NOTA BENE:
REFLECTIONS ON 'TRAGEDY' IN BUSINESS, MARKETS, AND SOCIETY:
How your learning at Kellogg helps you understand—and maybe even overcome—the "remorseless workings of things"

Assignment and Thought Questions

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The conventional concept of tragedy is that it is an unexpectedly devastating event that upends and possibly changes our lives. But tragedy's origins are actually in art—after all, tragedy is first and foremost a dramatic form, just as comedy, melodrama, or history are also dramatic forms. And while the focus of dramatic tragedy is indeed human suffering, it is suffering of a particular kind: suffering that cannot be stopped despite our best efforts as humans to stop the events that lead to it. As British mathematician and philosopher Alfred North Whitehead put it in his book, *Science and the Modern World*, "The essence of dramatic tragedy is not unhappiness. It resides in the solemnity of the remorseless workings of things."

Seen this way, we can find many interesting examples of dramatic tragedy—the remorseless workings of things—that unfold in business, markets, and society. And though a class session on tragedy might not seem like a natural topic on this significant and joyous day in your lives, the message of today's Nota Bene is, I think, an uplifting one: with what you have learned in your years at Kellogg you are in a position not only to understand the kinds of tragedy that can arise in business, markets, and society, but to avoid and even overcome them. This is something to be savored and perhaps even celebrated.

For you, your family members, and your friends to be prepared to attend this session, there is a bit of homework you must do. And like much of your work at Kellogg it involves reading cases. Don't worry, these cases are short, and they don't have exhibits that you need to work through. But please read them and be prepared to discuss them, guided by the question that follows each case. As in your classes at Kellogg, be ready: you may be cold called!

PLEASE READ EACH OF THE CASES BELOW AND BE PREPARED TO DISCUSS THEM IN THE NOTA BENE SESSION

Case 1: The devastated industry

What follows is a true story. The time period is real and the situation is real. Only the industry's name has been disguised.

For decades prior to the 1980s, the North American widget industry had grown and prospered. It provided a good that consumers valued highly, and indeed was an essential commodity for many consumers. The industry had rich geographic context; in the communities in which the industry was concentrated, sons, fathers, and their fathers before them drew their livelihood from the industry, and it was an article of faith among the young men in these communities that if a family member worked in the industry you probably would too. A case could even be made that the industry was part of the unique and compelling story that made America and its history exceptional.

The industry had, of course, gone through its ups and downs over time, but it had always bounced back. On those occasions in which it appeared that the industry was posed to decline, it was able to find new markets for its product, and it quickly rebounded.

But as the 1970s gave way to the 1980s, the North American participants in the industry faced some significant threats. New entrants from overseas had begun to enter the industry. Some were from Europe and some from Asia. Employing new technologies and methods of production, the international competitors were able to achieve levels of productivity that vastly exceeded those of the North American firms that, by and large, employed traditional methods of production. The success of these efficient global competitors revealed to some that the incumbent North American firms were "fat and happy," and needed to be fundamentally revitalized.

The initial response of the North American competitors was to lobby government to enact barriers to foreign competition, and government was obliging, taking steps that to some extent (though by no means perfectly) kept the market protected from international competition. But the new technologies and production methods were compelling, and soon most North American firms adopted them.

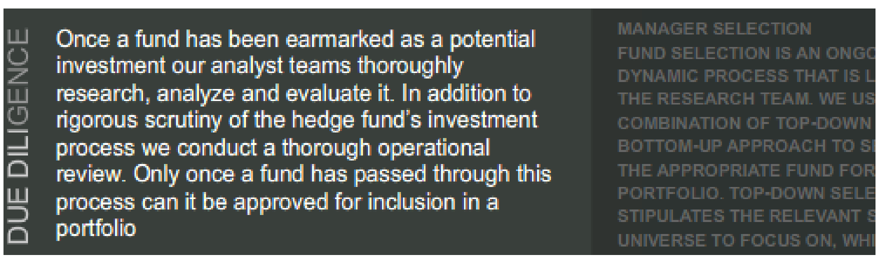
For a while the fortunes of the North American widget industry appeared poised for a turnaround. But in the early 1990s, the bottom fell out. Within a period of a few short years, the industry's output collapsed by over 90 percent. Most firms, even the largest, were forced to idle their assets, and many went out of business. In the geographies in which industry activity was concentrated, tens of thousands of workers in widget firms and firms in the widget industry's supply chain lost their jobs. Communities that had long relied on the industry were devastated. The collapse of the industry created an outmigration whose full social effects are still being felt today. Said one resident of the region at the center of the industry's collapse: "I'm pretty sure that at the university, one-third to one-half the graduates in business, engineering and some other disciplines are on a plane the day after they get their diploma. That's very sad, but what are the alternatives?" By the late 1990s, unemployment in the region had reached 19 percent. By 2012 things had not changed much. The widget industry has never come back.

As noted, this is a true story. What real-life industry is the "widget industry"? Why do you think it collapsed? Could the industry's collapse have been prevented if North American firms had been more skillfully and efficiently managed?

Case 2: The Madoff Ponzi scheme

Bernie Madoff's Ponzi scheme victims included some of the world's most sophisticated investors: billionaires, global banks, funds of funds, and endowments. When the scheme collapsed in December 2008, Madoff's investors lost approximately $65 billion in direct cash investments and "paper profits" that had been credited to customer accounts, making it the largest single case of financial fraud in American history. Though about $11 billion of the cash losses have now been recovered, Irving Picard, the court-appointed trustee representing Madoff's victims is still pursuing claims that may yet total $10 billion. Of course, the billions in fictitious profits that investors thought they had earned will never be recovered. Madoff himself was convicted in March 2009 of multiple counts of fraud, and is now serving consecutive jail sentences which, given his age, will amount to imprisonment for the rest of his life.

One of the more striking things about the Madoff scheme beyond its sheer magnitude was the sophistication of its victims. Madoff's clients included large international banks (such as Banco Santander of Spain and Bank Medici of Austria), hedge funds, insurance companies, and high net worth individuals (such as Fred Wilpon the owner of the New York Mets).[1] One of Madoff's victims touted its due diligence on its web site:



This particular investor was estimated to have lost over $3 billion.

To many observers, the collapse of Madoff's scheme in the midst of the global financial meltdown in 2008 exemplified the zeitgeist of the first decade of the 21st century. But for knowledgeable parties who had been following the remarkable performance of Madoff's investment portfolio, the collapse did not come as a surprise. One dogged investment analyst, Harry Markopolos, alerted the U.S. Securities and Exchange Commission (SEC) to his suspicions about Madoff as far back as 1999, pointing out that Madoff's purported investment returns were mathematically impossible. In 2001 *Barron's* ran a story that was skeptical of Madoff's success.[2] In retrospect, it is now clear that there were numerous "red flags" suggesting that something was amiss with Madoff's investment operations:

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[1] A list of Madoff's victims can be found here: http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html

[2] Arvedlund, Erin, "Don't Ask, Don't Tell: Bernie Madoff Attracts Skeptics in 2001: Bernie Madoff is So Secretive, He Even Asks Investors to Keep Mum," http://online.barrons.com/article/SB989019667829349012.html

- Madoff's returns were too good to be true: 1 percent per month, almost every month, for more than 20 years.
- The Madoff strategy should have caused price movements in options markets but didn't.
- Madoff's auditor was a three-person firm with a single CPA.
- Madoff cleared trades through his own firm, a significant conflict of interest.
- Highly sophisticated investors could not reproduce results of Madoff's "split-strike" strategy.

Though the Madoff case certainly raises disturbing questions about the failure of the SEC to follow up more vigorously on the warning signs of fraud, one also has to wonder about the institutions and individuals that had invested enormous amounts of money with Madoff. Why did sophisticated investors continue to invest with him for many years despite so many "red flags"? In light of your answer to this question, what do you see as the broader lessons of the Madoff case?

Case 3: Sirius versus XM in the U.S. satellite radio market

Since the first commercial radio broadcast in 1920 by station KDKA in Pittsburgh, Pennsylvania, commercial radio in the United States has experienced two significant technological leaps. The first occurred in the 1940s and 1950s when FM radio stations began broadcasting commercially. The second was the development of satellite radio in the 1990s. Satellite radio involves the possibility of offering listeners near-perfect reception over hundreds of channels that appeal to all manner of tastes. The service was thought to be particularly appealing to long-distance drivers (such as commercial truckers) who may traverse many local radio markets on a given journey.

The market for satellite radio officially began in 1997 when the U.S. Federal Communications Commission (FCC) auctioned off licenses to use the frequencies it had set aside for satellite broadcasting. Two firms won licenses: XM Radio (then known as American Mobile Radio), which paid $93 million for its license, and Sirius, which paid $85 million. XM launched its two satellites (known as "Rock" and "Roll") in spring 2001, and later that year it began its nationwide subscription service. Sirius launched its satellite in early 2002 and began its national service a few months later in July.

Throughout the 2000s, the market for satellite radio grew steadily, and by the end of 2006, Sirius had about 6 million subscribers, while XM had about 7.5 million. Each company acquired impressive portfolios of programming. For example, XM secured broadcast rights for Major League Baseball and the National Hockey League, while Sirius obtained the rights for the NFL and the NBA. Both firms also signed contracts with high-profile broadcasting personalities, XM with Oprah Winfrey and Sirius, famously, with "shock jock" Howard Stern. And yet despite rapid revenue growth, both companies incurred large net losses every year between 2002 and 2007. While Sirius brought in about $1.89 billion in total revenue over the period 2002 to 2007, it incurred a cumulative loss of about $3.88 billion over the same period.[3] XM generated about $2.98 billion between 2001 and 2007, and incurred a cumulative loss of $4.07 billion.[4]

Faced with the prospect of continued losses if the competition between them continued, in 2007 the companies made the decision to merge, with shareholders of each company receiving 50 percent of the consolidated firm, to be called Sirius XM. In early 2008, the merger was cleared by the U.S. Department of Justice, and it was approved by the FCC by a 3 to 2 vote. Sirius XM began operation as a unified satellite broadcasting network in 2009.

After losing money in 2009 and again in 2010, Sirius XM appeared to have turned a corner in 2011. For the first time ever, the company achieved positive net income, and with over 19 million subscribers, the future of Sirius XM seems brighter now than at any point since the merger.

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[3] Historical financial data for Sirius was obtained from Hoovers Online, http://subscriber.hoovers.com.turing.library.northwestern.edu/H/company360/financialHistory.html?companyId=46486000000000.

[4] Historical financial data for XM was obtained from the 2007 and 2003 10K reports available at http://investor.siriusxm.com/sec.cfm?DocType=&DocTypeExclude=&SortOrder=FilingDate%20Descending&Year=&Pagenum=2&FormatFilter=&CIK=1116317.

But in light of the outcome—a "truce" between two firms that took the form of a merger into a monopoly—one has to wonder what the point of the battle for market leadership between 2002 and 2007 had actually been. As of 2012, the market capitalization of Sirius XM radio was about $7 billion. But between 2002 and 2007, the combined capital investment and operating losses of the two companies was $11.6 billion.[5] In effect, Sirius and XM invested far more in the battle to dominate this market than the market was actually worth. Put bluntly, the fight for competitive position in this market destroyed billions of dollars in shareholder wealth.

Many observers of this market believed that merger between the two contestants was bound to occur (said one columnist in 2008, "This consolidation was inevitable and in many ways makes sense").[6] But if merger was inevitable why did Sirius and XM not attempt to merge three or four years earlier and avoid billions of dollars of destroyed shareholder value?

[5] Hazlett, Thomas, "The Economics of the Satellite Radio Merger," (working paper), July 2007, http://www.arlingtoneconomics.com/studies/economics-of-satellite-radio-merger.pdf (accessed June 4, 2012).
[6] "Is the New Sirius XM the Beginning of Satellite's End," http://voices.washingtonpost.com/rawfisher/2008/11/is_the_new_sirius_xm_the_begin.html (accessed June 4, 2012).