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Strategic Uncertainty: A New Risk Management Paradigm for CFOs

We believe that senior finance executives today face a challenging shift in the risk management paradigm: how can they effectively assess the future without relying on measuring what's happened in the past? On May 16, 2007, more than 850 executives heard Michael Raynor, Distinguished Fellow in Deloitte Research and author of a popular new business book, *The Strategy Paradox*, and Howard Weinberg, Principal, Deloitte Consulting LLP, discuss in a webcast presentation some leading-edge thinking around risk management as it relates to fundamental business strategy.

Raynor, who also coauthored with Professor Clayton M. Christensen the best-selling book, *The Innovator's Solution*, has for the past several years studied both innovation and strategy as they relate to business success. As the quest for profitable growth dominates corporate decision making, companies look for ways to create and capture value by launching new, innovative products or growth businesses—and to the extent possible, to try to bring some degree of certainty and predictability to the notion of innovation. "However," Raynor observes, "there may always be a certain level of irreducible unpredictability and risk that will color decision making." Operational and financial risks, he maintains, are joined by strategic risks in this decision making. "Strategic risk arises," he said, "as a result of the commitment an organization has made to specific ways of creating value in a particular product marketplace." This commitment can be undermined by certain sets of circumstances that may or may not be controllable. Decisions made may just turn out to have been the wrong kind of commitments, even though they were perfectly reasonable at the time: there is a risk/return trade-off in strategy just as there is in finance.

More than two-thirds of the audience said that to some extent their company sees effective management of strategic risk as a powerful tool in increasing enterprise value. The presenters found this comforting because all too often strategic risks are ignored. Many best-selling business books promote effective strategy development—and unrelenting commitment to strategy. But rarely is strategic risk given any significant attention, which could lead readers to assume that any increase in returns resulting from advice in the books are "free" of any risk. In fact, Raynor pointed out, it is counterintuitive to believe that increased results come with reduced or no risk. He described two infamous market disappointments experienced by (Betamax and Minidisc), an innovator who seems more often than not to succeed. These examples help demonstrate that despite excellent market wisdom at a certain point in time and a high degree of commitment and technical excellence, strategic uncertainties (in this case changes in consumer preferences and the introduction of Internet-related technologies) can undermine your returns. "That's the strategy paradox: the same strategies we're told to implement to achieve success in fact necessarily expose us to higher degree of strategic risk," Raynor said.

Figure 1. To what extent do you agree or disagree with the following statement: My company sees the effective management of strategic risk as a powerful lever for increasing total enterprise value
(Votes received: 782)

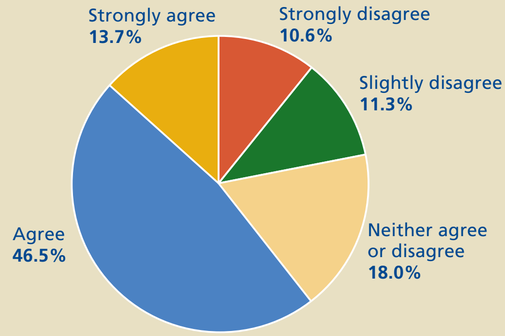
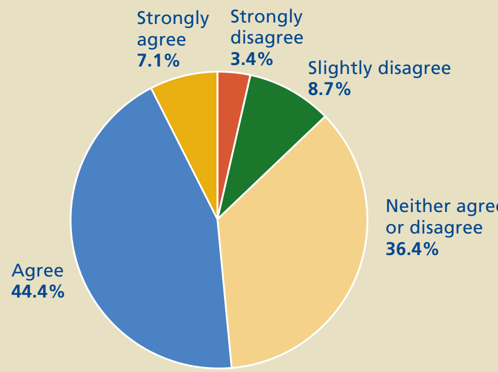


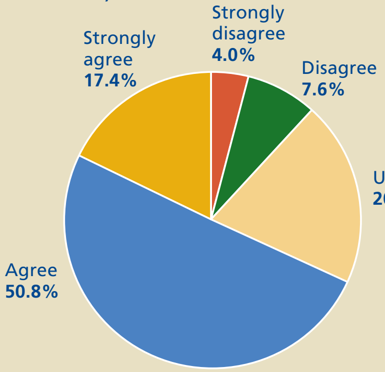
Figure 2. To what extent do you agree or disagree with the following statement: When it comes to reviewing and approving strategic plans, I am typically pushing the divisions (e.g., product groups, operating divisions, etc.) to achieve more demanding targets
(Votes received: 789)



So, while we believe that long-term and impassioned commitments are critical and that visionary companies do usually yield better results, most of the statistics that help us reach these conclusions are based on companies that survive. Raynor's most recent strategic research is based on data that includes companies that have failed, been sold, or otherwise shutdown. He found that there are a large number of companies with low levels of vision and commitment that also have experienced a low mortality rate, whereas many companies with a higher degree of commitment and vision suffer a higher mortality rate. "So everything we know about strategy is true but it is seriously incomplete," Raynor said. "You can drive your company from good to great, but you must make the right choices as you drive forward or else you can drive your company from good to gone!"

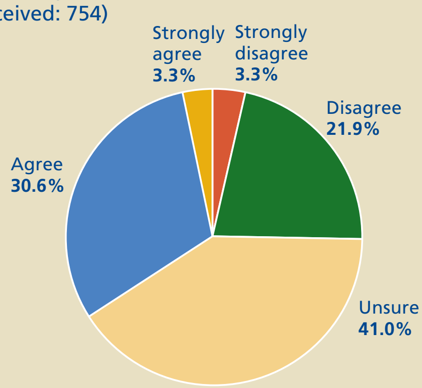
The choice is accepting risk and getting a higher return or avoiding risks and going for a higher survival rate. This can lead many strategy developers to work up plans that feature key tradeoffs, which drive them to the middle ground as it will be their challenge to meet the objectives set. Financial executives then find themselves pushing the operating units to achieve more demanding targets, as noted by slightly more than half of the webcast participants in an online poll.

Figure 3. To what extent do you agree or disagree with the following statement: In my organization the corporate level of the hierarchy plays and active role in identifying and managing strategic risk
(Votes received: 799)



Senior corporate executives can play a role in helping to manage strategic risks, and the vast majority of webcast participants agree with this notion. How? By trying to find a way to achieve the returns reserved for "dare devils" but at levels of risk reserved for "home-bodies." Raynor and Weinberg used Microsoft as an example of a company with diverse strategies, or what they termed a collection of "strategic options." These options, including simultaneous development of MS DOS, OS2, and Windows and teaming with seeming competitors like IBM and Apple, gave them the ability to commit to a variety of initiatives that collectively represented organizational flexibility. Each piece of their portfolio has a high commitment to bold moves, but they are carefully chosen for emphasis to minimize

Figure 4. To what extent do you agree or disagree with the following statement: In my organization there is a clear differntiation in planning time horizons at each level of the hierarchy
(Votes received: 754)



strategic risks. This approach enables them to learn about alternative models in the highly competitive and constantly changing context of the computing industry.

Raynor and Weinberg also recommend differentiation in time horizons for various levels of the business. They believe such differentiation is critical because the "corporate office" needs to help the organization create a portfolio that is designed for both growth and for creation of strategic options that help diversify and manage risks. They said that hierarchies work well when each level's time horizons are different. The board may be looking 15 to 20 years out, for example, the C-suite 5 to 10 years out, while divisional leaders are making decisions now in the face of uncertainty, and functional departments are delivering on commitments already made. Everyone is focused on a time line that they believe best suits their respective roles in managing current and future risks.

The presenters concluded by taking issue with some long-standing, conventional thinking about strategic management. They emphasized that addressing strategic uncertainty requires creating strategic options for the future— which is even more important than making the right strategic choices on the moment. And, uncertainty, they said, should be taken seriously, planned for, and prospectively "managed" as effectively as possible in order to create and preserve opportunities and value for the organization over the long term.

Driving Enterprise Value

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