THE ART OF DECISIONS

How to manage in an uncertain world

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Introduction

Once the ritual slaughter of the chicken was completed, the entrails were examined. The bloody mess was considered in silence, the expectant hunters jostling to get a glimpse. More moments passed in silence until the destination of the hunting party was declared. Excitedly the men dispersed to prepare and say farewells. Confidence was high; the hunting would be good.

For countless thousands of years, we have been turning to oracles, priests, and magicians to help us make decisions. Should we go to war? Where is the best hunting to be found? British economist and statistician Ely Devons was Director of General Planning during the Second World War and in an essay (1961) likened the "desperate search for trend signs" in economic statistics to ritual magic. He was struck not only by the futility of the science of prediction but also by the "very large numbers of magicians and witch doctors" that the government employed. The value of forecasting, he came to believe, was not in its accuracy but in its public acceptance. The hunters could have argued for days seeking a rational justification for hunting in one direction rather than another. The magician's intervention stopped the argument. It was no longer subject to debate; they would set off united. For Devons, the economists' models had the same function. There may have been very little validity in their predictions, but they did provide a framework that everyone could accept. Part of the power of magic is that if the prediction is wrong and the hunting disappointing, it is never the magic that is discredited. The reading may have been incorrect, but the oracle is never wrong. And so with the economists' models. There is nothing wrong with the science, but we promise that next time we will use better models, better data.

For most of human history, we had gods to make the difficult decisions for us. They were continually directing the path of every object and the fate of every soul. We may have been ignorant of our destiny, but we could be confident that the universe was unfolding as it should. But gathering momentum through the Enlightenment has been the idea that we can shape the future, that we can control our own destiny. If we could uncover the laws of society and of economics then, just as Newton's laws had given us control of nature, we could control our future. For the past 100 years, management science has been trying to uncover the laws that govern how organizations operate. The aim is simple. If we can understand the rules that govern organizations and the rules of trade, then we can design better and more effective organizations and management practices. We will no longer have to rely on trial and error to find out what works. A science of management will take us to a sunlit upland of efficient organizations and fulfilled individuals.

Theories have been developed to improve nearly every aspect of management. Some of them analyzed the triumphs of the great decision makers and then abstracted general principles (inductive theories). Others, borrowing the deductive logic of the physical sciences, outlined logical procedures that would inevitably improve performance. Rational models of decision making have been developed specifically to help us overcome the influence of emotion and subjective judgement. They offer prescriptions that call for a cool, dispassionate evaluation of the facts and promise to identify the best of all possible futures. Armed with these theories, we have been able to look back into the recent past and explain both today's failures and today's successes. The management textbooks and lectures are littered with stories that illustrate good and bad decision making. Each anecdote is selected to illustrate the explanatory power of the theory. And, just like the magician's ritual magic, it is never the science that is found wanting. It is always the individual manager who didn't read the signs correctly, who didn't follow the prescribed procedure. Looking backward in time, it appears easy to explain how we arrived at today. Like walking backward through a maze, there seems to be an inevitability about every route chosen. But now, standing before the maze, choosing the right path every time it divides doesn't seem so easy.

The compass that seemed so reliable for directing us backward through the maze is spinning wildly when we turn to face the future. How are we to choose one path rather than another? Rigorous application of scientific management theory, personal judgement or just guess and hope? With the theories faltering when we need them most, we have to conclude that luck must play a part.

Somewhat surprisingly, the word "luck" seldom if ever appears in the explanations of success and failure in the management literature. But I am in no doubt that luck has played an enormous part in my unusually varied career. It a career that has allowed me to see the decision-making process from every angle. I have managed international companies for global publishing groups, managed the launch of a new Internet venture in the late 1990s, spent four years as an investment director in the private equity industry, and then more recently built up a portfolio of investments in small early-stage companies. I have had to face the challenges of planning and deciding as a manager within a corporate hierarchy, as an entrepreneur, and as an investor of both my own and other people's money. I have worked in the seemingly unchanging world of book publishing and the second-by-second world of Internet retailing. I have been swept away by some of the technology changes that the past decade has wrought and stood there marvelling at how many of the old economy business models continue to thrive.

Luck was most prominent when I was establishing the online community www.babyworld.co.uk in 1997. It was luck that had brought me into contact with the willing business angel when the venture capitalists who would have thrown money at us a year later had all said no. Luck that saw Freeserve launch the UK's first free dial-up Internet service that sparked the UK Internet boom in the first month after we were funded. Luck that saw Freeserve buy us out as it became apparent that we had neither enough cash nor a sustainable business model in those early Internet days. And then, most of all, luck that Freeserve (later Wanadoo) kept the business alive through the worst days of the crash, only to sell us back the assets in 2003 just as Internet advertising and e-retailing were becoming sustainable business models. I am not sure that even one in a million monkeys with Excel spreadsheets could have come up with that business plan.

Why is luck never discussed? Because, according to the science of management, it isn't needed—we are the architects of our own destiny. After all, the promise behind each new management textbook is in essence, "Do X and you can have Y." X is a snappily packaged management practice, and Y is whatever you desire—growth, profits, wealth, etc. Its a claim that has much in common with the snake oil salesman who knows that if you promise something people want, then they will believe. These claims are based on two assumptions—both of which are false. First, that management theories have the same predictive powers as scientific laws and, second, that in a chaotic open system such as the global economy, we can necessarily make confident predictions about the future. Most management books are selling the hope of achieving certainty—a promise they can't deliver on. In this book I am going to tackle the question of how we should approach decision making once we accept that we can't control the future—how to manage with uncertainty.

Finally, giving up our dependence on the dream of certainty has a profound impact on how we look at the process of management. New metaphors are required. The dominant metaphor (starting with Taylor) is still the manager as machine operator, reading dials and manipulating levers to maximize the output from a machine—albeit a complex machine and with some of the mechanism hidden from view. In its place I offer the image of the manager as poker player—making investment decisions with the future always uncertain. Or the manager as explorer, charting unfamiliar territory and aware that the instincts acquired at home may not apply in this unfamiliar land.

One of the themes of this book is the gulf between what the management scientists have told managers how they "ought" to behave and how they actually manage. For decades it has been assumed that the theories were right and the managers uneducated or lazy. In fact, we now see that managers have been instinctively managing uncertainty and making effective judgements. Managers have been using their own judgement to make decisions quickly and effectively on minimal information—distilling past experience to help manage the future. This has proven effective in environments we know well. But what happens when we have to make decisions, as we must from time to time, in unfamiliar environments?

I will look at the power and pitfalls of intuitive judgement in decision making both in familiar and unfamiliar environments. You will see how we can uncover rules of thumb from the diverse worlds of poker and from agile programming methodologies to provide a guide to the art of making decisions in an uncertain world. This book is about the art rather than the science of decision making. Learning to let go of the myth of certainty and to manage effectively in a profoundly uncertain future is the key management skill for the twenty-first century.

Chapter 1

The Anatomy of Decisions

There is a mythology about decision making that is reinforced in the way decision makers are portrayed in film and on television. There is one pivotal moment and one all-or-nothing decision. His (it is nearly always a man) word setting in train a series of actions that will ripple outward for years changing lives—destiny unfolding. But, contrary to this popular image, most decision making is the mundane daily task of allocating resources. They're decisions that don't stand in isolation, but build on each other. Decisions made with other people's money and which therefore have to be justified. This chapter looks at the key characteristics of managerial decision making.

The $35 Billion Dollar Gamble

It is January 10, 1995, and Robert E. Rubin has just been sworn in as President Clinton's Secretary to the Treasury. Straight after the ceremony, Rubin is going to meet with the president and give him a very uncomfortable choice. The alternatives are stark: lend the Mexican government $35 billion dollars of American taxpayers' money, with no certainty that the money can ever be repaid; or sit back and watch the Mexican government default on foreign debt, causing a collapse of the Mexican peso and the inevitable consequences of rampant inflation, a prolonged recession, and massive unemployment. Not an easy decision for Rubin's first official day on the job.

The dilemma was not motivated by altruism toward Mexico and its people. The issue was, straightforwardly, about American interests. The consequences of a collapse of the Mexican economy for the U.S. was well understood. The previous crisis in 1982 was still fresh in political memory. The likely immediate consequences were predicted to include a 30% increase in illegal immigration (500,000 additional economic refugees), an increase in cross-border drug movements, up to 700,000 U.S. jobs at risk—in all between a 0.5% and 1% reduction in U.S. GDP. The indirect consequences of a Mexican default were immense but less quantifiable. They included an increased risk that other developing economies would default on loans and initiate a global recession. But apart from putting U.S. taxpayers' money at risk, there were other potential downsides from the decision to support the Mexican economy. Investors who took a known risk by lending money to Mexico would be "bailed out," potentially encouraging poor private investment decisions and making a repeat of this situation more rather than less likely. By intervening, Rubin would risk creating a bubble around investors, protecting them from "moral hazard."

The good news is that Rubin was not alone in his deliberations. He was supported by Alan Greenspan and Larry Summers. All of the outcomes were bad—it was a question of finding the least bad option. As Rubin reported in his frank and revealing memoir, *In an Uncertain World*, "[we] all came to a rough consensus… the risks of not acting were far worse than the risks of acting." Clinton agreed, and preparations were made to loan the better part of $50 billion (including funds from the IMF). As February slipped by, Mexico's foreign reserves dwindled to $2 billion, and default was a matter of a few days away. Much of Congress, which a few weeks ago had fallen under Republican control, was instinctively opposed to the "bailout." Congressional support was uncertain and likely to take at least another couple of weeks to secure. This only raised the political stakes for both Rubin and Clinton—if the intervention was to be made, it would have to be done *without* congressional approval. On the eve of the first $3 billion transfer, and with a unilateral "right to withdraw" still available, Rubin and his colleagues tried to evaluate the chance that the financial support would succeed in stabilizing the Mexican economy and stop the capital flight. There was no science there, just an approximate weighing of probabilities. Their estimates of the chance of success, Rubin recalled, varied from "1 in 2" to "1 in 3" against. He imagined the question that he would be asked at the inevitable congressional hearing, "So, Mr. Secretary, you thought that there was only a small chance that sending billions of dollars of American taxpayers' money would help? And you sent the money anyway?"

Rumors that the U.S. might back out the deal leaked into the markets, and the peso was falling rapidly. What would you have done?

What Do Managers Do?

Answering this question has filled miles of library shelves and occupied thousands of hours of lectures. Today's managers are required to play an ever-expanding number of roles: coach, controller, evaluator, visionary, monitor, resource acquirer, communicator, salesperson. A new role seems to be added with every new management book that makes it into the bookstores. But it's not that complicated. There is one role that managers cannot delegate or avoid. The one role that will be used to judge their effectiveness long after the team-building sessions and SMART objectives have been forgotten. Managers are paid to make decisions.

You *may* be paid to make decisions about the goals of your organization. You *will* be paid to make decisions about how your organization's resources are deployed to meet goals that have been set. The resources you control can be as varied as your own time, your departmental budget, a $10 million capital investment program, or a $1 billion war chest for acquisitions. Everyone from the CEO of a global corporation to the newly appointed departmental manager is making decisions about how best to deploy resources—once-a-decade strategy decisions, annual budget commitments, weekly target setting, minute-by-minute allocations of our own time.

The decisions we make as managers share some fundamental characteristics. They are usually made with someone else's money and therefore need to be justified; they build on one another and don't stand in isolation; the outcome is important to other people; and they are surprisingly forgettable—at least by us.

Decisions with Other People's Money

Unless we are working alone as a self-financed entrepreneur, we are always making decisions about how to deploy resources that are, at least in part, owned by other people. Rubin was steering a decision on what to do with $35 billion of U.S. taxpayers' money (not the easiest owners to please). There is nothing like running a business you have funded yourself to make you strikingly aware of the difference between spending your own money and spending it on behalf of shareholders. I admit to sometimes finding it easier to commit $1 million of shareholders' money than $10,000 of my own. It shouldn't be true, but most business managers will admit it—at least to themselves.

Decisions that Need to Be Justified

Because we are deploying assets owned by others, we have to account for our decisions. Rubin is very aware of how difficult it may be to justify his decision when he conjures up the questions at an imaginary congressional hearing. All too often the decision maker will select the route that can be justified to others. As we will see later, the rational and analytically defendable decisions are not always the best. An instinctive judgment, which can't be captured in bullet points on an overhead or calculated in the cells of a spreadsheet, can sometimes be correct. A lifetime's experience can be distilled into a hunch. But telling the shareholders you lost money on a hunch is seldom a winning strategy in the game of corporate survival. A wrong but logically plausible decision can look a lot more appealing than the intuitive judgment that others don't share.

The rational and analytically defendable decisions are not always the best.

Decisions that Build on Each Other

In business, in politics, and indeed in life more generally, no decision stands alone. Each decision builds on decisions taken the day or month before, layer after layer. This may sound obvious and unimportant, but contrast this with the stand-alone decisions that are the standard fare of textbooks on chance and decision theory. These discuss isolated decisions about which stock to pick, which horse to back, the expected gain from drawing a red rather than a black ball from the jar. Each of these discrete decisions can be judged a success or a failure in its own terms and, apart from influencing the weight of your purse, does not influence the next stock pick or your betting on the next race.

Contrast that with the manager who, over the course of a year, may decide which candidate to employ, what tasks to give him, how to monitor and support him in his new role, how to evaluate his performance, and finally whether she should terminate his employment for underperformance. Each decision builds on previous decisions; each decision is taken as more information becomes available. It's a constantly changing framework for her next decision. Navigating your way successfully through this tangled web of interlocking decisions is the mark of a good manager—the essence of good business judgment while keeping your sights on the overall goal.

Decisions that Matter

Being more aware of the way we perceive and judge risk in an uncertain business world can help us make better decisions. Does this matter?

It can matter for us personally, of course. The better our decisions, the more likely we are to enjoy a successful career (although we can all think of exceptions to this observation). But imagine if, over the long run, all managers were able to make better decisions about the way they allocated resources. The world would be, unquestionably, a better place. There would be less money wasted, less time wasted, fewer careers blighted. Just pause for a moment and reflect on the money wasted on various dot.com dreams at the turn of the last century. This wasn't paper money earned cheaply in a rising stock market. The billions spent on PR consultants, technical research on products nobody wanted, fictional business plans, and executive remuneration packages was hard-won cash from pension contributions and personal savings. It was all spent on the promise of abnormal gains by taking (what turned out to be, in most cases) ludicrous risks. Understanding how we reach business decisions is an important undertaking. What was the opportunity cost? What could have happened if we had invested that money in another way?

Decisions that Will Be Forgotten

Revisiting previous decisions can be a sobering experience. I spent four years at the height of the technology asset price bubble as an investment director for a venture capital company. It wasn't a time when that profession covered itself in glory. From the vantage of half a decade, it is easy to see the mistakes we made, the assets we overvalued. But we rarely look back. If the outcome is good, we rewrite our own history—forgetting the doubts and uncertainty that plagued the earlier decision—constructing a confident path to glory (much of business autobiography falls into that category). When the outcome is not good, we remember our doubts and reservations—we recall how we "knew" it wasn't going to work.

Other people also twist their recollection of decisions. Once the outcome of a decision is known, we tend to misremember what we thought at the time, when the outcome was still uncertain. This isn't motivated by political expediency but is a consequence of the way our memory works. Instead of recalling our previous decision, we rerun the mental process that led to our original prediction. Only now, with the benefit of hindsight, we also know the outcome. This knowledge of the outcome then becomes part of the evidence we use when we recall our initial prediction. It is called the *hindsight bias*—a tendency to believe that we predicted what actually occurred, when in fact we forecast the opposite. What is even more disturbing is that experiments have shown that we are unaware that the knowledge of the outcome is affecting our judgment. We genuinely believe we were right all along. This can explain what happens when the project you championed fails. Your colleagues who originally supported the project will now claim they always had their doubts. It isn't only office politics; the hindsight bias means they are convinced they were always right.

The $35 Billion Gamble—Revisited

So what happened in the U.S.–Mexico saga? The money was lent by the U.S. and the IMF to the Mexican government. A tough series of economic measures were imposed, which led to rising unemployment and a fall in real wages, and in the early months the peso continued to fluctuate in line with international confidence in the program. By as early as the start of 1996, the Mexican economy was growing again. In the crisis of the early 1980s, it had taken seven years for Mexico to be able to borrow again from international capital markets; in 1995 it took just seven months. The last of the loans was repaid in January 1997, including $1.4 billion of interest.

Rubin's telling of the episode (2003) illustrates many traits of the good decision maker. The money involved is beyond most people's imagination, and the outcome would make a difference to millions of lives. It is difficult to imagine a more unforgiving stakeholder than the U.S. taxpayer, and with Congress divided, there could be no sharing of responsibility. And yet Rubin, aware that his decision would be impossible to justify if the attempt failed, backed his instinct and his analysis. But then, blessed with a happy ending, he never forgot that it could have turned out differently—there is no rewriting of history to flatter the storyteller.

But this episode also illustrates another characteristic of decisions—outcomes are often not clear-cut, and our evaluation of an outcome as either good or bad can change over the course of a few years. The cloud around this particular silver lining started to emerge just two years later. Perhaps encouraged by the bailout given to the Mexican bondholders, there was a surge of investment in emerging markets.

The bailout of Mexican bondholders in 1995 was followed by further packages of support for Thailand and South Korea. Finally, in July 1998, at Rubin's urging, the IMF arranged a $23 billion bailout for Russia. There seemed to be no financial crisis the IMF and the G7 couldn't fix. Western banks and other investors had put billions into emerging markets—reassured by the knowledge that if things got bad, the cavalry would always come riding over the hill. With this apparent safety net in place, investing in emerging economies looked like a bet that couldn't lose. But only a month after the initial rescue package, Russia did what nuclear powers were not supposed to do—it defaulted on its debts. But this time there was no Rubin-inspired bailout. As Morris Goldstein (1998) put it, "The fund and the G7 finally managed to say no." This time the message finally got through to investors. No emerging market was safe. It set off a flight of capital, not just from emerging markets but from all investments perceived as high risk. The "moral hazard bubble" (Edwards, 1999) was finally punctured.

The Challenge

For more than a century, economists and management thinkers have been telling us how to manage and how we should make decisions. Again and again in the course of this book, we will find examples of the gap between what the theorists tell us we ought to do and what managers actually do. The theorists tell us we should make decisions using careful logical steps; in practice many of our decisions are intuitive. The theorists tell us that emotion has no part to play in rational decision making; in practice emotional responses are essential to decision making. The theorists tell us that we should evaluate all of the possible choices and select the one that maximizes our utility; in practice we look at only one or two options and often only one aspect. The theorists tell us that the optimal decision should be independent of context; in practice we make different choices if are winning or losing, to achieve a gain or avoid a loss, if we are feeling rich or strapped for cash.

Until the past decade or so, it has been assumed that because we don't do what the theorists prescribe, we are bad decision makers—emotional, subjective, and easily led astray. The only remedy was a more diligent application of the theory. We were being told to try harder. This view is starting to change. It turns out that in many ways humans are very sophisticated, practical decision makers. Our judgments in many situations are far more subtle and complex than the rational theories we are encouraged to adopt. Many of the textbooks still advocate a purely rational decision-making model. More recently there have been a number of authors celebrating our intuition and emotional wisdom. My aim in this book is to help you understand the nature of business decision making. To look at what works and what doesn't so you can understand both the power and the limits of intuitive decision making.

Humans are very sophisticated, practical decision makers.

The science of management is in many ways a very sick patient. It's a patient who stands up and gets about with the help of two crutches: one is that the world is ultimately predictable; the second is that we are, or at least should be, rational decision makers who do whatever it takes to maximize our own wealth. Both crutches need to be kicked away. What we will find is that the manager can walk perfectly well unaided. In fact, we can prosper if we learn to live with uncertainty and with a knowledge of how we really make decisions. The challenge is to be better decision makers—not by denying our instincts and following rational theories that can't work in the real world but by understanding the strengths and weaknesses of how we do make decisions and by learning to handle uncertainty.

In Other Words...

Every day managers are making decisions about the allocation of resources. Even the unconscious act of leaving resources deployed in the same way as yesterday is a decision. They're decisions that are made, more often than not, with other people's money. And because they are made with other people's money, you need to be able to justify your decision. These decisions are important: to the shareholders, to the staff and other stakeholders, to you as decision maker—you have the power to create value or destroy value. But these are also decisions that get forgotten or are misremembered. We focus on our successes and forget our failures. Hindsight bias means that we also believe we chose correctly more often than was the case. We are not as good at decisions as our memory suggests.

Which Means That...

- Every time you make a decision, however trivial, pause to consider how your decision is changing the deployment of scarce resources: attention, people, technology, money.
- Be aware of the extent to which you have to justify your resource allocations to people (usually other managers) who represent the interests of those who own the assets. In some organizations this can involve a disproportionate amount of time.
- It is easy to think you are a better decision maker than you really are. Selective memory and hindsight bias can make you overconfident. Keep a record of every decision you make.
- Start to become self-aware when you make decisions. What goes through your mind? Which factors are considered? Which are ignored? This isn't about criticizing your mental deliberations but about increasing your awareness about what is often a barely conscious process.

Rules of Thumb...

10 ♦ Record your decisions to calibrate your judgment.

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