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Management lessons from the financial crisis:

A conversation with Lowell Bryan and Richard Rumelt

Two business strategists discuss the nature of risk, the effectiveness of performance-measurement systems, and the difficulty of getting governance and incentives right.

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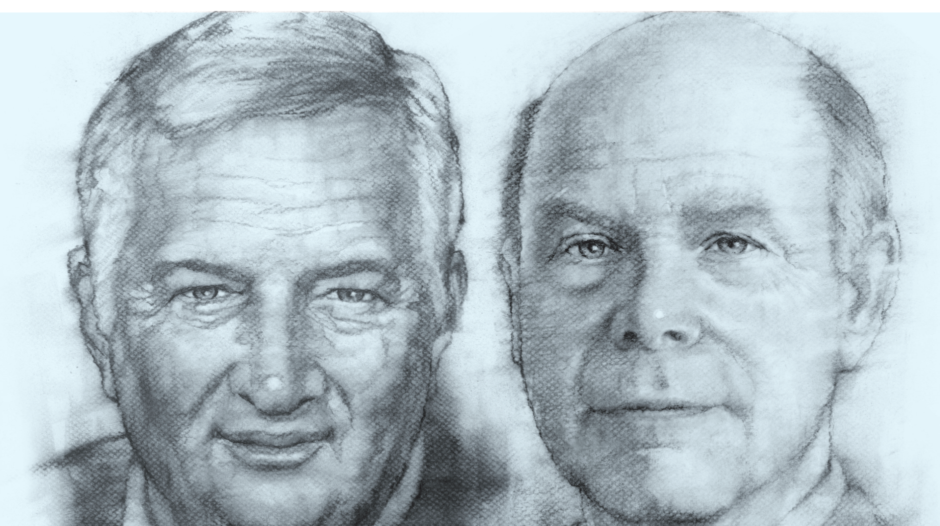

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This conversation is one of three installments summarizing Lowell Bryan and Richard Rumelt's reflections on the implications of the financial crisis. This first part focuses on the broad managerial implications of the crisis. The second examines the public-policy response to the downturn, and the third explores what the crisis means for corporate strategy today.

Eight months have passed since the collapse of Lehman Brothers punctuated the global financial crisis, touching off reverberations in the real economy that continue to reshape the business environment. Is it too early to start drawing management lessons from the crisis? Lowell Bryan, a director in McKinsey's New York office, and Richard Rumelt, a professor of strategy at UCLA's Anderson School of Management and the originator of the resource-based view of strategy,[1] don't think so.

In December 2008, they began formally addressing what strategists should make of the financial crisis, when the *Quarterly* published Bryan's "Leading through uncertainty" and Rumelt's "Strategy in a 'structural break.'" In late April, McKinsey's Allen Webb asked Bryan and Rumelt to reflect together on the most important lessons executives can begin to draw from recent economic events. While acknowledging, in Rumelt's words, that "it takes about five years for these things to unfold, so what we see now is just the beginning," the two strategists engaged in a rich discussion about topics including the nature of risk, the effectiveness of performance-measurement systems, and the difficulty of getting governance and incentives right. A portion of that discussion follows.

The *Quarterly*: *What management lessons do you think we should be learning, so far, from the financial crisis?*

Richard Rumelt: There's been a dramatic failure in management governance. And so our basic doctrines of how we manage things are in question and need revision.

At the heart of this failure is what I call the "smooth sailing" fallacy. Back in the 1930s, the Graf Zeppelin and the Hindenburg were the largest aircraft that had ever flown. The Hindenburg was as big as the *Titanic*. Together these vehicles had made 620-odd successful flights when one evening the Hindenburg suddenly burst into flames and fell to the ground in New Jersey. That was May 1937.

Years ago, I had the chance to chat with a guy who had actually flown over Europe in the Hindenburg. And he had this wistful memory that it was a wonderful ride. He said, "It seemed so safe. It was smooth, not like the bumpy rides you get in airplanes today." Well, the ride in the Hindenburg *was* smooth, until it exploded. And the risk the passengers took wasn't related to the bumps in the ride or to its smoothness. If you had a modern econometrician on board, no matter how hard he studied those bumps and wiggles in the ride, he wouldn't have been able to predict the disaster. The fallacy is the idea that you can predict disaster risk by looking at the bumps and wiggles in current results.

The history of bumps and wiggles—and of GDP and prices—didn't predict economic disaster.

[1] The resource-based view of strategy holds that neither industry structure nor corporate ownership can explain the lion's share of the differences in profitability among business units. The seminal paper on this topic is Rumelt's "How much does industry matter?" *The Strategic Management Journal*, 1991, Volume 12, Number 3, pp. 167–85. See also Dan P. Lovallo and Lenny T. Mendonca, "Strategy's strategist: An interview with Richard Rumelt," mckinseyquarterly.com, November 2007.

When people talk about Six Sigma events or tail risk or Black Swan, they're showing that they don't really get it. What happened to the Hindenburg that night was not a surprisingly large bump. It was a design flaw.

To see the disaster coming, you had to have looked beyond the data about flight bumpiness—beyond the professionalism of the staff—and really think, "Does it make any sense to have people riding in a gondola, strapped to a giant sack of flammable hydrogen gas?" There's just not a data series that lets you think about that. But it's not that hard to think about.

This smooth-sailing fallacy arises when we mistake a measure for reality. Competent management always looks deeper than the numbers, deeper than the current measures. Incompetent management just focuses on the metrics, on the body count, on quarterly earnings—or on GDP growth or the consumer price index. And that's how we get into these troubles. We really have to think about the redesign of a lot of institutions and doctrines around measurement. This lesson is fundamental: you cannot manage by just looking at the results meter.

Lowell Bryan: One of the other things that really characterized the period from about 1982 until literally last year was that economic volatility—in terms of degree and depth of business cycles—and financial volatility measurably declined.

Basically, people assumed they were always going to have flat seas. There weren't going to be storms. And they built up a set of business practices and strategies which may have had really deeply flawed assumptions, as Richard was saying. A lot of people do things because if it's been good for the last three years, they assume it's going to be good for another year.

I think that we are now into a period where whole generations of people—consumers, managers—who had been lulled into the view that the world was not volatile, now know in their gut that it is in a way that you couldn't describe to them before. And I think that's going to have unknown behavioral effects and unknown economic effects.

The *Quarterly*: *You've used two similar terms: Richard, you called it a "design flaw"; Lowell, "flawed assumptions." Either way, could you describe in a bit more detail what you think some of those flaws were?*

Richard Rumelt: The idea that these risks were independent is a central part of the design flaw. The independence assumption shows up in the collapse of various financial institutions and in derivatives, where people designed them, thinking that various risks were diversifiable—and they're not. And it shows up in the management of the whole economy, as Lowell mentioned.

The US Federal Reserve was very proud of the fact that the standard deviation of GDP growth had come down since about 1982. What they were calling the Great Moderation I would call smooth sailing—which is people reading meters rather than reading reality. The Federal Reserve, for example, managed its policies around the CPI—the consumer price index. And it continues to do so.

Now, the consumer price index doesn't really measure inflation; it measures a bundle of prices. It doesn't measure wages, it doesn't measure asset prices. And so, during these years, they came to the conclusion that they could keep interest rates at 2 percent or 1 percent and juice the economy constantly, with no inflation. It was wonderful.

Of course if you open your eyes and take them off the meter reading, you see that you're creating a giant credit bubble, a giant asset bubble. And that the world economy's getting destabilized. The same thing happened at Citigroup, or at Bear Stearns, or at Lehman Brothers, where you were showing these wonderful increasing earnings most years.

And just like the Federal Reserve, if you take your eyes off the meter reading and ask what's actually happening here—"What are we doing?"—you find you're making money by transferring funds into relatively unknown kinds of structures that your own designers can barely explain and that the rating agencies don't understand.

This focus on meter readings rather than on a deeper understanding of the forces at work is what gets you into trouble. And what I see in the companies that I work with is that while they don't have a solution to the problem, there's an increasing distrust of the meter readings and of the pronouncements from on high. There's a sense of, "Something is wrong with the system."

The *Quarterly*: *Are you referring primarily to nonfinancial companies?*

Richard Rumelt: Yes. Financial companies would just like to get the game going again, mostly.

Lowell Bryan: Building on what Richard was saying, I would use a slightly different set of words, as opposed to meter reading. I think that underlying a lot of the problems are hubris and a belief that you can actually predict the future, plus or minus 10 percent. It's earnings forecasts and expecting that you ought to be able to manage your delivery against them.

It's basically this presumption that, of course you're going to have smooth sailing. And that you're not a really good manager unless you can sail smoothly. And to keep the analogy going, the design flaw is trying to think that you can predict the weather—as opposed to designing a boat that is capable of withstanding all sorts of different weather. The objective is not to control things you can't control but to enable you to be relatively better at delivering results and performance over time, no matter what the weather is.

I think that what has been the big wake-up call for people—and why they feel disquieted—is because they know in their gut that they don't know where they're going. They can't see the future. And they haven't got a business model and a strategy designed for an uncertain, unpredictable environment. They've got a strategy and business model for smooth sailing.

Richard Rumelt: Yes. And if I was to put my finger on what I think is the core of the doctrinal problem, it's the way we measure and create incentives for institutions ranging from the Federal Reserve to the rating agencies, the financial companies, and the industrial companies. It's possible to create a record that looks pretty good for a certain number of years, by taking—consciously or unconsciously—hidden major disaster risks.

The ability to do that means we have to manage our companies and our divisions by understanding what they're *actually* doing, not just by looking at their results. And that, in my mind, is the core of the lesson learned about how we have to manage. Very few people have taken that lesson to heart. It's going to take years for it to percolate through the system.

Lowell Bryan: In addition to the incentives, I think that at the core are the agency issues that Adam Smith warned about some 240 years ago. You basically have management teams that win with heads but don't have the losses from tails if they come up. It's also related to public companies, where you have the disconnect between the principal and the manager and you have public companies who are being held accountable for each quarter's earnings.

I will bet that many private companies have done much better. I'm not talking about the private-equity, highly leveraged companies; I'm just talking about the run-of-the-mill private company that has been in business for years and is still family owned. I will bet that on average, they are doing better than public companies. Now, I don't know that that's true, but I suspect it's true in this environment because the incentives are so different.

Richard Rumelt: That's right. I have a couple of companies that I work with that are private firms—managed tightly, but very differently: it isn't so much about squeezing the last drop out of performance, the constant rabbits-out-of-a-hat game that gets played in public companies.

I guess the mystery for me as an academic is that we know this. We know that if you incent someone with a call option—and that could be a stock option where if it turns out badly you don't lose money, but if it turns out great you can become incredibly wealthy—if you set up that kind of an option (and most bonus systems for CEOs and top management work that way), then the person who owns that option is risk seeking. For them, it pays to take big risks. It pays to take uneconomic risks. I don't mean the kind of risks where performance wobbles around from month to month. I mean Hindenburg kind of risks. Because if you become the biggest zeppelin maker in the world, you become incredibly wealthy. And even if the thing blows up three years down the road, well, that's somebody else's problem. And yet we keep creating these incentive systems, as if they made sense. And they don't. And we know they don't.

Lowell Bryan: I would argue this is because of this principal-agent issue. It's because the management teams create these incentive systems for themselves.

The *Quarterly*: *It's all a little unsettling because when you think back to some of the corporate governance debates of the '80s and Michael Jensen's executive compensation work,*[2] *it seems as if people have been trying to address agency issues for a long time. Yet we haven't really wound up any further along, and it sounds like you're suggesting we may be worse off. How do you think that happened?*

Richard Rumelt: It's a deep problem, particularly for Americans. It's part of our political and cultural heritage that people should be able to do what they want, and you get that kind of freedom from the theory that if you get someone's incentives right then they will be self-regulating. You don't have to tell people what to do and you don't have to inspect what they're doing. If you get the incentives designed correctly, they'll do the right thing.

Now, that's a wonderful theory. The trouble is, the only way to get the incentives right is for the

[2] Michael C. Jensen and Kevin J. Murphy, "CEO incentives: It's not how much you pay, but how," *Harvard Business Review*, 1990, Volume 3, Number 3, 138–53.

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CEO to own the company. And so while we love setting it up that way—because it satisfies a doctrinal urge that we all have—the trouble is it's false; it doesn't work.

Lowell Bryan: The biggest problem is when you start talking about a financial firm, where you have these incentive issues and all sorts of market anomalies. There can be years between when you take the income in and when your actual loss is realized. That's the reason why you need to have regulation. Q

Allen Webb is a member of *The McKinsey Quarterly*'s board of editors.