occurs on the balance sheet.[7] This means that the balance-sheet number—which is what traditional accounting measures—represents only 10% to 15% of the value of these companies.[8] This data shows that the value of many firms comes as much from perceived value as from hard assets. Firms like Coca-Cola and Gilead have high market value from brands and patents. Technology-based firms like Amazon and Google have high market value with relatively little in the way of cash flow, earnings, hard assets, or patents. And even traditional companies like 3M and IBM are increasing market value by focusing on brands, leveraging the Web, and restructuring. Professor Lev further recommends that managers learn to win investors over by finding ways to more clearly communicate intangibles with them.[9]

Harvard professor Robert Eccles and his colleagues at Pricewaterhouse Coopers (PwC) call for a "value reporting revolution" by changing financial reports to include more intangible information. They find that only 19% of investors and 27% of analysts "found financial reports very useful in communicating the true value of companies." They argue for changing the performance measurement game to better allocate capital and assess the true value of firms. In identifying better measures of firm performance, they focus on "key performance measures—both financial and non-financial, and how they relate to each other, that they are measured and reported on, and that they create real value."[10] They propose a model they call "Value Reporting Disclosure" with enhanced business reporting where firms report information on business landscape (industry, technology trends, the political and regulatory environment, social, and environmental trends), strategy (mission, vision, goals, objectives, portfolio, governance), resources and processes (physical, social, organizational capital and key processes), as well as GAAP-based performance.[11] By reporting these more intangible factors, they give investors better information for determining a firm's true value. Analysts perceive the benefits of better disclosure when they help long-term investors have greater confidence in future earnings.

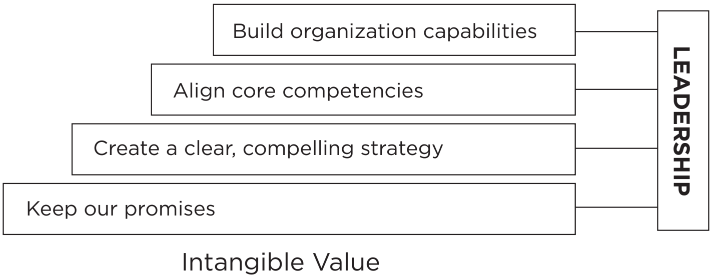
Accenture's finance and performance management group also reports that intangibles are an increasingly important part of a firm's value.[12] Its classification of assets still includes monetary and financial assets, but also intangible assets of relationships, organization process, and human resources, and it proposes measures to track these intangible assets.

Ernst & Young's Center for Business Innovation has also attempted to find out how investors use non-financial information in valuing firms.[13] It concludes that non-financial criteria constitute, on average, 35% of an investor's decision. Sell-side analysts use non-financial data, and the more non-financial measures analysts use, the more accurate their earnings forecasts prove to be.

Because of studies like those just cited,[14] in recent years intangibles have received more attention as a source of value.[15] Generally intangibles have been listed as intellectual capital or knowledge as evidenced in patents, trademarks, customer information, software codes, databases, business or strategy models, home-grown processes, and employee expertise.[16] Investors have worked to classify lists of intangibles that include intellectual capital but are more expansive. Baruch Lev categorizes intangibles into R&D efforts (such as trademarks, patents, copyrights), brand value (such as image, reputation), structural assets (such as business systems, processes, and executive compensation, human resources), and monopoly position.[17]

In our earlier work, Norm Smallwood and I synthesized the work on intangible value into four domains called the *architecture for intangibles* (see Figure 1.1). We found that intangibles could be clustered into four broad categories—making and keeping promises, having a clear strat-

Figure 1.1. Architecture for Intangibles



Source: Dave Ulrich and Norm Smallwood, *Why the Bottom Line Isn't: How to Build Value Through People and Organization* (New York: Wiley, 2003).

egy for growth, managing core competencies, and building organization capabilities—all of which depend heavily on the behavior of leaders.[18] To elaborate:

- *Keeping promises* comes when leaders build relationships of trust by doing what they say to employees inside and customers and investors outside, often measured as risk.
- *Creating a clear, compelling strategy* comes when leaders have strategic capital to define the future and work with customers to deliver value through brand identity and reputation.
- *Aligning core competencies* increases when leaders invest in R&D and the intellectual capital that comes from patents, copyrights, trademarks, and the like. Creating core competencies also comes when leaders access functional expertise in technology, manufacturing, and operations.
- *Building organization capabilities* comes when leaders have the ability to create a corporate culture consistent with its mission, which could mean a culture of innovation, collaboration, efficiency, risk management, or information asymmetry.

In this current work, I emphasize the point that leadership is a key underlying factor in an organization's ability to keep promises, set clear and compelling strategies, align core competencies, and build organization capabilities. When leaders at all levels of a firm guide these four domains, they create sustainable intangible value. Therefore investors who assess leadership will be more able to fully value a firm's intangible assets and overall market value.

As I've said, this is the right time for this book. Nearly every interested investor has access to publicly reported data, so essentially, each investor knows what every other investor knows about a firm's financial position and, increasingly, about its intangibles. Investors need to dig deeper to find new insights, and this is not easy to do. For example, the New York State Attorney General recently required BlackRock (the world's largest asset management company) to stop surveying Wall Street analysts to find out their collective views on a company's financial performance and likelihood of being taken over.[19] The argument was that financial data should be public, transparent, standardized, and shared so all investors have the same access to it. When financial data is widely shared, however, investors have to find other information, such as leadership, to inform and differentiate their investment choices.

LEADERSHIP: THE NEXT STEP

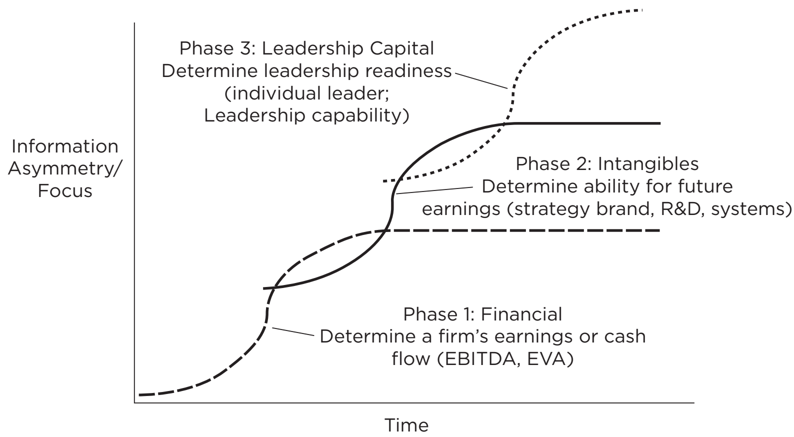
When New York University researchers administered a questionnaire to a hundred venture capitalists, exploring the criteria for fundability of new ventures, they found that the most important factor is the quality of the entrepreneur or management.[20] Similarly, when Boris Groysberg and his colleagues at Harvard surveyed analysts to find out what they valued in making their investment decisions, they found that quality of management was among the top factors.[21] However, they also found that analysts lack consistency in rating this dimension.

Research among joint ventures and venture capital firms has also found that information that has not traditionally been incorporated in the due diligence process, such as the quality of management and culture, can be critical to the future success or failure of the acquisition. The success of many companies can be traced to a few prominent managers who provided the required leadership. Without auditing intangible assets such as management, it is not possible to conduct a correct valuation of a potential investment.[22]

These studies show that work on valuation is moving toward an assessment of the quality of leadership—the leadership capital—that underlies and creates intangibles and leads to financial results. Figure 1.2 traces the s-curves in the history of valuation, showing how intangibles move beyond financial information and proceed almost inevitably to the inclusion of leadership.

These days investors are creating metrics for intangibles (like brand recognition, strategic clarity, innovation index). Investors who do a better job of assessing leadership will create information asymmetry for themselves and make better investment decisions. However, man-

Figure 1.2. Evolution of Firm Valuation



agement practices and leadership vary enormously across firms and countries.[23] Financial valuation sets the accepted baseline that levels the playing field, but leadership valuation differentiates how investors can determine long-term firm value.

Leadership Evolution: From Personal Style to Organization Impact to Investor Value

"What makes effective leadership?" That is the dominant question when it comes to the study of leadership, and its exploration has filled countless books, many thicker than this one. Nonetheless, it is useful to review the overall development of the idea. The answer to what makes effective leadership has evolved over time, each new stage building at least in part on its predecessors.[24] Some firms have celebrity leaders or an individual leader who gains notoriety. While these charismatic individuals become important to a firm's success, more often it is the depth of leadership talent throughout the organization that builds long-term success. When my colleagues and I talk of *leadership,* we mean the collective group of leaders throughout a company, not just the CEO or another individual senior executive. Thus, while individual leaders matter, increasingly the entire cadre of leaders, the *leadership,* matters more.[25]

Assessments of effective leadership have moved from a stance of believing that leaders excelled by first leading themselves, then being the sort of people others follow. Later assessments examined how leaders looked to others by leading in the organization, and the more modern view has them looking outside by creating value for external stakeholders.

WHO YOU ARE

Early leadership theorists tried to identify a core set of demographic traits that characterized an effective leader: height, gender, heritage, speaking style. They also tried to identify personality traits and backgrounds that made leaders more effective.

All to no avail.

It turned out that successful leaders could come from a variety of backgrounds and display a variety of physical and personality traits. The only trait that seemed to consistently differentiate better leaders was being somewhat (not too much) smarter than their followers.[26] Traits eventually combined to form a leadership style, often a trade-off between people and task. Generally, leaders exhibited a preferred style, but the best leaders could be both soft and hard, caring about people and managing tasks.

Defining effective leadership by looking inside a leader is still an active field, with some useful observations to offer. The focus is now on the core competencies—the knowledge, skills, and values—of successful leaders.[27] My colleagues and I have synthesized this competency-based work into what we call the *leadership code,* suggesting that leaders master five competency domains to be effective (strategy, execution, talent, human capital, and personal proficiency).[28] I discuss these domains in more detail in Chapter 2 and throughout the book.

While many leadership theorists and advisers emphasize one competence area (for example, authenticity, emotional intelligence, strategy, execution, talent management, or human capital development), my colleagues and I have found that effective leaders master all five competency domains to be effective. Personal approaches to leadership primarily focus on helping leaders become more attuned to who they are and who they can become to be effective.

WHAT YOU DO FOR OTHERS IN YOUR FIRM

Leadership theorists eventually recognized that looking inside the leader was not enough to define effective leadership. Leaders also had to deliver results according to the task at hand. Part of this effort was to determine which leadership approaches worked in which situations. In this view, effective leadership depends on the requirements of the situation. Situations may vary by maturity of team members, complexity of the tasks at hand, time horizon for doing the work, or uncertainty in predicting outcomes of the work. Any individual leadership style will work better in some situations than in others, and truly effective leaders can tailor their style to the needs of the moment.[29]

The other part of looking to others means that leadership effectiveness is less about a personality trait and more about how leaders help make organizations more effective. Leaders can drive organization effectiveness through employees, organization cultures, or financial performance.[30]

The impact of leadership on employee performance has been studied extensively.[31] Leaders' actions shape employee sentiment at work, a phenomenon that may show up as satisfaction, commitment, and engagement—or the reverse. Thousands of studies have shown that leaders drive employee response to work.[32] Leaders also create strategies that differentiate their firms for long-term success.[33] In addition, leaders shape an organization's culture or identity. *Culture* has often been represented as the values, norms, beliefs, and unwritten rules of an organization, and it tends to take on the personality of the leader.[34] Leaders create culture through managing people, performance, information, and work practices.[35] Culture in turn drives financial performance.[36]

Leaders also drive financial performance within a firm. Many studies have shown that leadership has about a 12% to 14% impact on firm performance.[37] In one study, extraordinary leaders doubled company profits.[38] Strategic leaders help make choices that help position their organizations for success.[39] For example, in her research, Alison Mackey wanted to find out how much CEOs affected firm performance. She looked at fifty-one firms over ten years with ninety-two CEOs. She was able to show that the CEO affected a 29.2% variance in firm performance, which was somewhat higher than corporate impact (7.9%) and five times the industry impact. In particular, in smaller and faster-growing firms, CEOs have more impact.[40]

Both the personal and organizational approaches to leadership effectiveness find that leaders' ability to match skills to situation enables them to deliver success within the organization.

WHAT YOU DO FOR EXTERNAL STAKEHOLDERS

More recently, in a further step in leadership thinking, the definition of leadership effectiveness has gone beyond the person or the organization outcomes and addresses what happens outside the walls of the organization.[41] Effective leadership in these terms is not merely what leaders know and do but also how their actions shape the experiences of customers. If customers choose to buy Lexus because of the quality and design, then leaders inside Lexus should make sure their actions drive quality and design to new and yet more attractive heights.

Leadership matters not just because employees are more productive, organization cultures are more conducive to strong results, or financial outcomes are better, but because external stakeholders receive value from what leaders do within the firm. For customers, leaders are effective when they link internal organization processes in ways that deliver on customer expectations. Culture becomes less focused on the norms and values inside the company and more on making the external identity of the firm (its brand) consistent with the internal culture.[42] For leaders, this means not only creating an internal culture consistent with an external identity but also building a leadership brand. Such a brand exists when leaders ensure that the behaviors of employees reflect the expectations of customers outside the company.[43] Work has begun to define leadership effectiveness through the expectations of customers.

Linking leadership actions to investor expectations would be part of measuring what this book calls *leadership capital*.[44] Chapter 2 reviews how people have approached the connection of firm valuation and leadership, but to highlight the importance of this connection here, I offer some snippets from Warren Buffett's annual letters to his shareholders. (Warren Buffett is among the most influential and successful investors of all time, and his annual letters highlight his philosophy and approach. Similar sentiments appear every year, but these are some of the most vivid from the past decade.)

Selected Quotes from Warren Buffett Annual Shareholder Letters

- **2007**

  "A terrific CEO is a huge asset for any enterprise. . . . At Berkshire . . . their abilities have created billions of dollars of value that would never have materialized if typical CEOs had been running their businesses."

  "But if a business requires a superstar to produce great results, the business itself cannot be deemed great."

- **2010**

  "An outside investor stands by helplessly as management reinvests his share of the company's earnings. If a CEO can be expected to do this job well, the reinvestment prospects add to the company's current value; if the CEO's talents or motives are suspect, today's value must be discounted. The difference in outcome can be huge."

- **2011**

  "The primary job of a Board of Directors is to see that the right people are running the business and to be sure that the next generation of leaders is identified and ready to take over tomorrow."

- **2014**

  "For good reason, I regularly extol the accomplishments of our operating managers. They are truly All-Stars, who run their businesses as if they were the only asset owned by their families. I believe the mindset of our managers to be as shareholder-oriented as can be found in the universe of large publicly-owned companies."

As definitions of leadership effectiveness move from inside the person to inside the organization to beyond the organization's borders, it is important to recognize the emerging connection between leadership and investors. Leaders are more effective if and when they meet investor expectations. Investors are effective if and when they understand and realize the market value of leadership.

Investors Value Leadership: Research Results

To answer the question of how investors value firms, my colleagues and I interviewed twenty-five investors, had twelve focus groups with forty-five seasoned investors, and reviewed research on the topic (summarized in subsequent chapters).[45] From this preliminary work, we defined three broad domains of information most important to investors: industry favorableness, company performance, and quality of leadership.

- *Industry favorableness* refers to the characteristics of the industry, such as its growth potential, barriers to entry, competitiveness, social trends, customer opportunity, regulatory opportunities, and so forth. Industries may be more or less favorable (for example, twenty-first-century demographics favor care of the elderly and are less favorable to traditional printing).
- *Firm performance* refers to consistency of financial results as indicated by a variety of metrics. Firm performance also refers to the intangibles related to strategy, technological advantage, and organization capabilities such as speed to market, degree of innovation, customer service, and so forth.
- *Quality of leadership* refers to the confidence investors have in the leadership capability of the company. Investors are more likely to invest in companies with leaders who have a strong track record and have more ability to set and execute strategy, to manage current and future talent, and to develop future leaders.

Next, we determined the relative weight of each of these three domains for investor decisions by asking them to divide 100 points across the three domains and their confidence in assessing each domain. We received 430 responses from portfolio managers, institutional investors,

Table 1.1. Relative Importance to Investors and Investor Confidence to Assess

Domain	*Importance (Standard Deviation)*	*Confidence to Assess (Standard Deviation)*
Firm performance	38.5% (15)	4.47 (0.58)
Industry favorableness	33.1 (16)	4.33 (0.66)
Quality of leadership	28.4 (14)	3.75 (0.96)

Note: To rank importance, survey participants were asked to divide 100 points based on how important each domain is for investment decisions. To evaluate confidence in ability to assess, they were asked to rate themselves on a scale of 1 to 5 (highest) for each domain.

mutual and hedge fund managers, private equity investors, and venture capitalists. These investors each had, on average, more than fifteen years of professional investment experience.

Table 1.1 reports the relative importance of each domain, along with investors' confidence in their ability to assess each area.

Investors consider company performance the most important domain for making investment decisions (38.5 percent) and also have the highest confidence in their ability to assess it (4.47). The standard deviation of 0.58 is the lowest of any domain. This result is not surprising; performance is the most objectively measurable of the domains, and it is comparable across firms and consistent with most investor training.

Industry favorableness also matters (33.1 percent) to investors, and they have high and consistent confidence in their ability to track it (average score of 4.33 with a standard deviation of 0.66).

Although ranked lowest among the three domains, quality of leadership clearly matters to investors (28.4%) in a consistent way (standard deviation of 14). But investors have much less confidence in their ability to assess quality of leadership (3.75) and they sense a much higher risk (standard deviation of 0.96) associated with their evaluations. Their comments reflect these findings:

- "Quality of leadership is important but . . . if high quality of leadership is required for an investment to succeed, then there may be other investments out there . . . with fewer hurdles to success. . . . At the end of the day, it always comes down to people."
- "We care a *lot* about this. This is what drives a firm to capture opportunity. Nearly all the pathologies of leadership are easy to find if you know where to look. Too many CEOs are such great toadies (some seem to be sociopaths) that you can't depend on just meeting

them—they will charm you, and they'll figure out what you want to hear. So, you have to get out into their operations and walk around. If you know what real leadership is and what real integrity is, you will find it or the absence of it out on the front lines where products and services are being forged and delivered to customers."

- "Leadership is one of the most important considerations that our fund makes when considering a potential investment. If we are not comfortable with the management team, we will usually not invest until changes are made."
- "This is a leading nonfinancial indicator, yet all information systems and research services are designed to provide financial metrics. Quality of leadership, culture, quality of relationships with core stakeholders are critical to understand but are also difficult to gauge. We've spent four years trying to get better in this area."

Clearly, leadership matters to investors, but they often find it difficult to define, measure, or track. Investors vary more in how much confidence they have in their ability to assess leadership. This tells me that investors would indeed be glad to have a usable leadership capital index.

In our interviews with investors, my colleagues and I almost always heard a resounding "of course" to whether leadership mattered in valuing a firm, but then we heard skepticism about how to accurately assess leadership. Most investors have spent their careers studying spreadsheets and computer programs, not dealing with the more subjective and behavioral assessments of individuals. But there is a body of knowledge on assessing leadership that can be accessed by investors to help them make more informed decisions.

Conclusion

In a nutshell, here is the logic. Firm valuation has evolved from increasingly granular financial metrics to intangibles to leadership (Figure 1.2). Quality of leadership has evolved from personal leader traits to how the leader delivers to others within the organization to creating value outside the organization. Leadership can inform the valuation effort to create information advantages for investors and to deliver sustainable intangibles within the firm. The intersection of firm valuation and quality of leadership benefits creates leadership capital.

It is time for a leadership capital index that would benefit investors and others interested in both valuation and leadership.

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