

**Private Equity – after the crisis is before the crisis:
excellent execution > strategy + planning**

by Reinhard Pöllath¹

In spite of the lime light, I can see you, barely. I hope you can hear me. Even if I don't see you, I can tell that you worry, despite the glasses in your hands and despite the crisis that was, and because of the crisis that may and will be. And if you don't worry, I'm sure that is because someone else is worrying on your behalf. And if you don't worry nor anyone else worries on your behalf, then you should really be worried. Why worry at all? Because of uncertainty? Uncertainty is normal. And so is worrying. It is the core survival and success talent (not the core strategy, but the core talent) of mankind, including private equity investors and managers and M&A advisors.

Let me try to share with you two encounters I had on a recent weekend and two thoughts. The two encounters were with, what you might call, presumably global corporate leaders, very normal people, extremely normal people.

Investment by Endowments

The first ones were chief investment officers of US endowments. US endowments are the top investors worldwide I believe, and in order to learn from them, I asked: "What do you, what did you change in light of what you have experienced recently?" And the unanimous answer was: "Yes, we are paying more attention to liquidity, cash, commitments, balancing cash and commitments, but otherwise, no change". Why no change, except for the possible reason of arrogance? Why no change? They said, and they follow that in their behavior, they said public investments will provide less return and more risks, so they are moving more into private equity. That entails more risk, that requires a bit more diversification, but diversification on a broad scale, not by changing strategic asset allocation, and not by changing any top-down strategy at all. The consequence of this is that they say, they claim, they will put more emphasis, even more emphasis than before, on selecting and monitoring managers, "alpha". Very, very much bottom-up. Selecting and monitoring by two criteria, and all of them are well known. One is alignment of interests in order to foster virtues, self-discipline and paranoia. And I will come to that later. And the second criterion is: What is a manager, what is a management team, what is a GP good at? Consisting of three

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things, or two or three things, a concept and an idea, again not a strategy but a way of specializing and focusing and second, procedures to execute that concept or idea. And that should lead to a track record. But investors are, more than previously, also interested in “first timers”. So the question is what am I good at? What is my own thing and how can I do that thing? Steady, stubborn, down to earth, like the hedgehog often referred to. Or in other words, more “alpha” than “beta”.

Execution Over Strategy

The other encounter I had, actually on the same weekend, was with the CEO of a big worldwide industrial company, very well known. He said, unrelated to my conversation with the investment officers, when I asked him what is the reason for your success and for that company’s century-old success, he said: if he had to choose between 100 % execution and 70 % strategy over 100 % strategy and 70 % execution, he would take the first. With 100 % execution, even 51 % strategy may be fine. Not the other way round. And again we should ask us what are we good at, individually and institutionally, what is the talent of your people and your organization, what are we good at or what are we best at or, realistically, what are we better at than our competitors. And in his, and his company’s instance, that talent was to organize distribution and logistics. Not all the hype, great marketing and high flying things you would think of when you hear the name of that company and their products. Simply deep distribution, down to earth, a big talent, but really down to earth. And whatever the talent of anyone is, it is about knowing yourself and sticking to yourself and win with your talent and not with someone else’s talent.

These two encounters, you might call them anecdotal evidence, which means it is not evidence at all, it’s just anecdotes. Let me add to that something which is even more dangerous, two thoughts. Not fact-based, not an empirical analysis or anything, just two thoughts.

Too little knowledge: Don’t plan or strategize

One is why execution is more important than strategy. And the answer has something to do, in my thinking, with the unavoidable complexity of reality. Yes, we do plan tightly, we budget our resources because our resources are scarce. We have too few to waste any. But we should not plan, and certainly not plan tightly, the way to reach our objectives. Because these objectives and the conditions under which we try to

achieve them, these are all changing, inter-related, inter-active. And there are too many of them to distinguish them and to digest them. This is well known and has been broadly accepted, it is conventional wisdom nowadays, in respect of nations and national economies. We learned that capitalism is superior to communism. Planning is bad, venturing is good. How about applying that same principle to our corporate life, to our investors' life? Let's be skeptical about planning and adore execution. Why? Because reality is inscrutable, and more importantly, it is changing, and more importantly, it is interactive. Whatever we do, there is a reaction. Whatever action there is in one place there will be another action in another place, and actually myriads of them. And there are more and more interactors. For example, originally we were only landowners sitting tight, then participating in an economy, then owners of tangibles, now holders of intangibles. The world has gone global, walls have come down, there are more people competing with each other. We are competing with people we can't even think of. And of whose culture we know nothing. And very importantly, in the present and in the near future, to this universe of interactors, women are being added at the top, and a billion consumers and actors are being added as well. I don't want to scare you by any one of these remarks, each one of them may be scaring, but these are all only aspects of one principle: reality is an open-ended process. That is true for the economy and the market, for the society, for the climate, inside each atom and in the outer-space. And mankind has developed in an open-ended process to deal with all of these. Much research goes into this nowadays. For example the brain: It is a non-hierarchical, decentralized, open-ended process. Man as a species has survived and succeeded because of this. The brain is not made to follow orders or plans. Actually, there is a competition out there whether we are worse in following orders and plans or in making them. They are not the basis for survival and success. Rather, mankind has succeeded and survived by realizing reality as it emerges and by reacting and adapting as soon and as well as possible. We should not prevent ourselves from realizing, reacting and adapting by a strategy or plan.

Chains of actions and interaction

This has been conventional wisdom actually for a couple of centuries. Georg Christoph Lichtenberg, one of these moralists like Adam Smith, reflected the conventional wisdom of the 18th century by talking about the benefit which guides everything, and man seeking his or her benefit, as a general basis for thinking about

the world. And these moralists also shared thoughts, concepts of the chains of actions and interactions, the web which constitutes the world.

Lichtenberg gave two examples of these chains of actions and interactions in his aphorisms. One about analyzing a disaster ex post and claiming that the best way of avoiding disaster, however only ex post, would be changing that little element in the long chain of actions and interactions which would have been easiest to change, and that usually was not the most direct and not the last element which caused the disaster. Similarly, when learning about a criminal and his or her crime, he would thank god that he himself was not put at the start of that long chain of elements which led up to the crime, and again, that may have been an element long, long ago. That element easiest to change in the chain of events or that start of the relevant chain, ex ante they cannot be known. So all what we are doing is characterized by ignorance of what comes in the future, by too little knowledge, making it impossible to strategize or plan. This is why “beta” is so difficult to achieve, except maybe by betting.

Too much Perceived Knowledge

To this thought of too little knowledge, Mark Twain added the thought of too much knowledge, at least perceived knowledge, by saying: What gets us into trouble is not what we don't know, it is what we know for sure that just ain't so. Too much perceived knowledge is as harmful to the right action as is too little knowledge. And there is too much knowledge, too much accepted knowledge at any point in time.

As an example, the emerging market story is an obvious, self-evident, self-sustained element of knowledge. China is the investment story. And there is good reason for that because basically China is now sort of going back to normal. It is not even particularly successful, actually its relative share in worldwide GDP, even now and in a foreseeable future, is less than what it was in the 17th century. And it is only about equal to what it was when Christ was born. So, the recent success of China is totally normal, self-explaining. Still, the Endowment CIOs I talked to don't believe in it when they make their investments. They said: “Yes, we are doing some investments there but it is too difficult to predict, too difficult to look through, we are investing only a little bit there”.

And there are good stories, experiences from the past, which support that view. The biggest losses UK and other investors ever took were by investing in US and other

railroads in the 19th century when the US and railroads were really on the upswing and the US was going to its present state of dominance. Or take other things which we take for granted, like stability in conservative Arabian countries. The more we come to know by science, investment analysis or common thinking, the more we come to realize the inscrutable interactive complexity, and the more we perceive risk, instability, change, everywhere all the time, as the "condition humaine", as the world as it is.

Reliability, Predictability, Fairness

Let me come to the second thought, which is the opposite of the first. Human talent, and human opportunity, is to reduce the avoidable complexity and risk and to become foreseeable, predictable for each other and to add to the world the stability and the transparency which we need to invest or operate the business or to do anything else worth doing. This human talent, this human opportunity is how mankind deals with the world out there, as opposed to how the world is out there.

Let me take more of your patience by citing Walter von der Vogelweide. Many of you may not be aware of his investment insights. He was talking about real risk in the 11th century, real risk which was there at the roadside. It did not need any analysis to find that risk. Then, you just walked down the street or the road and you found violence: in the broadest sense, external influences on human behavior and success. And he claims in a well known poem (which many of you may have had to learn, assuming you were old enough to learn poems at school), he claims that you need peace and justice as prerequisites for worldly and spiritual welfare, for "Habe" = possession, "Ere" = honor, and for "Gottes Huld" = salvation.

There are two sets of tools of mankind to accomplish peace and justice and other prerequisites for welfare, well-being, investment success and other good things: social tools and individual tools.

Due Process, Justice

Social tools have been brought to bear on a broad scale over the centuries, particularly in the most recent times, by creating peace as opposed to violence, by due process, "Rechtstaatlichkeit" and human rights, by substantive justice, most often defined simply as equality, by equity, non-discrimination, and by compliance, by trying

to root out corrupt practices and unfair competition, discrimination and other unsocial behavior. And mankind has made quite some progress on that way. Of due process, “Rechtsstaat”, human rights, equality, justice, we often think that they are very important for human beings, for the soft issues, but not for the hard issues like business or the economy. This is not true. In fact, reality proves the opposite. Human beings, families exist absent human rights. They cannot even be suppressed by violations of human rights. And I’m taking this very serious, this firm supports a lot of human rights exercises, so I’m not talking lightly about it. But what is more important in our context is this: human rights, “Rechtstaatlichkeit”, justice, equality are even more important for business, investment, economic development, *for the “hard issues”* more so than for human beings. Because these businesses, investments, they do not exist absent justice, “Rechtstaatlichkeit”, due process, but only if these prerequisites are met. And since the stone ages until very recently, this has been shown, and shown, and shown again. I’m not saying that justice, peace, due process, “Rechtstaatlichkeit” must be there forever. Maybe unfortunately they are not permanent, because the world is changing. But they must be there for as long as possible, as soon as possible, in order for interest to accumulate on interest, for return to be turned into capital, and for investment and business to flourish. I had the opportunity to lecture and discuss these matters in Sudan, in Iraq, in “off” places, where human rights are very important. And people, the lawyers, the businessmen I met there understood what I was talking about.

Excellent Execution

Now from the social tools of achieving economic development, let us turn to the individual tools or actually, to the individual tool. And it is related to excellence in execution.

Execution is low key, and therefore the methods used in excellent execution are low key. They are low key virtues, like modesty, due diligence, self-restraint, openness, the power to accept others. These virtues are so low key that they are often being referred to as secondary virtues. Mr. Lafontaine, against Helmut Schmidt, once said these are the virtues you need to run a concentration camp. The opposite is true when you start thinking about it. There is a poem by W. H. Auden about managers. He talks about the development of managers, from the grand rulers with their feasts to the fact-based managers of business with their lunch which they can eat with one hand because they need the other hand to go on holding their pencil (or now their

i-phone). It's an old poem from before 1950. The individual tool to accomplish economic development is excellence in execution. Add to that a bit of paranoia, the healthy fun in being anxious, nervous, enjoying being nervous. Paranoia is not about anticipating what cannot be anticipated like in a plan or a strategy. But it is attending to reality as it emerges and becomes visible from time to time. Excellence in execution is not about being self-satisfied by confidence in a strategy, and claiming to do the right things as an excuse for poor execution, doing things not rightly, because of the glory of the rightness of the things we believe we do. But rather it is being really attentive to real things and, therefore, in all modesty, doing things right. It is all about worrying and enjoying worrying as a reality, a talent. This is actually what management is all about, private equity management, corporate management, everywhere: To handle that unavoidably interactive complexity and uncertainty of the world by accepting it, not by deceiving oneself by some perceived and ill-conceived certainty, and by reducing the avoidable complexity and uncertainty by analysis and compliance. By these little managerial virtues which we have been taught to practice all the time, particularly recently, but also centuries ago. This is what we are supposed to do, excellence in execution when we invest, by a company, in that company or outside of that company, or when we invest into a company. Only business management and businesslike management creates "alpha", and only "alpha" and excellent execution create value.

Thank you very much, and good luck!