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How Strategic Caution Can Limit Value Creation

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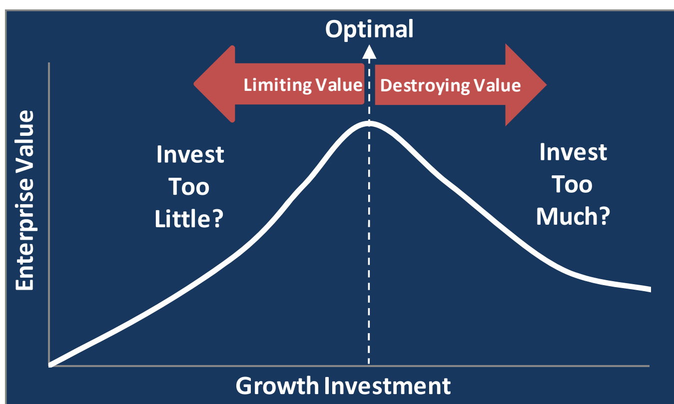
As companies continue to recover from the financial crisis and set their strategic plans for the future, many are pushing agendas that emphasize "caution". However, an overly cautious strategy is unlikely to yield exceptional shareholder returns 3, 5, or 10 years from now.

A "hunker-down" approach leads to inaction and missed opportunities creating a "slow-leak" whereby forgone investment today leads to a strategic disadvantage tomorrow.

This is analogous to the anecdote that if a frog is placed in a pot of boiling water it will jump out, but if it is placed in cold water that is slowly heated, it will not perceive the danger and will be cooked to death. Similarly, companies on the sidelines missing investment opportunities may not feel like anything is really wrong but they risk being overtaken by more aggressive competitors as the economy recovers.

Companies can under-achieve their potential by investing too much or too little. Investing too much in an overly aggressive strategy is more risky as large scale failures make for splashy headlines and financial pain that is unmistakable to shareholders.

However, that shouldn't imply that an overly conservative approach is better as under investment and missed growth opportunities can be damaging to shareholder value just like over investment.

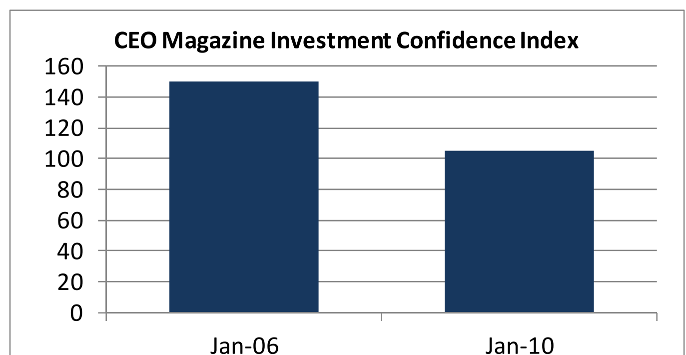


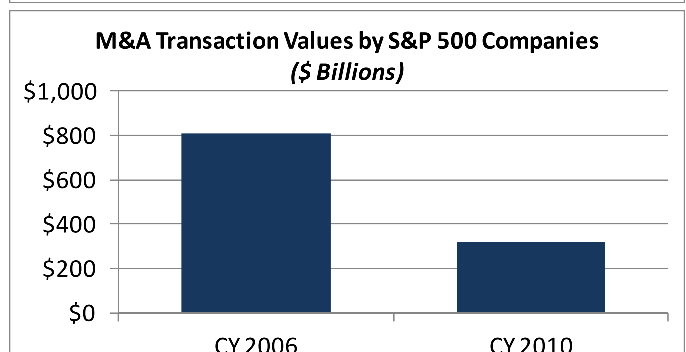
Illusory Appeal of "Conservative" Strategies

The global economy is awash with economic uncertainty, sovereign debt crises, ambiguous regulatory and tax regimes, decreased consumer confidence and consistently high unemployment. It is easy to understand the appeal of a strategy of caution.

After all, executives must have confidence and conviction in the outcome of their decisions in order to proceed. Unfortunately we humans are simply "programmed" to dislike uncertainty; for the most part uncertainty leads to inaction.

Consider how over and under confidence impacts M&A activity. The January 2006 confidence index published by *Chief Executive* magazine found CEO's to be very optimistic about investment conditions and not surprisingly M&A was quite strong that year. In 2010, CEO confidence dropped by nearly 50 points and M&A activity declined by 60%.





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With the current economic uncertainty, many executives feel more confident in their ability to cut costs and constrain outlays than in their ability to seize investment opportunities created by the downturn.

The Human Blockade

A litany of common human biases impact executive decision making and in the context of growth and investment there are a few that are truly important for executives to be cognizant of and actively mitigate to arrive at better and more balanced decisions.

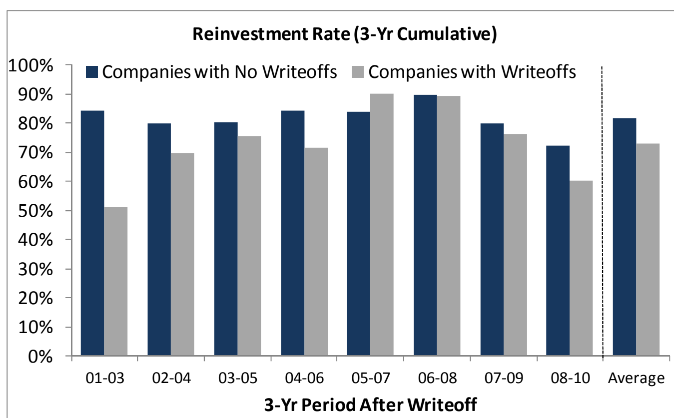
1. Loss Aversion

Decision makers generally have an aversion to loss whish sounds rational on the surface. After all, who likes to lose? What it really means is that decision makers have a natural tendency to avoid the potential for even a small loss even if it means forgoing the possibility of a larger gain. This tendency grows in the wake of a loss.

We studied companies that incurred goodwill and intangible write-offs or impairments and examined their reinvestment rate over the next three years compared to the reinvestment rate of companies without write-offs. The reinvestment rate measures the proportion of cash flow generated that is reinvested in the business via capital expenditures, R&D, leases, working capital and acquisitions.

In all but one time period, companies that incurred a charge systematically under invested during the next three years. On average the companies with impairments reinvested 9% less of their cash flow back into the business.

This translates to nearly $80 billion of forgone investments or roughly $135B of unrealized enterprise value at the prevailing average enterprise value to gross assets ratio. The negative consequences of these inactions are enormous. The cumulative impact of the forgone investment is the equivalent of not creating Bristol Myers Squibb (BMY), Honeywell International (HON) and Nike (NKE) combined!



It seems the executives at the companies who experienced a write-down had a heightened aversion to loss leading them to under invest in the years following their write-off. These companies span a wide variety of industries and likely had similar investment opportunities to their peers that did not suffer a write-down yet they chose to reinvest less cash flow back into their business.

It is common for Boards and Executives with a loss fresh in their minds to "shorten the leash" to avoid making the same mistake twice. This may not be a desirable strategy.

2. Recency Bias

The companies in our study that underinvested following a loss may have put too much emphasis on their recent experience when considering their next opportunity to deploy capital. This is often referred to as a "recency" bias.

More broadly this also explains why executives are slow to reinvigorate growth investment as the financial crisis is still fresh in their minds.

Mitigating the impact of these biases requires robust and integrated strategic planning and risk management processes. Evaluating potential gains and losses simultaneously with the same analytical rigor leads to a balanced approach to decision making.

In addition, properly designed incentives and performance targets must encourage prudent risk taking. To accomplish this, incentives must be designed so that executives reap the full gains of success and feel the full pain of failure for the decisions they take.

3. Anchoring

Managers often anchor their decision making in preconceived biases or "anchors". For example, in September 2011, two different publications reported on a capital investment survey quite differently. One used the headline *Businesses Boost Orders for Equipment, Machinery* while the other reported *CapEx Numbers Reflect No Expansion*.

These articles imply different sentiments regarding

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the economic outlook. If the executives from one company read the first article and those from another company read the second article, they might come to vastly different decisions if they faced a similar investment decision. In reality, the investments might yield the exact same positive Net Present Value (NPV) for their respective companies but the anchor bias might cause one to make the investment and the other to pass on it.

Without knowing it, their thought processes may be influenced by the article which becomes an "anchor" or point of reference. A single article may not be enough to cause an anchor bias on an important decision, but a barrage of overly upbeat or downbeat news can change the way executives perceive their decisions.

These anchors become swing factors that cause companies to be too aggressive or too conservative. These biases can lead executives to make poor decisions based on their initial "gut" feel. Understanding and compensating for these factors will help to remove "emotion" and improve the decision making process.

These types of biases help to explain why two people can look at the same analysis or read similar news stories and interpret them completely differently.

4. Confirmation Bias

Anchoring is particularly unfavorable when paired with a confirmation bias where an executive has a preconceived thought that is confirmed through receipt of external information.

For example, today many executives are hesitant to invest in the future as we come out of the downturn and the ongoing negative news stories provide confirmation. It is reminiscent of when Franklin Roosevelt's famously said the "only thing we have to fear is fear itself."

Conversely in 2007 and even more so in 1999, the general business mood was quite positive in most executive suites and external news only served to reinforce this euphoria. Executives were more likely to proceed with investments when in reality many investments made at the peak did not turn out very well. Companies made more acquisitions and bought back more stock when prices were at their highest which made it very difficult to deliver solid returns to investors.

Overcoming Decision Making Biases

All of these decision making biases can significantly influence a executives' predisposition towards a particular choice, even if it is not the optimal alternative. They must learn to rely less on information that validates their instinct and instead seek out more information and advice that challenges their views.

Well conceived fact-based analysis can help to overcome these biases. Of course, it's important to ensure that the analysis isn't biased as well. It is not uncommon (or helpful) for decision support analysis to embed overly conservative assumptions at the bottom of the economic cycle and overly optimistic assumptions at the peak. Despite many years of economic cycles, most forecasts don't anticipate them.

Decision makers must come clean with themselves and accept that they are biased. While it may sound like an Abbott and Costello routine, if executives believe they are less biased than others - well that in itself is a bias.

So how do you overcome this bias? Surround yourself with opposing ideas, encourage debate and bring in a trusted independent advisor (either internal or external) who is not vested in the outcome of the decision and/or is not the champion of the idea.

Often their unbiased perspective will identify risks and opportunities that those closest to the decision had not considered.

Conclusion

Creating long term shareholder value requires investment in the business and it requires business leaders to avoid being satisfied with the status quo (yep that's a bias).

Moving from a "hunker-down" mentality to a more opportunistic strategy requires overcoming many inherent biases both at the organizational and personal level. Executives should take solace in the fact that on average over time most companies get it right, but should always seek to improve.

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