Winthrop Perspectives

Leading in Uncertainty: Four Proven Principles from History

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The global economic crisis has paralyzed businesses around the world, leaving otherwise nimble firms aimless and becalmed. Business loathes uncertainty and craves control. How, in times like these, can leaders assert control over events and set a new course?

The onset of the Great Depression, to which this recession is most often compared, was greeted with a similar sense of foreboding. Within two years of the 1929 stock market crash, U.S. industrial output had plummeted, gross domestic product had fallen by a third, and unemployment had soared to 25 per cent. The conventional wisdom, then as now, argued in favor of consolidation and retrenchment in the face of economic crisis: cut costs, hoard cash, and (hopefully) ride out the storm.

History points to a wiser course of action. In fact, some of the most successful companies of the 1930s rejected conventional wisdom in favor of what Joseph Schumpeter later called a "creative response", by which they sought to shape and use change for their own purposes. To be sure, their strategy was counter-intuitive: invest heavily in outstanding people and ideas, engage in inspiring, purposeful activity, and act independently of competitors and analysts' expectations. But it worked. Faced with prolonged economic weakness, these firms managed to seize control of their own destinies when others were foundering and to lay the foundation for robust growth in the years ahead.

Four principles define this creative response:

1. Take the long view.
2. Take advantage of down markets.
3. Invest for the future.
4. Build loyalty through purpose and appreciation.

In this essay, we explore how several Depression-era firms, both in the United States and abroad, used these proven principles to navigate even more treacherous times than we face today—and emerged stronger as a result.

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1. Take the long view.
Before 2008, nearly a quarter-century of steady economic growth and rising share prices had conditioned investors to expect more of the same. Managers, in turn, became prisoners of those expectations. Too often, they pursued short-term strategies designed to sustain earnings and profitability while neglecting long-term investments in areas like basic research, recruiting and training, and organizational development—the very things which fuel innovation. The temptation to focus on the short-term is all the stronger in difficult economic times. It is a temptation to resist. Now more than ever, companies must take the long view. Now, when no one expects a profit, is the time to rethink the balance of short-term and long-term investment and set the stage for future growth and competitive advantage.

The American automotive industry was among the hardest hit by the Great Depression, with production off by more than 75 per cent from its late 1920s peak. Yet the most innovative of these companies used this otherwise bleak time to develop new products and markets that would bear fruit over the long haul. Take Thompson Products (now TRW). When General Motors announced the closing of its Muncie, Indiana products division, Thompson's new president, Fred Crawford, negotiated financing from GM itself to purchase the plant equipment and then supply GM with valves and other products at a 10 per cent discount, which in turn went to pay off the debt. Crawford also invested in new products with patented designs that required a high-level of engineering and manufacturing skill to produce in volume and thus commanded a higher margin. In addition to sustaining Thompson through the downturn, these products became pillars of its expansion when economic growth resumed.

Timken Company, a leading manufacturer of bearings and steel, took a similar approach. Diversification into railroads and other industrial applications in the 1920s had helped to soften the impact of falling demand in the automotive sector. Now, even as the crisis deepened, the company continued to expand into new markets for bearings and became a major producer of alloy steel and a leader in seamless tubing, all financed through earnings rather than debt. Far from alienating investors, this long-term focus earned their confidence. "Timken will ride out the storm," the *Magazine of Wall Street* assured its readers after the company posted its first net loss in 1932, "and will return to satisfactory profits whenever normal industrial revival sets in." As it happened, its first net loss in 1932 was also its last—for 50 years.

Meanwhile, Procter & Gamble was busy pioneering brand management. The maker of Ivory soap, Crisco shortening, Oxydol laundry detergent, and countless other household products, P&G had long struggled to integrate research and development, production, merchandising, marketing, and distribution. In 1931, based on a three-page memo from a young advertising manager named Neil McElroy, P&G assigned dedicated teams to market individual brands as if they were separate businesses. Today, that is common practice; then, it was revolutionary. Indeed, it remains one of the signal innovations in American marketing in the 20th century. What's more, P&G had the courage to embark on a major reorganization just as the world economy was beginning to sink into Depression. And it didn't stop there. Two years later, the company launched a radio program called *Oxydol's Own Ma Perkins*—the first soap opera. By

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the late 1930s, P&G dominated national network radio with five hours of sponsored programming every weekday.

Doing Great Things in Hard Times

When workers started construction of the Empire State Building in March 1930, the future of commercial real estate in New York looked grim. But General Motors Vice-President and financier John Jacob Raskob, locked in a competition with Walter Chrysler to build the world's tallest skyscraper, would not be deterred. He held his nerve, and persuaded his investors to hold theirs. Just 14 months later, the building was completed, under budget and ahead of schedule.

At first, the Empire State Building had trouble attracting tenants—according to one account, the observation desk earned as much in visitors' fees during the first year as the owners did in rents. Still, long before it sold in 1951 for a then record sum of $51 million, it would come to symbolize the grit and determination of New Yorkers. Today, few would doubt the iconic and financial value of the Empire State Building.

Elsewhere, the Hongkong and Shanghai Banking Corporation (now HSBC) was wrestling with its own challenges: a monetary crisis in Britain, the impact of depreciated silver, and a deepening global downturn, as well as growing nationalist sentiment and political instability in China and the specter of Japanese aggression. Survival did not come without sacrifice, but the Bank made sure that sacrifice was broadly shared. In addition to reductions in salaries and allowances, the Bank cut its annual dividend and used the savings to build up a sizeable sterling reserve fund. This long-term focus, it turns out, gave the Bank the flexibility it needed to manage the crisis on two fronts.

Thanks to those robust reserves, the Hongkong Bank was able to provide critical exchange banking in the region. In 1935, it helped the Chinese government to weather its own monetary crisis and make an orderly exit from the silver standard. Amidst heavy speculation in gold and silver, this was no mean feat. As V. M. Grayburn, the bank's chief manager, put it: "I would not say we came through unscathed, but I can safely say that we found ample balm to cure any bruises we received." When Japan invaded Manchuria in 1937, the Bank continued to defend China's currency.

Despite its growing international stature, the Hongkong Bank was above all a local bank. Founded by the Hong Kong trading community to finance trade between Hong Kong and the United Kingdom, it had long supported development initiatives in mainland China, including factory construction and railway expansion, and it continued to provide this vital service during the difficult decade after Chinese nationalists came to power in 1928. In Shanghai, for example, it made a major rehabilitation loan to the Municipal Council in 1932, and agreed an innovative debenture scheme with the Shanghai Power Company. The success of these operations and

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others like them led to still more business in the Shanghai market. In fact, this active local investment policy, together with the prudent management of its currency reserves, enabled the Hongkong Bank to maintain a high profile in the East even as other banks had pulled back. This paid rich dividends after 1945, when the Bank enjoyed extraordinary growth.

2. Take advantage of down markets.
The sharpest, shrewdest firms see economic crisis not as the apocalypse but as merely another business environment rich in opportunity. This is precisely the time to acquire knowledge, expertise, and assets which in better days could never have been afforded, as competitors vied for labor, capital, and capacity.

Thus did Corning, a maker of specialty glass and ceramics, use the worst years of the Depression to recruit a cohort of gifted young research scientists from leading universities. The most notable of these was J. Franklin Hyde, a bright organic chemist from Harvard. For Hyde, Corning was an unlikely choice. The company had done nothing to date with organic chemistry, and he already had an attractive offer from the much larger DuPont. But Corning wanted him badly enough to outbid DuPont by $200—no small difference in the midst of the Depression. It also offered him what DuPont could not: contacts at companies like General Electric, which did have an organic chemistry program; a reputation for doing work in the latest scientific developments; and most important, an exceptional degree of freedom in research and experimentation. For Corning, it proved to be a wise investment. Before the decade was out, Hyde would go on to invent both the vacuum deposition process, critical later to optical fiber, and silicone, a compound with a wide range of applications in cookware, adhesives, lubricants, and glass. Thanks to this fresh infusion of talent, Corning witnessed a surge in research productivity during the Depression that paved the way for several new businesses in the decades after the Second World War.

Siemens, even in the economic and political tumult of Germany in the 1920s and 1930s, was similarly opportunistic. It could afford to be. Unlike its main competitor, Allgemeine Elektriciäts Gesellschaft, which had undertaken heavy debt on overvalued assets, Siemens had stuck to a conservative financial approach. When hyperinflation struck in 1923, it had enough cash on hand not only to sustain its elaborate benefits programs and avoid major layoffs but also to expand and diversify through selective acquisitions—including Reiniger, Gebbert & Schall in 1924. At the height of the Great Depression in 1932, Siemens merged RGS with other interests it held in medical devices, building the world leader in electrical medicine. At the same time, it centralized R&D functions into a single department dedicated to fundamental research. In 1935, at considerable risk to its position under the new Nazi regime, it recruited a Nobel Prize-winning physicist, Dr. Gustav Hertz, to lead its research effort, after Nazi race laws had forced the half-Jewish Hertz from his academic post.

3. Invest for the future.
In good times, most companies tend to invest in people, capital, and ideas only in so far as they promise to yield immediate returns. It is the rare firm that has the courage to make investments in fundamental research that may not produce marketable products or higher

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productivity for a decade or more—and rarer still the firm that can sustain those investments in lean times. In fact, some of the most visionary companies have used economic crisis to cultivate innovation and nurture success over the long term.

Alcoa was a prime example. By 1929, aluminum had become a common metal with a wide range of applications, but for the next five years, aluminum sales and profits languished. Still, Alcoa plowed ahead with basic research, and to great effect. From its Aluminum Research Laboratories, opened in 1930, the company developed most of the basic and wrought alloys that would dominate the market for the rest of the century. It worked with leading edge customers and strategic partners in search of new prototype applications. And it continued to recruit talented research scientists; by 1940, it boasted more than 200 researchers with advanced technical degrees. True, Alcoa's research budgets declined during the worst years of the Depression. But the company took pains to defend its program at a time when investment in industrial research was suffering under a growing public backlash against technology of any kind.

The Radio Company of America (RCA) offers one of the most striking examples of investing for the future. When most of his counterparts were cutting discretionary spending, RCA's chief executive, David Sarnoff, was pouring money into research—especially television. The breakthrough advance in early television, an understanding of the fundamentals of vacuum tubes, came in 1930. Over the next few years, RCA launched an extensive program of field testing, recruited or promoted a large group of technical experts, built transmission and relay systems, and filed dozens of patents on new products and processes related to this new technology. By 1939, RCA's work was the talk of the New York World's Fair.

All of this did not come without opposition, of course. Sales were down, reinvestment in production facilities was an urgent and costly priority, and RCA's operating managers were hardly enthusiastic about long-term research. This lack of support would almost certainly have spelled the end of television at RCA were it not for Sarnoff's decision (mirroring that of Siemens and other innovative Depression-era firms) to establish a unified corporate research program, focused on fundamental research into leading-edge products and funded centrally. As Sarnoff later recalled, "We cut costs, we cut salaries, we cut everything but research while the storm was going on." This was decisive in making RCA the leader in television for decades to come.

4. Build loyalty through purpose and appreciation.

One of the keys to building a successful enterprise over the long term is a clear, consistent corporate purpose that can unite and inspire people. Large-scale, indiscriminate layoffs do serious, perhaps irreparable harm to that sense of purpose. Not only do they deny the company the skills and experience it needs to meet demand once recovery begins, but they also undermine the loyalty of the people who remain, leaving the firm's best talent vulnerable to competition later on. On the other hand, companies that find creative ways to retain employees and engage them in inspiring, purposeful activity, in spite of budget cuts, will build enduring loyalty while at the same time unleashing innovation.

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The example of the Royal Dutch Shell Group is a cautionary tale. The firm's main response to the Depression was to undertake massive job cuts. While this enabled it to protect its financial position in the short-term, it struggled for years afterward to recruit university graduates, as university staff warned their students away from Shell lest they be fired at the next downturn. RCA did just the opposite and benefited as a result. By cutting hours and bonuses, Sarnoff preserved jobs—especially in research, which earned him the abiding personal loyalty of many researchers who had seen their colleagues laid off from other companies.

Timken, too, went to great lengths to avoid layoffs, even as conditions deteriorated. Instead, it shut down plants for two weeks in July. It retained its most experienced workers in engineering and production by asking them to take unpaid leave for a few days each month. Later, it instituted a three day work week and reduced the standard workday from 10 hours to eight. And it adopted a sliding scale of salary reductions based on income level for white-collar workers, including the company's top executives. Thanks to these enlightened policies, Timken was well-positioned to meet demand when conditions began to improve in 1933. Within a year the company had raised wages and salaries by 11 per cent, effectively restoring its earlier across-the-board cuts. At no point had it sacrificed performance. On the contrary, Timken established a reputation as one of the most solid, well-managed industrial firms of the Great Depression.

Corning, for its part, maintained steady employment levels by taking on low margin work it would ordinarily have refused—an investment that would pay for itself many times over. The Mount Palomar Observatory project is a case in point. When the original contractor, General Electric, ran into severe technical problems and cost overruns in 1932, Corning stepped in with a new design for the telescope's 200-inch mirror, then the largest piece of glass ever cast. Unlike GE, which priced its project to support new, custom-built facilities as well as labor and profit, Corning relied on existing facilities, enabling it to charge cost plus 10 per cent. This was a small price to pay for an opportunity to tap into a growing market. The Mount Palomar project also reinforced in the public mind a direct connection between business and research at Corning that only redounded to its benefit. Indeed, more than any other single event in its history, Corning's investment in telescope mirrors cemented its reputation as a leading-edge research company and yielded a significant, visible, and highly profitable business for the rest of the century.

Learning from Experience

What does all of this mean for today's firms? As the global economic crisis deepens, it is only natural for leaders to hunker down, waiting for the old boom time conditions to return. But history suggests that at moments of profound disequilibrium such as this, the important thing is to concentrate on finding new sources of competitive advantage under what are sure to be very different market conditions. So it was for the 1930s. More regulation and limited access to capital discouraged the start-ups that had fueled innovation in the chaotic growth of the 1920s. Yet these same conditions allowed well-managed companies like Procter & Gamble, Siemens, RCA, and Corning to pursue a new kind of corporate entrepreneurship based not on immediate demand but on long-term investments in people, capital, and ideas.

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Soon enough, our own economic crisis will generate a new and different set of conditions. How firms respond will depend as much on their understanding of the past as on their vision for the future. With the benefit of historical perspective, they will be better able to pose the right questions and to see problems in context, to recognize emerging patterns and combinations, to identify untapped resources, and ultimately to regain control for the long term.

Much in today's economic outlook may be frightening. Far from all of it is new.

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