Hidden Flaws In Strategy

I take great pleasure sharing the following excerpts from an article by Charles Roxburgh, a director in the London office of McKinsey Consulting. In the article, which appeared in the McKinsey Quarterly in 2003, he presents eight "flaws" that undermine, both consciously and unconsciously, the clarity required for successful strategic planning. His article substantiates our findings regarding the overwhelming number of inadequate and unsuccessful strategies. We have consistently found that 90% of strategic plans do not succeed, and this is because most of the input data is inaccurate and based on unsound and unsubstantiated reasoning. I have extracted some key points that Mr. Roxburgh identifies as causes of this phenomenon.

Overconfidence

Our brains are programmed to make us feel overconfident. The brain is particularly overconfident of its ability to make accurate estimates.

We also tend to be overconfident of our own core capabilities. Almost all financial institutions, for instance, believe their brands to be "above-average" value.

The twin problems of overconfidence and overoptimism can have dangerous consequences when it comes to developing strategies, as most are based on estimates of what may happen – too often on unrealistically precise and overoptimistic estimates of uncertainties.

Mental accounting

Richard Thaler, a pioneer of behavioral economics, coined the term "mental accounting," defined as "the inclination to categorize and treat money differently depending on where it comes from, where it is kept, and how it is spent." Gamblers who lose their winnings, for example, typically feel that they haven't really lost anything, though they would have been richer had they stopped while they were ahead.

Mental accounting pervades the boardrooms of even the most conservative and otherwise rational corporations. Some examples of this flaw include the following:

- being less concerned with value for money on expenses booked against a restructuring charge than on those taken through the P&L

- creating new categories of spending, such as "revenue-investment spends" or "strategic investment"

Avoiding mental accounting traps should be easier if you adhere to a basic rule: that every pound (or dollar or euro) is worth exactly that, whatever the category. In this way, you will make sure that all investments are judged on consistent criteria and be wary of spending that has been reclassified. Be particularly skeptical of any investment labeled "strategic."

The status quo bias

One explanation for the status quo bias is aversion to loss—people are more concerned about the risk of loss than they are excited by the prospect of gain.

A similar bias, the endowment effect, gives people a strong desire to hang on to what they own; the very fact of owning something makes it more valuable to the owner. Richard Thaler tested this effect with coffee mugs imprinted with the Cornell University logo. Students given one of them wouldn't part with it for less than $5.25, on average, but students without a mug wouldn't pay more than $2.75 to acquire it. The gap implies an incremental value of $2.50 from owning the mug.

The status quo bias, the aversion to loss, and the endowment effect contribute to poor strategy decisions in several ways. First, they make CEOs reluctant to sell businesses. McKinsey research shows that divestments are a major potential source of value creation but a largely neglected one. CEOs are prone to ask, "What if we sell for too little—how stupid will we look when this turns out to be a great buy for the acquirer?" Yet successful turnarounds, such as the one at Bankers Trust in the 1980s, often require a determined break with the status quo and an extensive reshaping of the portfolio—in that case, selling all of the bank's New York retail branches.

The challenge for strategists is to distinguish between a status quo option that is genuinely the right course and one that feels deceptively safe because of an innate bias. To make this distinction, strategists should take two approaches:

- Adopt a radical view of all portfolio decisions. View all businesses as "up for sale." Is the company the natural parent, capable of extracting the most value from a subsidiary? View divestment not as a failure but as a healthy renewal of the corporate portfolio.

- Subject status quo options to a risk analysis as rigorous as change options receive. Most strategists are good at identifying the risks of new strategies but less good at seeing the risks of failing to change.

Anchoring

One of the more peculiar wiring flaws in the brain is called anchoring. Present the brain with a number and then ask it to make an estimate of something completely unrelated, and it will anchor its estimate on that first number. The classic illustration is the Genghis Khan date test. Ask a group of people to write down the last three digits of their phone numbers, and then ask them to estimate the date of Genghis Khan's death. Time and again, the results show a correlation between the two numbers; people assume that he lived in the first millennium, when in fact he lived from 1162 to 1227.

Anchoring can be a powerful tool for strategists. In negotiations, naming a high sale price for a business can help secure an attractive outcome for the seller, as the buyer's offer will be anchored around that figure. Anchoring works well in advertising too. Most retail-fund managers advertise their funds on the basis of past performance. Repeated studies have failed to show any statistical correlation between good past performance and future performance. By citing the past-performance record, though, the manager anchors the notion of *future* top-quartile performance to it in the consumer's mind.

However, anchoring—particularly becoming anchored to the past—can be dangerous. Most of us have long believed that equities offer high real returns over the long term, an idea anchored in the experience of the past two decades. But in the 1960s and 1970s, UK equities achieved real annual returns of only 3.3 and 0.4 percent, respectively. Indeed, they achieved double-digit real annual returns during only 4 of the past 13 decades. Our expectations about equity returns have been seriously distorted by recent experience.

Besides remaining unswayed by the anchoring tactics of others, strategists should take a long historical perspective. Put trends in the context of the past 20 or 30 years, not the past 2 or 3; for certain economic indicators, such as equity returns or interest rates, use a very long time series of 50 or 75 years. Some commentators who spotted the dot-com bubble early did so by drawing comparisons with previous technology bubbles—for example, the uncannily close parallels between radio stocks in the 1920s and Internet stocks in the 1990s.

The sunk-cost effect

A familiar problem with investments is called the sunk-cost effect, otherwise known as "throwing good money after bad." When large projects overrun their schedules and budgets, the original economic case no longer holds, but companies still keep investing to complete them.

Financial institutions often face this dilemma over large-scale IT projects. There are numerous examples, most of which remain private. One of the more public cases was the London Stock Exchange's automated-settlement system, Taurus. It took the intervention of the Bank of England to force a cancellation, write off the expenses, and take control of building a replacement.

Why is it so hard to avoid [the sunk-cost trap]? One explanation is based on loss aversion: we would rather spend an additional $10 million completing an uneconomic $110 million project than write off $100 million. Another explanation relies on anchoring: once the brain has been anchored at $100 million, an additional $10 million doesn't seem so bad.

What should strategists do to avoid the trap? Be prepared to kill strategic experiments early. In an increasingly uncertain world, companies will often pursue several strategic options. Successfully managing a portfolio of them entails jettisoning the losers. The more quickly you get out, the lower the sunk costs and the easier the exit.

The herding instinct

The banking industry, like many others, shows a strong herding instinct. It tends to lend too much money to the same kinds of borrowers at the same time—to UK property developers in the 1970s, less-developed countries in the 1980s, and technology, media, and telecommunications companies more recently. And banks tend to pursue the same strategies, be it creating Internet banks with strange-sounding names during the dot-com boom or building integrated investment banks at the time of the "big bang," when the London stock market was liberalized.

This desire to conform to the behavior and opinions of others is a fundamental human trait and an accepted principle of psychology. Warren Buffett put his finger on this flaw when he wrote, "Failing conventionally is the route to go; as a group, lemmings may have a rotten image, but no individual lemming has ever received bad press." For most CEOs, only one thing is worse than making a huge strategic mistake: being the only person in the industry to make it.

Initially, an innovative strategy might draw skepticism from industry experts. They may be right, but as long as you kill a failing strategy early, your losses will be limited, and when they are wrong, the rewards will be great.

False consensus

People tend to overestimate the extent to which others share their views, beliefs, and experiences—the false-consensus effect. Research shows many causes, including these:

- *confirmation bias*, the tendency to seek out opinions and facts that support our own beliefs and hypotheses
- *selective recall*, the habit of remembering only facts and experiences that reinforce our assumptions
- *biased evaluation*, the quick acceptance of evidence that supports our hypotheses, while contradictory evidence is subjected to rigorous evaluation and almost certain rejection; we often, for example, impute hostile motives to critics or question their competence
- *groupthink*, the pressure to agree with others in team-based cultures

False consensus, which ranks among the brain's most pernicious flaws, can lead strategists to miss important threats to their companies and to persist with doomed strategies. But it can be extremely difficult to uncover—especially if those proposing a strategy are strong role models. We are easily influenced by dominant individuals and seek to emulate them. This can be a force for good if the role models are positive. But negative ones can prove an irresistible source of strategic error.

The dangers of false consensus can be minimized in several ways:

1. Create a culture of challenge. As part of the strategic debate, management teams should value open and constructive criticism. Criticizing a fellow director's strategy should be seen as a helpful, not a hostile, act. CEOs and strategic advisers should understand criticisms of their strategies, seek contrary views on industry trends, and, if in doubt, take steps to assure themselves that opposing views have been well researched. They shouldn't automatically ascribe to critics bad intentions or a lack of understanding.
2. Ensure that strong checks and balances control the dominant role models. A CEO should be particularly wary of dominant individuals who dismiss challenges to their own strategic proposals; the CEO should insist that these proposals

undergo an independent review by respected experts. The board should be equally wary of a domineering CEO.

3. Don't "lead the witness." Instead of asking for a validation of your strategy, ask for a detailed refutation. When setting up hypotheses at the start of a strategic analysis impose contrarian hypotheses or require the team to set up equal and opposite hypotheses for each key analysis. Establish a "challenger team" to identify the flaws in the strategy being proposed by the strategy team.

An awareness of the brain's flaws can help strategists steer around them. All strategists should understand the insights of behavioral economics just as much as they understand those of other fields of the "dismal science." Such an understanding won't put an end to bad strategy; greed, arrogance, and sloppy analysis will continue to provide plenty of textbook cases of it. Understanding some of the flaws built into our thinking processes, however, may help reduce the chances of good executives backing bad strategies.