

# What is trust worth?

Steve LaVoie founded Arrowstream to improve supply-chain management in the restaurant business. He discovered that the benefits of trust in markets have been overlooked, in part because of an overemphasis on individual actors as opposed to relationships. He also learned that building and maintaining trust is hard work.

I began Arrowstream seven years ago as a new way to solve an old logistics problem: How do you efficiently utilize the assets of a truck to move goods from point A to point B? I believed that our business innovation was sure to unlock unparalleled savings for our customers in the food supply chain and huge profits for Arrowstream. My ideas of instantaneous growth met with the reality of trying to manage a plethora of unforeseen problems. Not until we completed our 18th month did we generate our first revenue dollar.

What started as a new solution to an old logistics problem ended up revealing a much larger structural problem. We found that businesses and people can generate significant inefficiencies by acting only in their own self-interest. What we eventually learned was that to solve the problem created by the counterproductive actions of self-interest, we needed an expanded definition of a market, one that included an understanding of our collective interests and payouts.

Historically the logistics market has operated in the normal functioning of a supply and demand market for trucking/transportation resources. Buyers and sellers of these services have aggressively negotiated with each other for the amount of cargo they need to move and the trucks or rail to move it. When there was excess capacity, the prices of transportation dropped and over time many carriers fell into bankruptcy. When carriers could not keep pace with demand, the price rose significantly.

In the face of this dynamic, Arrowstream found a new solution that materially changes how the industry can function. We saw a business rife with inefficiency where everyone in the supply chain basically threw their orders over the fence. For example, restaurants sent their orders to distributors, distributors

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to manufacturers, and the manufacturers to raw material suppliers. This is what they've always done, everyone acting within their own four walls of self-interest. The problem is they are optimizing their own set of activities almost without regard to the consequences for others.

At Arrowstream we envisioned an alternative state: instead of the supply chain operating in a reactionary mode where everyone managed their own requirements, the supply chain and all of its participants would be significantly better off if we proactively planned these activities as opposed to just reacting to them.

The concept was usually met with comments like "that makes sense." The leaders in both the food service and consumer products industries had long recognized that massive inefficiencies existed. Each commissioned exhaustive reports in the 1990s showing that tens of billions of dollars in savings were available to these industries if only they found a way to cooperate with one another.

We were faced with a similar set of problems: How do we get businesses to participate in our new solution? The issue that kept surfacing was who would receive the savings? That's the hurdle that we had to overcome. In the end, the most important issue that Arrowstream solved was not the logistics problem but the problem of getting businesses to cooperate for mutual benefit.

Adding to our dilemma, several large potential customers wanted to use their market power to obtain a disproportionate share, if not all, of the savings that our new business produced. Based on the Arrowstream model, we needed the active cooperation of *all* the supply chain participants in order to deliver the savings opportunity for *everyone*, and so we could not accept those terms and still deliver our solution. In order to execute our solution, we needed to get all of the parties to agree to a shared-savings model. The entire concept of sharing led many people to feel as if they were leaving money on the table. Within a traditional competitive context, it's understandable that they feared they were at a disadvantage regardless of whether or not they were better off.

We now truly believe that our greatest contribution has been the value derived from creating a "trusting market" where the participants agreed to share. We needed to create a fair playing field, which meant we would not allow participation in the network unless the participants agreed to the ground rules, chief among them that there would be an equitable sharing of the savings.

We realized we had to participate exactly the same way everyone else did. That meant working on a shared percentage basis and agreeing to report in a transparent way. In other words, no hidden income streams. Therefore, what we have tried to build is a company that can be a "trusted third party," not just to one powerful party, but to *all*. This has become the most fundamental and important aspect of who we are, and our firm commitment to our principles has accelerated our growth.

We did not begin with an interest in trying to "do the right thing" or any kind of altruistic intent. We offered customers a material cost advantage over how things were currently done and we thought that was enough. To generate these savings we were required to become a different kind of entity, equally focused on solving two distinct problems. The first was to transform the supply chain from a reactive to a proactive process. The second was to create a new kind of market based upon shared savings, trust, and collaboration. Together these initiatives helped companies improve their results and those of their trading partners simultaneously.

We became a spokesperson for fairness and the value of trust. Our message was twofold: 1) If you agree to share, all are better off. 2) You need each other — no individual can do this alone. In implementing our shared-savings model, we may be pointing to an intrinsic problem in the current economic model of self-interest.

This problem of trust penetrates everything we think about in this business. And it's an issue I've pondered since I was a graduate student. I recall wandering into Martin Shubik's class and hearing him ask a simple question, "What is money?" While there were numerous attempts made to answer Professor Shubik's question, none was on target. What Shubik proposed was that money is simply a representation of trust. I found it stunning then but as I have thought about it over the years it has come to make more sense.

This concept of trust is a central problem of modern economic theory. In the middle of the 20th century, Paul Samuelson, an economist at Harvard, transformed economics, giving it a mathematical foundation by defining human beings as economic actors. He called human beings "individual utility maximizers," meaning that all human beings act in their own self-interest. This has become the mainstream view in economics, although there are a number of leading economists who are trying to broaden the economic paradigm (including members of the SOM faculty). Unfortunately, the self-interest-based model is the predominate paradigm in the business community.

The problem is that the value of life is not only about seeing oneself as an individual but seeing oneself as related to the world. I would argue that the definition of a person as an individual, separate and distinct from others, is the heart of many problems in business. And this is best revealed by a classic problem in economic theory, that of the Prisoners' Dilemma.

The Prisoners' Dilemma is a simple game involving two bank robbers and a district attorney. The DA informs them both simultaneously that they have been caught "red-handed." If A "rats" on B, then A goes free and B goes to jail for 10 years, but this also applies to B. If they both rat on each other, then they each get five years. However, if they both say nothing, then they only get one year each. The punch line of the story is that if they think of themselves only as individuals, each will conclude that he is better off ratting on the other and spending five years in jail.

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Let's look at the Prisoners' Dilemma problem in the context of relationship. Rather than two individuals in the game, let's think of a parent and child. Would a parent act in his or her own self-interest? Both people understand themselves as connected or part of a relationship. They naturally act in a way to optimize the payout as a whole and in doing so generate the optimal solution for both. Such a perspective transforms the Prisoners' Dilemma into a simplistic exercise. It is only in seeing ourselves as unrelated actors that the problem has any relevance.

Most of us value our lives in relationship to others. And that's the case in business too. The conversation you hear across industries is, "this is a relationship business." The problem is we don't act that way.

The challenge for Arrowstream has been to encourage customers to take a leap of faith that this new spin on classic economic theory makes sense. We had to convince people that if we worked together we could deliver the savings that our model produced. In other words, what they needed was each other in order to be able to achieve the savings. Once we executed our refined version of the supply chain, we generated savings across the board and the model was proved out in day-to-day operations. And after an agonizingly slow start, Arrowstream has seen revenue grow every year in excess of 100%. We now do business with three of the top 12 restaurant chains in the United States and by the end of this year revenue will exceed \$80 million.

Employing the economics of interdependence when thinking about the broader economic model might provide a significantly expanded opportunity for the business community. And since economics is a normative system, or one that informs the way we think about ourselves, perhaps the idea that businesses view their success as linked to each other could be helpful not just to the professional community but also to how we relate to one another. ●