

STRATEGY

DECEMBER 2008

Creative destruction and the financial crisis: An interview with Richard Foster

A coauthor of *Creative Destruction* explains how the business world—and the capitalist system—will change in the aftermath of the financial crisis.



Richard Foster, a McKinsey director from 1982 to 2004, is a coauthor of *Creative Destruction: Why Companies That Are Built to Last Underperform the Market—and How to Successfully Transform Them*. In that book, he and Sarah Kaplan argue that to endure, companies must embrace what economist Joseph Schumpeter called “creative destruction” and change at the pace and scale of the capital markets, without losing control over current operations. In a recent interview with the *Quarterly*, Foster offered his view of how the current financial crisis might change the business world and the capitalist system.

The Quarterly: How does your vision of creative destruction apply to today’s situation?

Richard Foster: Let’s start by looking back. In the 1970s, we had the “Nifty 50”—invulnerable companies that couldn’t possibly lose, and of course they all did. It will be the same today; there will be surprising losers, and survival will come down to simple things, like cash and margins. If you’re a low-margin company without a lot of cash or perhaps with too much leverage, you will not make it. Someone will figure out how to do better.

In the financial-services sector, the upheaval will create a new generation of leaders. Fifty years ago, we didn’t have 8,000 hedge fund managers. Then somebody said, “We can go short as well as long; we have much better information than people did in the 1930s, and the information comes to us instantaneously rather than days after the event. We can make a lot of money modeling and leveraging that information.” So the hedge funds were born. How many of those guys had been successful at mutual-fund management? I don’t think any. They might have been commodity traders, but few were mutual-fund managers. Today, other kinds of people with no experience or expertise will challenge incumbents from outside the industry, and there will be a lot of them. Most of the challengers will fail, but a few will succeed, and they’ll become the heroes of the next generation. If you had to bet on anything, that’s it because that’s what has happened in the past.

The Quarterly: Could you elaborate on this life cycle?

Richard Foster: In the book, Sarah Kaplan and I show that over the long term, the market performs better than companies do. There can be periods—5, 7, 10, even 15 years—when that isn’t the case, but corporate performance always reverts to a lower level than the market because the economy is changing at a faster pace and on a larger scale than any individual company so far has been able to do without losing control. That’s the challenge: to create, operate, and

trade—to divest old businesses and acquire or build new businesses—at the pace and scale of the market without losing control.



Richard Foster

Vital Statistics

Born June 10, 1941, in Cleveland, Ohio

Married, with 3 children

Education

Earned BS (1963), MS (1965), and PhD (1966) in engineering and applied science from Yale University

Career highlights

- **Millbrook Management** (2004–present)
 - Managing partner
- **McKinsey & Company** (1973–2004)
 - Director (1982–2004)

Fast Facts

- Coauthor of *Creative Destruction: Why Companies That Are Built to Last Underperform the Market—and How to Successfully Transform Them* (2001)
- Elected a fellow of the American Academy of Arts and Sciences and the President’s Circle of the National Academies
- Member of the board of directors of Memorial Sloan-Kettering Cancer Center, Yale School of Medicine Dean’s Advisory Board, W. M. Keck Foundation, Council of Foreign Relations, and Council for Aid to Education, among others
- Senior Faculty Fellow, Yale School of Management

The balance among creating, trading, and excelling operationally changes over time. When the economy is in a growth spurt, there’s more creating. Few companies are trading very much and operations are fine. In those circumstances, the newer companies in the economy tend to outperform the index, and the older companies that are only focused on operations underperform the market.

As the market collapses, the weaker upstarts get squeezed out. The survivors are the cash-rich “operators,” which perform at levels closer to the averages, which themselves are lower. Companies that operate well shine in down times, as they are now. Every investor on the planet is looking for companies that have cash left. The turmoil will clear away the weaker companies—the companies that have taken too much risk. This doesn’t mean they’re bad companies; it’s just that they’ve taken on too much risk given their balance sheet resources.

The Quarterly: What happens then?

Richard Foster: New, young companies that have conserved cash and have solid and often expanding margins surge ahead. When this happened in the ’70s, companies such as The Limited, The Gap, Home Depot, and John Malone’s TeleCommunications Inc. sprung from the burned forest. After the crash of 1987, Microsoft, Oracle, and Amgen took off. Then in the ’90s, we had the Internet companies. Creation will happen again and will again leave behind the big guys trying to rely solely on operations.

The Quarterly: To what extent is today’s financial crisis different from earlier ones?

Richard Foster: The granddaddy of cycles in this economy is the equity premium, which is the difference between the longer-term total returns to shareholders and the supposedly risk-free debt rate. It is the premium the equity investor gets for taking the equity risk. Looking back, we can see seven great cycles. During the boom times, when the equity premium goes way too high, everybody hocks everything to get in on the game, and this creates the conditions for a crash. When the crash occurs, the politicians come in and say it was this or that person’s fault. Then they create regulatory institutions, and virtually every one of those institutions—starting with the Federal Reserve, in 1913, as a result of the crash of 1907—has been quite productive for the nation in the longer term. This includes the formation of the Securities and Exchange Commission, in 1934; the Investment Company Act, in 1940; the beginning of the end of fixed commission rates in 1970; and the Sarbanes–Oxley Act, in the early 2000s.

The Quarterly: What happens in the aftermath of the new regulations?

Richard Foster: What do self-respecting entrepreneurs do when subjected to new regulations? They learn the regulations backward and forward and then vow never to start another business that falls within the scope of those regulations. And so off the entrepreneur goes to find a new way. That’s one reason credit

default swaps eventually took the form they did—the other options were regulated.

The new entrepreneur often seeks ways to innovate outside the scope of the newly established regulations. In the beginning, all that works out fine. We have innovations, we love the people who created them, they're great heroes, the returns are strong, everybody says, "I'm going to be one of those guys." Eventually, all the truly good guys who are going to get into that business have done so. The opportunity starts drawing less savory figures—charlatans who overmarket, cut corners, establish usurious contracts, and do other clever things to generate profit for themselves. They end up bringing the system down. Then guess what happens? At the end of that period, after the equity premium has soared and collapsed again, the government steps in and regulates the systems, this time focusing on the last wave of abuse. And then we start over.

We were getting somewhat better at handling these cycles until 2000, but since then we've gotten worse. The collapse of 2008 isn't like the crash of 1929, because we have the institutions that were created in the last century, and they are very effective. Understanding the differences between the '30s and today is at least as important as understanding the similarities.

The Quarterly: Capitalism has just taken a beating. What will the future look like?

Richard Foster: The essence of capitalism is capitalizing—bringing forward the future value of cash to the present so that society can grow more quickly by taking risks. It goes back to the Dutchmen in the 16th century, sitting at their coffeehouses in Amsterdam and Leiden, loaning each other money for a guaranteed return. Someone said, "I'll give you a little higher return if you give me a piece of the action"—and equity was invented. That had the effect of bringing forward, into real cash today, the net present value of future earnings. That levered society and allowed it to grow at a much higher rate than it would otherwise have. Equity was a very clever invention, and we are not going to give it up. This is the way people are. This is the way commerce works and will continue to work unless capitalism ends. And that won't happen, regardless of what you read in the press. Q

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