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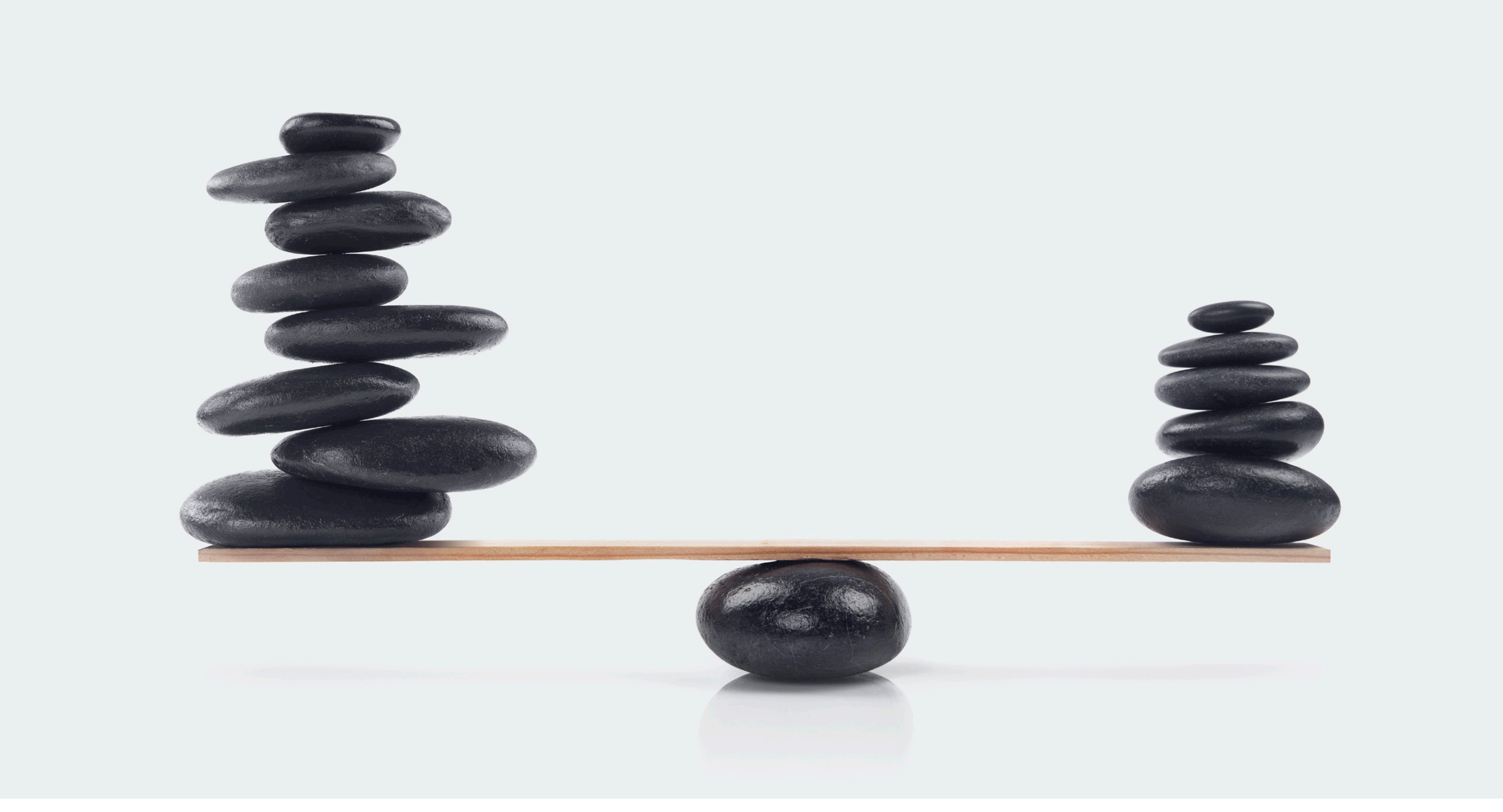
How to be objective about budgets

Addressing anchoring bias can lead to more accurate budget forecasts, better budget conversations, and more dynamic resource reallocation.



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In this episode of the *Inside the Strategy Room* podcast, McKinsey partner Tim Koller, professor of business strategy at the University of Sydney Dan Lovallo, and Sean Brown tackle the anchoring bias. They discuss practical techniques executives can employ to overcome the weight of last year's budget numbers and make better forecasts. Countering anchoring bias can also help executive teams break through budget inertia and have more productive budget discussions.

(For more conversations on the strategy issues that matter, subscribe to the series on iTunes.)

Sean Brown: From McKinsey & Company's Strategy and Corporate Finance Practice, I'm Sean Brown. Welcome to *Inside the Strategy Room*. Today we continue our series on bias, specifically, how executives can fall prey to cognitive and organizational biases that get in the way of good decision making. Joining me in our New York office are McKinsey partner Tim Koller and Dan Lovallo, a former McKinsey consultant and a professor of business strategy at the University of Sydney. They, along with Olivier Sibony, a former McKinsey partner, recently wrote an article on being objective about budgets. This is part of a larger series on bias busters.

Tim and Dan, welcome. I think everyone understands the situation you address in this article. During the budget-planning process, the numbers you end up with are usually pretty close to the ones you started out with. It's something that you refer to in the article as anchoring. Can you talk about what you mean by that?

Dan Lovallo: Anchoring was something developed by [psychologists] Daniel Kahneman and Amos Tversky. It refers to the tendency to anchor on any number given. One of the best examples of it was people were asked to estimate Gandhi's age at death. This may be imprecise, but one group was given an age of ten and another was given an age of 140. These are obviously completely ridiculous numbers, but they strongly affected the predicted age of death. If something that you know is ridiculous impacts your forecast, then imagine how much more salient last year's budget is.

We call this endowed anchoring. You're endowed with this anchor, which is what you did last year. It's a stronger anchor than ten years old being when Gandhi died. You're anchored to that in psychological ways. Tim's probably better placed to talk about how hard it is to move these organizational anchors and budgets.

Tim Koller: Thank you, Dan. First off, another example that I think is interesting. We take a group of executives in a room and split them into two. We give one group a set of opportunities for different resource allocation for the coming year and what the payoffs would be. That's all we give them. We give the second group exactly the same information, plus we give them the information about how the resources were allocated across units the prior year. What you'll find is the answer is very different between the two groups because that second group automatically assumes, because of this bias, that maybe last year's information was right. There is an innate push toward what happened last year, and that is a major problem that has to be overcome in organizations. Organizations typically start with last year and then move up or down incrementally. Rarely do they start from scratch and think, "What's the best place to allocate our resources?"

Dan Lovallo: And you can see this in the whole economy. We've done a study that looks at business segments, which are proxies for business units. The data comes from Compustat and includes the year-on-year correlation between the different business units' allocations. What we found is for the bottom third, the lowest reallocators, the correlation is 0.99. For the median reallocators, it's around 0.93. And then for the highest reallocators, it goes below 0.90. What that's telling you is that if you have some way to move your resources across your business units, the returns are a lot higher. Loosening this up is a very, very big deal. And not enough companies are focused on it.

People produce these huge strategy books every year, or strategic plans. They spend a lot of time on it. For most companies, you would save a lot of time if you got a dartboard out that said, "We're not reallocating anything to some very small number." Throw the dart and be done with the whole process. That's why you see these strategic plans up on the shelves and rarely used. But companies can spend up to three months doing it.

Sean Brown: Clearly there's an unconscious bias that's going on when anchoring. But there might be other reasons why budgets don't change year to year. I'd imagine it's quite disruptive to reallocate people and capital dramatically on a year-to-year basis. Have you seen companies that have overcome the anchoring bias actually then overcome some of those other challenges associated with significant reallocation?

Tim Koller: I might challenge your premise about how difficult it is to do that. I think that's often an excuse. It's not that you're going to change a lot every year across different business units. In other words, if one business unit is on the upswing and it needs more resources, that's probably going to be the same for a couple of years, versus a business unit which is more mature. It's not like you're going to be changing a lot from year to year. I don't think it's a good excuse to say it's hard to do, because you need to do it at some point or another. And better to do it sooner rather than later.

With respect to projects, though, it is much easier because you typically have resources that you can move. For example, some of the oil companies will just do a forced ranking of all the different projects. Then they can pick the projects. Initially they do it mechanically and pick projects that have the highest returns. You might make some modifications later on, but that is a technique you can do for business units as well. You start out with something which is a forced ranking, which ignores history, and is entirely forward looking. Therefore, your starting point in the discussion is an allocation that is sometimes very different than what you did last year. You might modify it a little bit, but at least you've got a starting point that pushes you away from the anchor of last year.

Dan Lovallo: One of the things that I enjoy about working with McKinsey is I often do an academic article that takes years and years and years. And we do a version that has the same answer more quickly, but I have to prove it beyond X percent. But anyway, in turning some of this research into an academic article, what we found was shocking. We thought that as you reallocate too much there would be a drop-off. And that's only true for 1 percent of the people who reallocate the most. I can say with 95 percent academic certainty that almost everybody can do better if they reallocate more.

Sean Brown: What steps can people take to remedy this situation?

Tim Koller: One of the steps is to make sure you have some nonhistorical way to come up with an allocation or a forecast.

Dan Lovallo: Nonhistorical to your company.

Tim Koller: Exactly. Your starting point should not already be anchored in what happened last year. You need to look at it with cleansheet before you even compare it to what happened last year. That will help push you in the right direction. Obviously there has to be some fact base and good analysis behind that. That's one of the things that will help to break that anchor.

Dan Lovallo: Let me add to that. This is a little bit like how you form a reference class and a little bit like how you do a regression. You pick some of the biggest indicators. In other words, let's say you're a consumer-goods company, and you've got a store in Hong Kong. You might look at the growth of the entire sector, the growth in Hong Kong, and the growth of your product line. This is a quick-and-dirty thing. It doesn't have to be fundamentally detailed. You take these attributes, and you run a quick regression model and predict what you think the sales would be in the Hong

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Kong store for this product line. And then you're going to compare that to your inside view, which means focusing on your own plans and actions and last year's budget, to set up a different anchor. The only way to fight an anchor is with a new anchor.

The second thing is to calibrate a simple sales forecast for our consumer-goods company in China. This model, as I said, is not meant to be strictly accurate. It's just the best piece of advice. This provides you with a security anchor that you can use. The beauty of this isn't just that it provides you with a second anchor that's going to help you be more accurate, but what you'll find is that 80 percent of the time the two numbers are going to be close. So those budget discussions…

Sean Brown: Are easy?

Dan Lovallo: …yeah, very easy. You don't have to spend all that time on each budget discussion. It's a big time-saver. And then with the 20 percent where they're off, those are the tough discussions that you focus on. Not only is it a way to get a better forecast, it's also a way to be more efficient with your time.

Tim Koller: The other thing you have to overcome is the internal dynamics or politics of the organization. For example, one technique people will use is to try to talk to everyone who's going be in a meeting before the meeting to get them to buy in so there's no debate at the meeting, and they get their point of view. Or people will go around the process directly to the CEO and say, “I really need those resources.” That person knows they're not going to be getting resources because they are going to go somewhere else otherwise. Because of this, you really have to be strict about the processes that you go through in order to overcome those internal dynamics that will work against the more fact-based objective reallocation. People's prestige and their view of how they're perceived in the organization are all at stake here. Often, they're not looking at it from the perspective of the whole company. They're going to try to move things back to where they had them. This is particularly true for those who have a lot of resources. You have to take specific steps to prevent that from happening.

Sean Brown: Tim, does that lend itself more to an annual budget process, or one where it happens more regularly? Is there a way to lower the stakes so there's not as much pressure to try and save your resources?

Tim Koller: I think it may be impractical to go entirely to a non-annual process. It's nice in theory. There are some things you can do though to make it better. We did some research and found that when companies did their strategic planning at the beginning of the year, they put together a three- to five-year forecast. The first year of that forecast, ideally, should be the budget for the next year. But what we found was that when companies actually got around to budget time—let's say they did they did the strategic plan in June, and the budget in October—the budget reverted back to the prior year's allocation even though in their strategic plan they were going to have a big reallocation. One thing you can do is be more precise, or require that you don't make changes from that three- to five-year plan to the next year's budget through the process.

Another thing that you can do to give you more flexibility during the course of the year is to not allocate all of the resources and hold some back either for the CEO, or for the investment committee, or whatever body makes those decisions. That way when opportunities come along, you can allocate new resources.

The other thing you need to do is to make sure that even if you did allocate something to a project, if you're not going to start spending the money until next September, when September comes around, you actually revisit and say, "Do we still want to spend it?" You might take money back. You might have a budget that is not set in stone. You can add pieces in some cases and take it away as you gain more information. I know it's not easy to do. But it is doable because you have a lot of information that'll allow you to make those adjustments during the year.

Dan Lovallo: Another process-oriented way to move budgets is to have more bottom-up requests than top-down demands. In other words, if the top of the corporation says, "This is division A's budget. This is division B's budget. This is division C's budget," you're very unlikely to move things around.

Tim Koller: And our evidence also suggests that you're less likely to outperform when you have things that are too top-down oriented because it just doesn't provide for any new ideas or significant shifting.

Sean Brown: How do you do that from the bottom up more effectively? That sounds like it'd be a lot more work than a top-down budget.

Tim Koller: One way is to ask each unit to come up with a number of scenarios. What would they do with additional resources? They would come up with maybe four different scenarios and say, "Here's our baseline. If we received 10 percent more resources, we'd do this. If we got 25 percent more, we'd do this. If we had less, this is what would happen."

The corporate center can then see how these things fit together because each individual unit doesn't know what the opportunities are for the other units. First you have to do a good job of creating the different scenarios. And then you have to have a body who's in a position to say, "OK, I'd rather this unit improve or get 10 percent more. We'll take it away from this unit in order to come up with a better end result."

Dan Lovallo: This is an important point. Rather than presenting one initiative at a time, you should have multiple options that attack that initiative. That gives corporate a better view on what they could do, and what they could shift. Because if you just give them one, it's take it or leave it.

Sean Brown: It's binary.

Dan Lovallo: Yeah. And it makes it harder to shift the resources. And you're not just shifting resources to shift them. We've shown that it definitely leads to increased performance.

Sean Brown: Are there any cases where anchoring happens in real life?

Dan Lovallo: In the real world, anchoring happens all the time. Last night I happened to be at dinner with Daniel Kahneman. He's a very generous guy. He took me and my family out and he said to me, "Dan, order any wine you want." We were at a nice French restaurant with a fairly limited wine list. One of the wines was priced in the $100 region. Then there were a bunch of wines in the $200 region. Then there was one wine in the $500 region. Danny said, “You know, they’re anchoring us.” And I said, “Yeah. But they’re making a mistake. They’re giving us two anchors.” And then the waiter came back. He said, “I’m sorry. We’ve got a new list.” And they made a wise decision. They got rid of the $100 wine, so there was only one anchor at the $500 level. We ended up getting a $200 bottle of wine!

Sean Brown: Tim, Dan, thanks very much for joining us today.

Sean Brown is McKinsey’s global director of communications for strategy and corporate finance and is based in the Boston office, **Tim Koller** is a partner in the New York office, and **Dan Lovallo**, an alumnus of McKinsey’s San Francisco office, is a professor of business strategy at the University of Sydney.

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