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The Virtues of Fact-Based Decision Making

Using fact-based analysis even when the facts are hard to come by can keep companies from spending money wastefully on initiatives that don't make sense. Gregory V. Milano

Corporate executives sometimes describe decisions by saying, "it's not financial, it's strategic." This reflects a misunderstanding of both finance and strategy, since a corporate decision will only turn out to be strategic if, in fact, it is financially beneficial. Even expenditures that are designed to benefit such seemingly non-financial factors as safety, the environment and employee benefits can have meaningful financial effects that are often positive.

Not all decisions described as "strategic" are bad. Indeed, many decisions described as "strategic" are really financial but the financial benefits take time to materialize or are difficult to isolate and quantify. And sometimes strategic decisions won't lead to an improvement in financial performance but avert a potential decline. In each of these cases, the benefits of the decision versus the alternatives are, in fact, quite financial.

Consider an investment by a transportation company that is designed to improve safety. If the investment is effective and safety improves, there should be many economic benefits enjoyed by the company and its stakeholders. Employees will feel a greater sense of security, which can lead to better productivity and retention. Customers will value being transported more safely, which should result in increased demand through some combination of higher sales volume and better pricing. However, given the many other variables also involved in things like pricing or retention, it can be very difficult to quantify the benefits of some initiatives like those focused on safety. As a result, such investments are often considered "strategic." But without a doubt they have financial benefits.

Why do executives describe these decisions as strategic when in fact they do provide financial benefits? Frankly, it's because it's easier to do so. It can be difficult to estimate the precise expected benefit from an improvement in safety, and it is simpler to just say "it's the *right* thing to do."

OPINION

The problem is that when decisions are made without weighing the facts, there is a risk that the expected benefits will not be adequate. Would it be worthwhile to spend $10 billion on enhanced employee benefits if the net effect were to only retain one or two mid-level employees? Of course not. What about spending $1 million? What about $1,000? Without weighing the facts and considering alternatives, we simply do not know how much is enough. One way to get around the difficulty of estimating financial benefits that are vague or far off in the future is to do the analysis in reverse. To illustrate, consider a professional services company with an employee-attrition problem that contemplates an investment in enhanced employee benefits that would cost a total of $1 million per year.

While evaluating changes in attrition may be hard, it is often easier to determine and evaluate the minimum improvement required and judge whether this is reasonable than it is to estimate a specific level of improvement. To determine the minimum improvement required in this case, you first need to estimate how much it costs when each person leaves your organization. This includes the lost productivity while the position is vacant, the cost of interviewing and selecting a replacement and the cost of training the new employee. There are other harder-to-quantify costs like the morale drain when the remaining employees witness colleagues leaving for supposedly greener pastures. Or the negative effect attrition has on clients when their favorite employee leaves (potentially for a competitor). It is important to think these costs through.

But, for our example, let's say the total cost is estimated to be $25,000 for each employee who leaves. Let's further assume the company has 1000 employees and they average 6 percent annual attrition. In other words, 60 employees leave per year and need to be replaced. At $25,000 per person, the total cost of attrition is $1.5 million. In order for the $1 million investment to pay off, we would need to believe we can reduce attrition by two-thirds ($1 million / $1.5 million).

We may not be able to accurately predict how much attrition will decline. But we may feel comfortable assessing whether or not attrition will drop by two-thirds, from 60 per year to 20 per year. When put this way, the decision becomes easier. Since most companies are unlikely to reduce attrition this much by simply changing benefits, most will reject this investment.

Using fact-based analysis even when the facts are hard to come by can keep companies from spending money wastefully on initiatives that simply do not make sense financially.

Avoiding Cognitive Biases

Another important reason for embracing fact-based decision making is to mitigate our inherent cognitive biases. The burgeoning field of behavioral finance examines the ways in which we humans tend to behave less rationally than what was assumed in our economics classes. While cognitive biases can stand in the way of rational decision making, fact-based analysis can help restore rigor and direction in order to avoid suboptimal decisions.

For example, executives often make more investments when the economy and stock market are strong, despite paying more than they would at the midpoint or bottom of a cycle. Acquisitions, for example, are often justified by comparing current valuations to comparable companies even though a whole industry might be trading at double the value it traded at a few years earlier (and maybe a few years later).

Extensive analysis can be completed, of course, but it's not always fact-based. Many acquisitions that happen at the top of the cycle are made without considering the impact of the next down-cycle on the value of the acquisition target. Similarly, we tend to avoid acquisitions at the bottom of the cycle without adequate consideration for the upside when the economy improves. We tend to act as if good and bad times will last forever.

This is particularly relevant right now. It seems many pundits are predicting a rise in M&A activity this year. But, since we are hovering at pretty high stock-market valuations, many of the acquirers will regret their purchases in a few years, when the inevitable down-cycle occurs. To avoid such situations, use fact-based analysis and evaluate down cycle scenarios in any major investments you consider, and don't be afraid to work in reverse to determine minimum required benefits when facts are less certain.

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