

FORBES > LEADERSHIP > LEADERSHIP STRATEGY

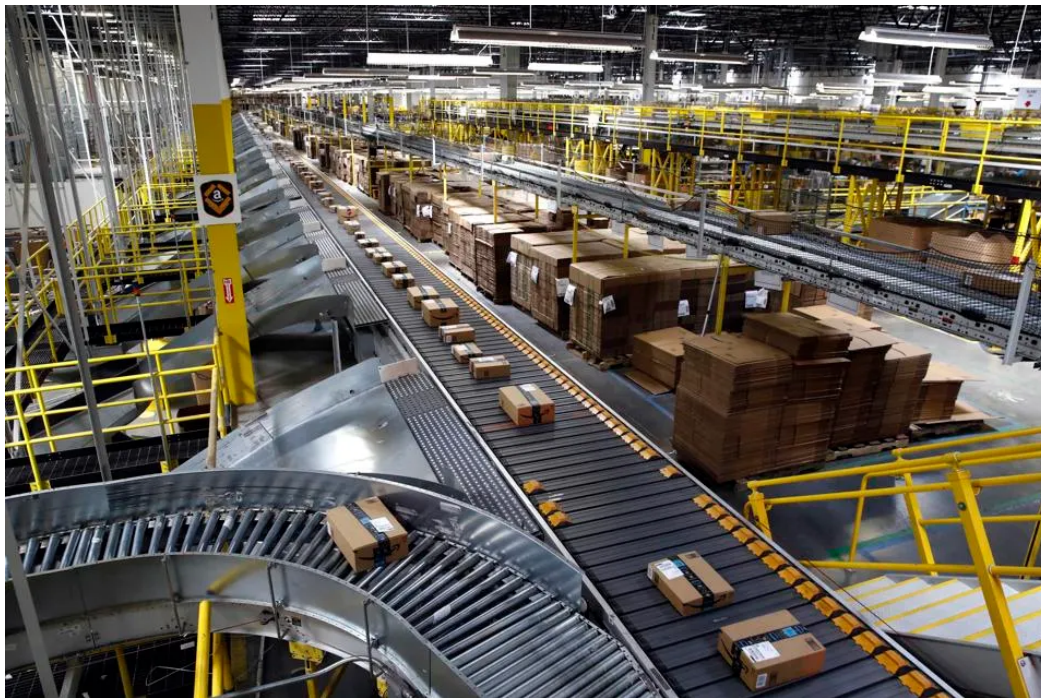
Our Economic Model Is Out Of WACC

Dante Alighieri Disparte Former Contributor ⓘ

I write about risk, readiness and resilience.

May 28, 2018, 10:08am EDT

🕒 This article is more than 5 years old.



In this Aug. 3, 2017, photo, packages ride on a conveyor system at an Amazon fulfillment center in... [+]

The profit motive, which has driven private enterprise since prototype multinationals emerged more than 500 years ago, such as Portugal's *Casa da Índia* or the British East India Company, is arguably a successful, if controversial, facet of business. Indeed,

nothing has lifted more people out of poverty than private enterprise, despite the irony that severe income inequality is one of the top global threats, along with [climate change](#), [pandemics](#) and the [erosion of institutional trust](#). Singular focus on profits (and self-advancement) invariably perpetuates this income disparity. Yet, the profit motive and the financial myopia it creates causes problems of its own. For one, far too many businesses are trapped in a zero-sum game of he who has the lowest weighted average cost of capital (WACC) wins, loosely speaking of course.

This “victory” is nominal, unsustainable and hardly translates into lasting competitive advantage. Indeed, entire industries, such as banking, insurance and investment, are limping around on two crutches - with the one being anemic interest rate environments and the other being low customer switching costs. Value added based on economic costs alone is an oxymoron. Both challenges are set against a growing wave of corporate mistrust courtesy of our worst fears about the greed and misdeeds that thrive under opaque corporate structures, such as Wells Fargo’s [massive account rigging](#) scandal, are not only being proved right, they are proved all too frequently. Indeed, the expense ratios in many industries have ossified into high double-digit fixtures making the preservation of status quo and the general aversion to risk and innovation the norm in many large firms.

A moat built around an organization based solely on the cost of capital will be a shallow moat indeed, rendering the business model, people, customers and value chains that lie behind it indefensible over the long-term. This is particularly true as the tug-o-war between short-term profit maximizers and long-term business optimizers wages on, with the latter group often

leveraging disruptive technologies and radically new structures to their advantage. Cost conscious and short-term focused firms are answerable to the quarterly beat of Wall Street, rather than the long-term challenges and opportunities that loom on the horizon. Indeed, for many of these firms, particularly banks, insurers and large-asset holders, such as pension funds, they are proving to be at once too big too fail, [too big too hide](#) and too big (or slow) to adapt. This reality conspires to make them particularly vulnerable to the coming wave of digital disruption, courtesy of startups, cryptocurrencies, blockchain, alongside the confluence of complex risks that may be a double jeopardy on their balance sheets.

For many large asset holders, the practice of asset-liability management (ALM) presupposes long-term stability on both the risk and reward sides of the balance sheet. So, for example, many insurers will at once take risks by insuring center city properties against natural hazards, while at the same time they own these very properties in desirable center city locations to offset risks with rental income and real estate appreciation. The challenge, however, as we saw in the city of [Houston in 2017](#) when Hurricane Harvey flooded the 4th largest city in the U.S., these city centers are very much [carrying crosshairs](#) on their backs. The result is that asset-liability management is now being “stressed” in ways that were henceforth considered (from a statistical point of view) as out of sample. Indeed at a macro-level, the fact that the global economy may be statistically off kilter may be one of the hardest challenges for traditional enterprises to grapple with. If economic and statistical volatility are subjecting firms to model error and neither asset nor liability performance is conforming to the norm, then traditional economic order is in for a wild ride. 2017 may have only been the opening salvo.

Another example of this ALM mismatch and how the cost conscious are paying a particularly painful slow-boil toll, is what life insurers and pensions systems call longevity risk. Insidiously, those pesky policyholders and pension beneficiaries were never supposed to live as long according to dated actuarial models. Rather they were supposed to die earlier, or so the models would have it, leaving unclaimed proceeds as a bonanza for future liabilities and investment returns. Life expectancy in the U.S. in 1900 was 47.3. By 2000, the average was 79.5, adding 30 years of stress, claims and mathematical uncertainty to the system.

It is safe to assume that life-prolonging medical advancements, along with lifestyle changes courtesy of the embarrassment of riches held by baby boomers, were not factored into this asset-liability calculus. As a result, pensions systems globally, not only in spendthrift economies or businesses, are woefully underfunded. Indeed, as many traditional firms labor with millions of past employees claiming pension liabilities, they look more like pension administrators, rather than automotive companies, airlines or manufacturers. The so called American, British, European or advanced economy dream now appears to be a fleeting image out of reach with a career ladder that is not only in tatters, but the rungs are far too distant and appear to be greased by those that had the fortune of clambering up. This reality is not lost on millions of underemployed “side-hustling” youth whose career prospects and income mobility seem less than assured and as fractional as the things they own or have access to. In the gig economy, food, shelter and water may prove to be just as fleeting.

The cost conscious, as opposed to the value-driven, are also to blame for the very real risk of job-killing industrial automation,

which not only preys upon hitherto safe career paths, such as law, banking and many service jobs, it also preys on traditional labor. It is not uncommon to see McDonald's locations with large touch screens, making the employee redundant as the service frontline. Indeed, this same pattern holds true in industry after industry, as the cost conscious drive people out of virtually every "value chain," whereby chatbots, artificial intelligence and the occasional mobile phone check deposit are now our tellers, bankers and service providers. This would not be a problem if the displaced work and employees were being replaced with alternative productive activities, contrary to the Utopian view that automation frees up humanity for higher and better purposes. The jury is out however and pitiable investments and outcomes along the educational axis of the future will leave many advanced economies behind. Indeed, asset-liability mismanagement on a national scale is also taking place in the U.S., a country of immigrants, laboring under a talent shortage, while erecting barriers to entry for the world's best and brightest. Talent, like capital, is fungible and will find the path of least resistance and highest productivity.

This too has insidious long-term effects on the asset-liability equation, as the under-employed side-hustlers of the present and future will enjoy materially lower purchasing power and savings than the generations that preceded them, thus further fractionalizing the very assets and services establish firms depend on. What will happen to the auto insurance industry if fewer people own cars or even drive them, where the liability shifts to the manufacturer or Uber? What will happen to property insurers and mortgage lending if people are comfortable with living in veritable hives? The [asset-light economy](#) driven by firms like Uber and Airbnb has done wonders monetizing stranded assets,

but it has also imperiled traditional employment through a massive wage and labor arbitrage. As we near the bottom of the global downward spiral that has fueled the highest rate of income inequality in history along with combustible antiestablishment tendencies, it begs the question in boardrooms and statehouses, what now of our status quo?



Dante Alighieri Disparte

Dante Disparte is the EVP for Policy and Social Impact at the Diem Association. He is also the founder and... **Read More**

[Editorial Standards](#)

[Reprints & Permissions](#)