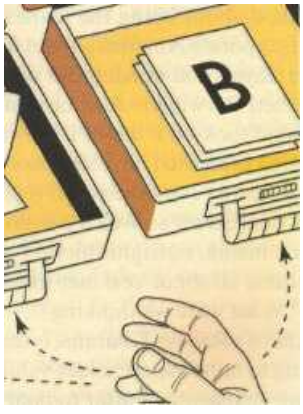
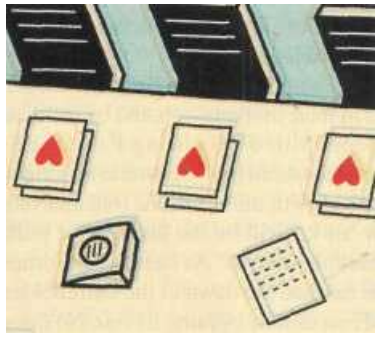
Once upon a time, there was a route to success that corporate America agreed on. But in today's fast-changing landscape, that old formula is getting tired. And a search is on for…

THE NEW RULES

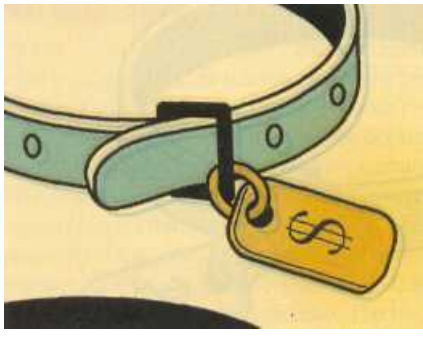
BY BETSY MORRIS • Even now, nearly five years after his retirement from General Electric, Jack Welch commands the spotlight. He is still power-lunching, still making the gossip columns, still the charismatic embodiment of the star CEO. His books are automatic best-sellers. More than any other single figure, he stands as a model not just for the can-do American executive but for a way of doing business that revived the U.S. corporation in the 1980s and dominated



the world's economic landscape for a quarter-century. Just try to find an executive who hasn't been influenced by his teachings. What came to be known as Jack's Rules are by now the business equivalent of holy writ, bedrock wisdom that has been open to interpretation, perhaps, but not dispute.



But the time has come: Corporate America needs a new playbook. The challenge facing U.S. business leaders is greater than ever before, yet they have less control than ever—and less job security. The



volatility of the markets is so unpredictable, the pressure from hedge funds and private-equity investors so relentless, the competition from China and India so intense, that the edicts of the past are starting to feel out of date. In executive

suites across the country, a dramatic rethinking is underway about fundamental assumptions that defined Welch and his era. Is an emphasis on market share really the prime directive? Is a company's near-term stock price—and the quarterly earnings per share that drive it—really the best measure of a CEO's success? In what ways is managing a company to please Wall Street bad for competitiveness in the long run?

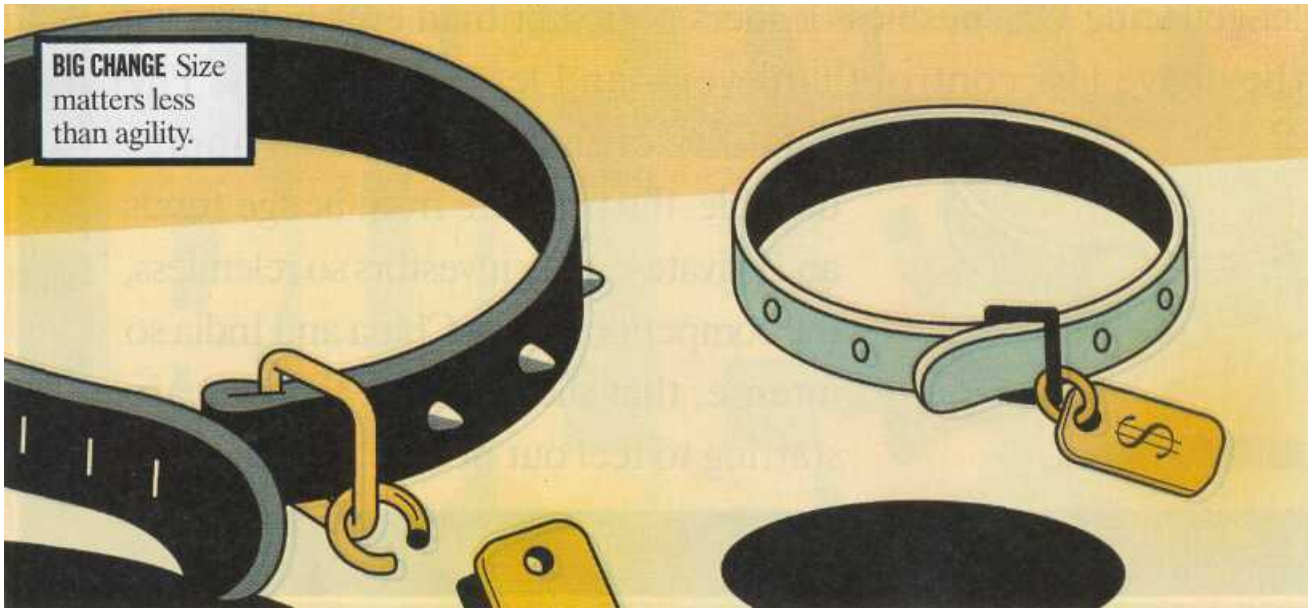
Jack Welch, needless to say, is having none of it. When FORTUNE caught up with him recently, he was as confident and outspoken as ever. "I'm perfectly prepared to change," says Welch (who co-writes a column in *Business Week* with his wife, Suzy). "Change is great." But, he asserts, he sees no reason to back away from the principles by which he and other star CEOs like Roberto Goizueta of Coca-Cola managed. If applied correctly, Welch contends, his rules can work forever.

Sorry, Jack, but we don't buy it. The practices that brought Welch, Goizueta, and others such success were developed to battle problems specific to a time and place in history. And they worked. No one questions today that bloated bureaucracy can kill a business. No one forgets the shareholder—far from it. Yet those threats have receded. And they have been replaced by new ones. The risk we now face is applying old solutions to new problems.

Early on, Welch argued that lagging businesses—those not No. 1 or No. 2 in their markets—should be fixed, sold, or closed. In a 1981 speech titled "Growing Fast in a Slow-Growth Economy," he announced that GE would no longer tolerate low-margin and low-growth units. GE, he told analysts at the Pierre Hotel in New York, "will be the locomotive pulling the GNP, not the caboose following it." As much as any other single event, Welch's words marked the dawn of the shareholder-value movement. And GE eventually became its star. No question who was Welch's boss. His report card: the stock price. His goal: consistent earnings growth.

As his ruthlessly efficient strategy wrenched GE into high performance, the company's stock took off. Soon virtually everything Welch said became gospel—often to the extreme. When Welch embraced Six Sigma, the program began to proliferate all over corporate America. He talked about being the leanest and meanest and lowest-cost, and corporate America got out its ax. Welch advocated ranking your players and weeding out your weakest, and HR departments turned Darwinian. As time went on, the mantra of shareholder value took on a life of its own. Cheered on by academics, consulting firms, and investors, more and more companies tried to defy history (and their own reality) to sustain growth and dazzle Wall Street as Welch was doing. Accounting tricks, acquisition mania, outright thievery—executives went overboard. "It became all about 'real men make their numbers,' " says one CEO. "What were we thinking?"

This, says Harvard Business School's Rakesh Khurana, is the legacy of the Old Rules. Managing to create shareholder value became managed earnings became managing quarter to quarter to please the Street. "That meant a disinvestment in the future," says Khurana, author *of Searching for a Corporate Savior*. "It was a dramatic reversal of everything that made capitalism strong and the envy of the rest of the world: the willingness of a CEO to forgo dividends and make an investment that wouldn't be realized until one or two CEOs down the road." Now, he



believes, "we're at a hinge point of American capitalism."

There is another model. In breathtakingly short order, the rock star of business is no longer the guy atop the FORTUNE 500 (today Rex Tillerson at Exxon Mobil), but the very guy those FORTUNE 500 types used to love to ridicule: Steve Jobs at Apple. The biggest feat of the decade is not making the elephant dance, as Lou Gerstner famously did at IBM, but inventing the iPod and transforming an industry. Dell spectacularly upended Compaq and Hewlett-Packard, yet few big companies paid close enough attention to see that new technologies and business models were negating the power of economies of scale in myriad ways. Nobody has proved that more than Google.

Yet in the corridors of corporate power, the old rules continue to cast an outsized shadow. Many CEOs are following a playbook that has, at best, been distorted by time. "How do you think about building shareholder value when a lot of people are really just going to hold the share for the moment?" says Jim Collins, a former Stanford Business School professor and the author of *Good to Great* and *Built to Last.* "The idea of maximizing shareholder value is a strange idea when [many shareholders] are really share flippers. That's a real change. That does make the notion of building a great company more difficult."

That doesn't mean everything about Welch's era is wrong. Indeed, we named him "manager of the century" in 1999. Were he at GE today, he might well be in the forefront of the current wave of rethinking, as his successor, Jeffrey Immelt, surely is. Still, in the way of all good analogies, we must begin by tearing down the old so that we can really open ourselves to something different. In that spirit, then, here are seven old rules whose shortcomings have become apparent and seven replacements that point toward a new model for success. Some of the old rules are inspired directly by Welch's teachings; others are not. You may not agree with all of our conclusions (Welch certainly didn't—see box at right). We welcome the debate. What's most important is to get the discussion started.

OLD RULE BIG DOGS OWN THE STREET.
HEW RULE: AGILE IS BEST; BEING BIG CAN BITE YOU.

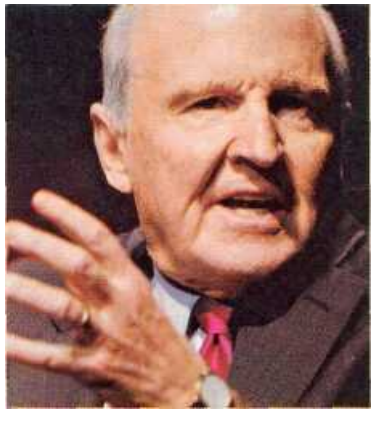
UNTIL THE VERY END of the last century, big meant good in the business world. B-schools taught the benefits of economies of scale.The greater your revenue, the more you could spread fixed costs across units sold. With size came dominance—of airwaves, store shelves, supply chains, distribution channels. Until the mid-1990s, a company's market value usually tracked its revenue.

Then strange things started to happen. Microsoft's market cap passed IBM's in 1993, even though Bill Gates' $3 billion in revenue was one-twenty-second that of IBM. Scale didn't insulate GM from near-catastrophic decline. The big dogs seemed to hit a wall. (The median FORTUNE 500 company is now three times the size it was in 1980, in real terms, and thus much harder to manage.) Citigroup, built through acquisitions by Sandy Weill to deliver consistent earnings, suddenly found the market focused on whatever bad news emerged in Citi's far-flung units instead of

WELCH FIRES BACK
Neutron Jack defends his turf.

JACK WELCH was about to head to a television studio for what he calls "the best job I've ever had"—on-air analyst for the Boston Red Sox pre-game cable show—when we caught up with him. As usual, he had no shortage of opinions.

> On the power of size. It's great to be big. Being big doesn't mean you have to be slow. It doesn't mean you have to have tons of layers. It doesn't mean you can't have highly entrepreneurial people.... You can get fat. Monopolies are often guilty of not moving. If GE had stayed pat and we didn't grow in financial services and we stayed No. 1 in light bulbs, we'd have been in deep yogurt. But that doesn't mean you don't want to be big and strong.


Welch: Still confident

> On leadership. You want to be No. 1. There's nothing wrong with that. You don't want to be a loser. Nos. 3,4, and 5 don't have the same flexibility. You don't have the same level of resources. You can't do R&D at the same level. I agree being No. 1 in a static environment is not by itself sufficient. No. 4 might have smarter management that uses money more wisely. What you do with the resources that come from being a leader—that's what determines your future.

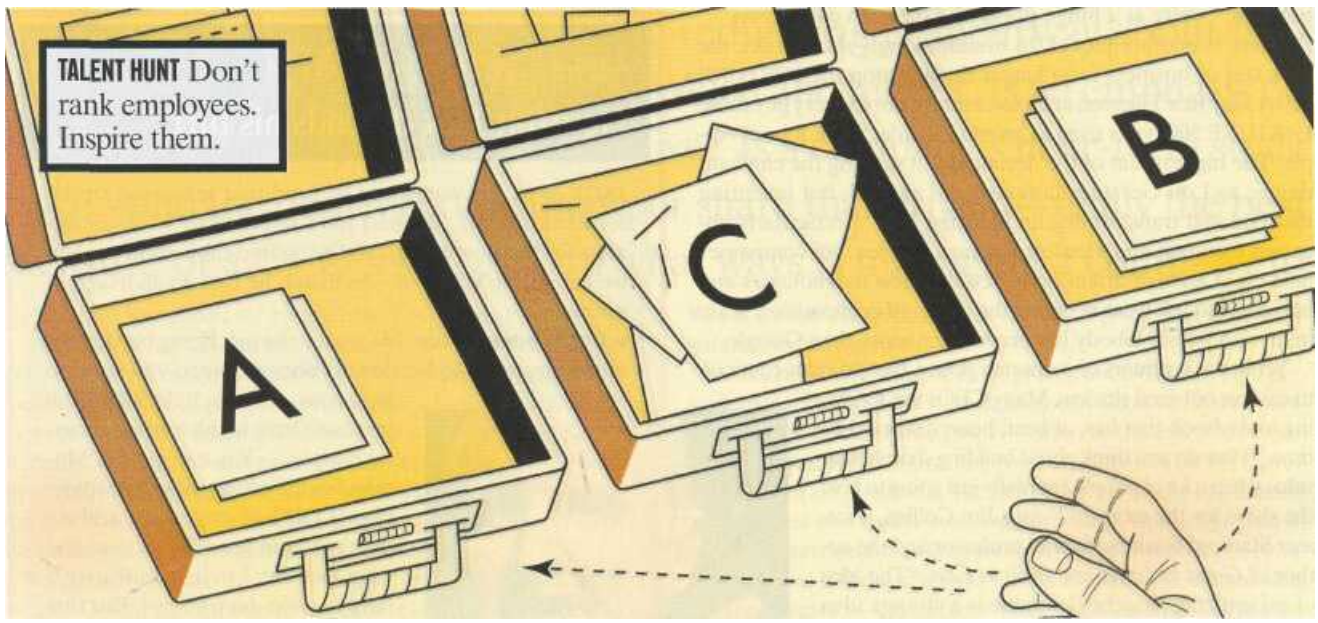
> On keeping lean. I was all for de-layering and flattening organizations. Today I'd flatten them even more. Some companies are still too hierarchical. Some are right out of Bethlehem Steel.

> On exploiting niches. It's not inconsistent at all with wanting to be No. 1, No. 2. In a big company you'd better be out exploring new niches. Today's niches, tomorrow's big things. Those aren't inconsistent.

> On customers. When has there ever been a divergence between shareholders and customers? No one is out saying, "Let's screw this customer today, and if we do, our share price might go up 20 cents." They're just not doing it.

> On looking outward. GE in the 1990s was all about looking outward. We traveled to other companies constantly to bring back best practices. It is one of the great ways to multiply the intellect in your organization.

> On ranking employees. That was very controversial. Weed out the weakest. The Red Sox and the Mets are playing tonight. Guess what? They're not putting on the field guys in the minors. It's all about fielding the best team. It's been portrayed as a cruel system. It isn't. The cruel system is the one that doesn't tell anybody where they stand.



on the smoothness of its overall performance. Big Pharma used to be prized for its unmatched R&D spending; now it is the smaller biotech firms that generate the cutting-edge drugs—and drugmakers Merck, Bristol-Myers Squibb, and Eli Lilly all have smaller market caps than biotech Genentech, despite significantly higher revenue and profits.

Technological advances and changing business models have diminished the importance of scale, as outsourcing, partnering, and other alliances with specialty firms (with their own economies of scale) have made it possible to convert fixed costs into variable ones. Dell, it turned out, was not an anomaly, it was just the beginning—a pioneer at all this, keeping its costs down by outsourcing disk drives, memory chips, monitors, and more, freeing itself to focus on (and clean up in) direct selling and just-in-time assembly.

OLD RULE: BE NO. 1 OR NO. 2 IN YOUR MARKET. NEW RULE FIND A NICHE, CREATE SOMETHING NEW.

NOBODY WANTS TO BE a laggard, of course, and there is much to be said for being the market leader. Nike, Wal-Mart and Exxon certainly don't wish they were anything else. But more and more, market domination is no safety net. Disney's stranglehold on animated films meant nothing once Pixar's digital innovation hit the scene. AOL's established user base couldn't slow down Google.

Look at Coca-Cola, whose still-strong No. 1 position in cola turned out to be not an insurance policy but proof of what consulting firm McKinsey calls the "incumbent's curse." Coke's archrivalry with Pepsi was always about market share—capturing it or defending it by tenths of a percentage point in grocery stores, restaurants, and faraway lands. Coke executives defined their industry as "share of stomach"—that is, the total ounces of liquid an average person consumes in a day and what percentage of it can be filled with Coke. CEO Roberto Goizueta told Jack Welch in a conversation in FORTUNE a decade ago that the soft drink industry wouldn't run out of growth until "that faucet in your kitchen sink is used for what God intended"—dispensing Coke from the tap.

With size came dominance—of airwaves, store shelves, supply chains. But risks arose.

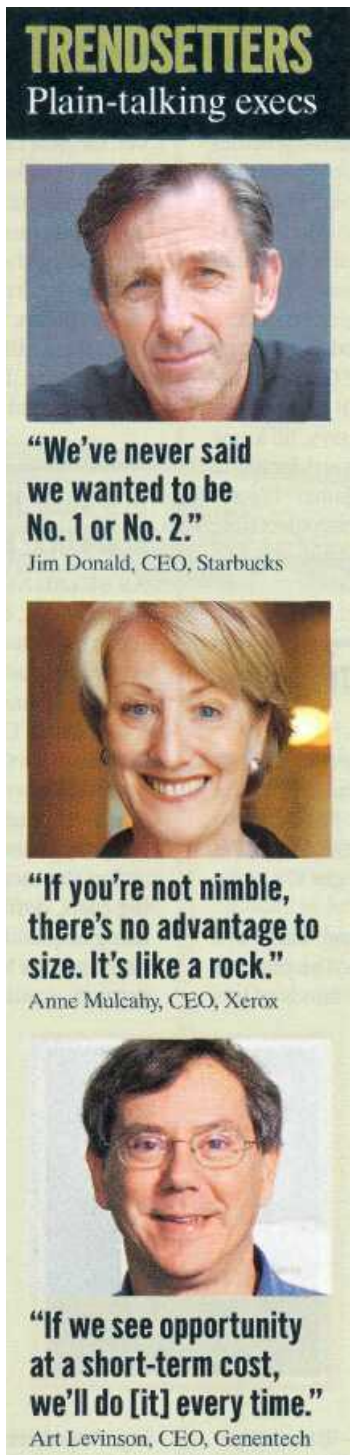
But eventually Coke's monomaniacal focus backfired. When bottled waters like Evian and Poland Spring began to gain traction, Coke didn't pay sufficient attention. Its board vetoed management's proposal to buy Gatorade in 2000 (sending the sports drink into the arms of Pepsi). Such niche products were viewed as low-volume distractions. Yet last year, in a turnabout that would have been inconceivable a decade ago, soda sales fell, and water, sports drinks, and energy drinks all soared. The jaw dropper: Energy drinks—which boast a profit margin of 85%, according to Bernstein Research—are now expected to outearn every other category of soft drink within three years.

Not everyone missed the opportunity. Out in Corona, Calif., tiny Hansen Natural Corp. didn't care about being No. 1 or No. 2. CEO Rodney Sacks was instead noticing how consumers were migrating from carbonated soft drinks to juices, iced teas, and "functional drinks." So in the '90s he began moving Hansen beyond its base as a maker of natural sodas (Mandarin Lime, Orange Mango) toward vitamin and energy drinks. Never mind that the energy-drink market was tiny then. "We look for niches and see how they grow," he says. Since launching an energy drink called Monster four years ago (deftly packaged in a dramatic-looking f6-ounce can adorned with a claw mark), Hansen's sales have quadrupled to $348 million, vaulting its shares to $79 from a split-adjusted $2.

Coke has gotten religion. CEO Neville Isdell's team is pushing an array of new drinks, including a half-dozen of its own energy entries that have earned the company a significant stake in

the U.S. market. "We believe there is value in those niches," Isdell told FORTUNE this spring. "It will not drive the volume number, but volume is something we've often chased to the detriment of the long-term business."

Starbucks, on the other hand, is a drink-seller that has avoided the incumbent's trap. "We've never said we wanted to be No. 1 or No. 2," says CEO Jim Donald. Starbucks isn't a brand per se; it's more an identity that's morphed from a product (a latte) to a place to get wireless, to a place with music to meet friends. "If we said we wanted to be the No. 1 coffee company, that's what would be on our mind," Donald says. Instead, the company has kept moving, evolving, trying new things. "It doesn't matter where you end up," says Donald. "It matters that you're the company of choice."



OLD RULE SHAREHOLDERS RULE. NEW RULE THE CUSTOMER IS KING.

WHENEVER YOU ASK A CEO about the importance of customers, you hear the requisite platitudes. But in fact, customers have often lost out in the relentless push to maximize shareholder value (as represented by the stock price) and to maximize it immediately. One Bain & Co. study found a huge gap between the perceptions of executives—80% of whom think they are doing an excellent job of serving customers—and the perceptions of customers themselves: Only 8% of them agree. Every four years, according to Bain, the average company loses more than half its customers. Aggressive pricing (on hotel phone bills, rental-car gas charges, and credit card fees, to name a few examples) has increased as the profit pressure on companies has mounted, says Bain's Fred Reichheld. Abusing customers this way, says Reichheld, "destroys the future of a business." He believes that such behavior—and not scandals like Enron and Tyco—is why fewer than half of all Americans have a favorable opinion of business today.

This is shareholder-value theory taken to the extreme: the tail wagging the dog. One CEO, who asked not to be named, describes the pressures this way: Businesses became disconnected from their fundamentals, producing "perceived value" instead of real value, because that's what the stock market rewards. When investor-driven capitalism took over from managerial-driven capitalism, as Harvard's Khurana puts it, CEOs began managing the company by earnings per share instead of focusing on details like new products, service calls, customer-satisfaction scores—all those things that are supposed to produce the earnings per share.

Yet some renegades thumbed their noses at Wall Street and truly kept the consumer experience front and center. Think Apple, which has from inception been predicated on dreaming up what customers want before they know it. Or look at Genentech, whose employees are greeted each day by billboards of the cancer patients who take its drugs, to remind everyone of the importance of their work. At GE, CEO Immelt has instigated what he calls "dreaming sessions" to brainstorm with key customers. He also requires all businesses to be judged using a metric called Net Promoter Score, developed by Reichheld and his colleagues at Bain, that measures how likely a customer is to have you back. "When everything is focused on delivering for customers, that makes employees proud," Reichheld says. "They become the powerful engine."

OLD RULE BE LEAN AND MEAN. NEW RULE LOOK OUT, NOT IN.

IN 1995 JACK WELCH "went nuts," as he later put it, over Six Sigma, a set of methods for improving quality—plus a powerful way to reduce costs—that had been developed by Motorola in the '80s. At GE's annual managers' meeting in Boca Raton the following January, he told his troops that embracing Six Sigma would be the company's most ambitious undertaking ever. GE's "best and the brightest" were redeployed to put the methods into action. And it worked. Welch would later write that Six Sigma helped drive operating margins to 18.9% in 2000 from 14.8% four years earlier.

No wonder that after Welch adopted Six Sigma (to which he devotes a chapter of his book *Winning*), more than a quarter of the FORTUNE 200 followed suit. Yet not all firms were able to find the same magic. In fact, of 58 large companies that have announced Six Sigma programs, 91% have trailed the S&P 500 since, according to an analysis by Charles Holland of consulting firm Qualpro (which espouses a competing quality-improvement process).

One of the chief problems of Six Sigma, say Holland and other critics, is that it is narrowly designed to fix an existing process, allowing little room for new ideas or an entirely different approach. All that talent—all those best and brightest—were devoted to, say, driving defects down to 3.4 per million and not on coming up with new products or disruptive technologies. Innovation is "a meta-stable entity," says Vishva

Dixit, vice president for research of Genentech, who oversees 800 scientists at a company that has created some of the most revolutionary anticancer drugs on the market. "Nothing will kill it faster than trying to manage it, predict it, and put it on a timeline."

An inward-looking culture can leave firms vulnerable in a business world that is changing at a breakneck pace—whether it's Craigslist stealing classified ads from local newspapers or VoIP threatening to make phone calls virtually free. "The availability of information and the opening of key markets is exploding," says Clay Christensen, a Harvard Business School professor and the author of *The Innovator's Dilemma*, "and now you put a few million Chinese and Indian engineers to the test of disrupting us too." No business can afford to focus its energies on its own navel in that environment. "Getting outside is everything," says GE's Immelt (who still deploys Six Sigma). From the day he took over as CEO, he says, he knew the company would need to be "much more forward-facing in the future than we ever were in the past." He explains: "It's not about change. It's about sudden and abrupt and uncontrollable change. If you're not externally focused in this world, you can really lose your edge."

OLD RULE: RANK YOUR PLAYERS; GO WITH THE A'S. NEW RULE: HIRE PASSIONATE PEOPLE.

AT GE UNDER WELCH, employees were ranked as A, B, or C players, and the bottom group was relentlessly culled. "We're an A-plus company," Welch told his executives in 1997, according to Robert Slater's book, *Jack Welch and the GE Way*. "We want only A players. Don't spend time trying to get C's to be B's. Move them out early."

Pretty soon places as diverse as Charles Schwab and Ford began ranking employees. But as with Six Sigma, the practice became overdone. Welch's "vitality curve," in the hands of less deft managers, became the "dead man's curve," or "rank and yank." Everybody, it seemed, was expendable. There was a price to pay. According to a Rutgers and University of Connecticut poll in 2002,58% of workers believed most top executives put their own self-interest ahead of the company's, while only 33% trusted that their bosses have the firm's best interests at heart. "All of a sudden, when big companies had to change and respond to the marketplace and move quickly, they found out they couldn't, because they didn't have people engaged and aligned around the corporate mission," says Xerox CEO Anne Mulcahy. "Then being big is a disadvantage. If you're not nimble, there's no advantage to size. It's like a rock."

> "Nothing will kill innovation faster than trying to put it on a timeline."

While studying companies trying to transform themselves, Christopher Bartlett of Harvard Business School and a colleague found the major obstacle was inefficient use of increasingly disenfranchised employees. "People don't come to work to be No. 1 or No. 2 or to get a 20% net return on assets," Bartlett says. "They want a sense of purpose. They come to work to get meaning from their lives."

Steve Jobs has emphasized that Apple hires only people who are passionate about what they do (something that, to be fair, Welch also talked about). At Genentech, CEO Art Levinson says he actually screens out job applicants who ask too many questions about titles and options, because he wants only people who are driven to make drugs that help patients fight cancer. GE still ranks employees, but Immelt has also added a new system of rating—red, yellow, or green—on five leadership traits (including creativity and external focus). Employees are rated against themselves, not one another. Immelt doesn't talk about jettisoning the bottom 10%. He talks about building a team. "When you're 18 years old, you say, 'The iPod is neat,' " Immelt explains, "but people don't dream about making a gas turbine. If we can recruit the best 22-year-olds, we can double and triple in size. If not, then we're already way too big. You've got to be pragmatic about what turns people on."

OLD RULE HIRE A CHARISMATIC CEO. NEW RULE: HIRE A COURAGEOUS CEO.

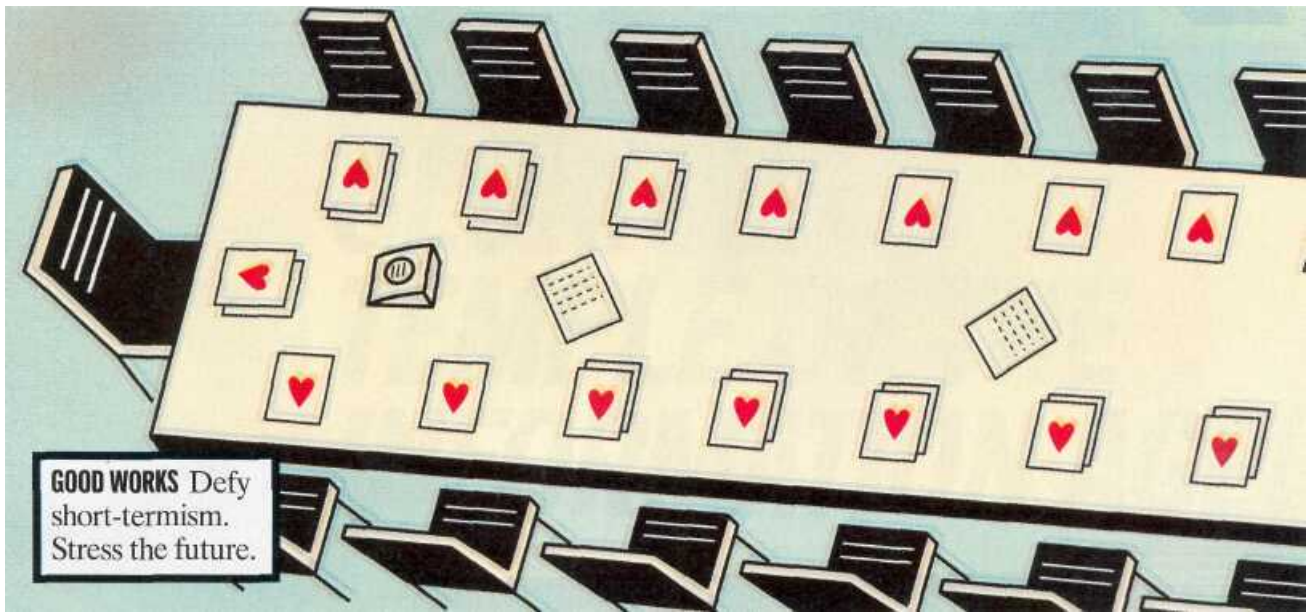
AS BIG SHAREHOLDERS began to throw their weight around in the 1980s, boards sacked their CEOs and named dazzling replacements. And the celebrity CEO was born. The stars of that era were a varied crew: Jacques Nasser, Lou Gerstner, George Fisher, Michael Armstrong, Jack Welch, Ken Lay, Al Dunlap, Sandy Weill, Carly Fiorina. Some got more credit than they deserved, others more blame. A voracious business press helped burnish (or break) reputations. The bull market fueled the myth that a truly superior CEO could hit earnings targets quarter after quarter and propel the stock price unrelentingly higher.

But the tactics used by this generation of leaders—squeezing costs, deftly managing financial and accounting decisions, using acquisitions to grow—did not always provide long-term solutions. (A McKinsey study of 157 companies that bulked up through acquisition in the '90s found that only 12% grew significantly faster than their peers, and only seven firms generated returns that were above the industry average.) Today many of those methods have fallen out of favor. Tellingly, one top management tool du jour is the stock buyback, which can buoy share prices and pacify investors—but also indicates that the CEO has no better ideas for deploying capital.

If the celebrity CEO needed a spotlight, then today's leaders need internal fortitude. Of 940 executives surveyed by Boston Consulting Group last year, 90% said organic growth was "essential" to their success. But less than half were happy with the return on their R&D spending. And therein lies the rub: Organic growth is not a quick fix.

Real growth requires placing big bets that probably won't pay off until far into the future—and today's impatient culture offers little incentive. What practically killed Xerox was its leaders' resistance to making the technological leap from analog copying to digital, which was almost guaranteed (as most such changes are) to cut margins. By the time they were finally forced to, their business was in free fall. The company was eventually

REPORTER ASSOCIATE *Patricia A. Neering*



charged with improperly accelerating revenues and overstating earnings. (It settled without admitting wrongdoing and paid a $10 million fine.)

"You have to change when you're at the top of your game in terms of profit," says Mulcahy, who cleaned up the mess, made the changes to digital and color, and is now trying to jump-start revenue. "It's hard to do. Your business looks its best. Your margins are at their best. All that makes your job easier. Then you're like, 'Oh, shit, here we go again.' You've got to jump into that risk pool, and once again you're in this mode of 'You know, this could fail.' "

Never before has a CEO more needed to take risks, but rarely has Wall Street been less receptive. A recent Booz Allen study found that a CEO is vulnerable to ouster if his stock price has lagged behind the S&P 500 by an average of 2% since he took the top job. Cisco Systems CEO John Chambers says he knows a number of colleagues who are planning to step down because of the difficulty of balancing the short-term pressures of the Street with what's in the long-term best interest of the company.

Real growth requires big bets that probably won't pay out until years later.

But standing tall is precisely what all those corner-office pros get paid the big bucks for, isn't it? "You have to have the courage of your convictions," says Chambers. Immelt agrees that you must be willing to spend time "in the wilderness with no love." And directors need some courage too: to resist pressure to judge a CEO by the company's stock price today and get back to harder measures like return on invested capital. Hark back again to that seminal Jack Welch speech in 1981. It hardly took the world by storm—in fact, Welch has talked about how little it seemed to impress analysts that day, barely moving the stock. But leadership is not about following the rules of the past. It is about standing up for what you believe is best, regardless of the consequences.

FEEDBACK *bmonis@fortunemail.com*

OLD RULE ADMIRE MY MIGHT. NEW RULE: ADMIRE MY SOUL.

TODAY BRAVADO IS DANGEROUS. Soft-drink companies became bad guys when they were slow to leave the school lunchroom. Nike got smacked by sweatshop allegations. Try surfing wakeupwalmart.com to see how powerful a critical community of Internet activists can be. That old notion that has served Goldman Sachs so well is creeping back into vogue: It's okay to be greedy as long as it's "long-term greedy." Says Isdell at Coke: "I do not [agree with] Milton Friedman—that the role of the corporation is solely to make money. Our legitimization in society is a very important part of what we do."

Having a "soul" as a corporation is more than contributing to causes or being transparent about executive compensation or adhering to environmental regulation (though it is certainly all of those things). It is defining a company's vision in a sustainable, long-term way—and to hell with what the hedge funds or other pay-me-now investors say. CEOs must get better at courting long-term investors—explaining their strategies, saying exactly what they intend to do, avoiding the temptation to sugarcoat. "There is so much pressure to hit your numbers," says Genentech's Levinson. "I've been very clear with Wall Street since 1995 that if we see an opportunity to make better drugs and more money down the road at a short-term cost, we will do that every time. And you need to know that's the kind of company we are."

That's easier to do, of course, when you're a glamorous, fast-growing little biotech. So it raises the question: Does the rest of corporate America have the moral fiber to defy the present, when needed, and focus on the future? And do shareholders have patience enough to support them? In other words, are they willing to be long-term greedy—or are they just greedy? F

Fonte: Fortune, v.154, n.14, p. 44-51, 28 Aug. 2006.