Interview: Why Good CEOs Make Bad Moves

Eric Jackson
01/27/09 - 05:04 PM EST

Sydney Finkelstein is the Steven Roth Professor of Management at the Tuck School at Dartmouth College. He authored the 2004 No. 1 business best-seller, Why Smart Executives Fail, based on extensive research on what causes successful companies run by smart executives to suddenly drive off a cliff in terms of performance.

The book is as relevant today as it was in the post-Enron world of Sarbanes-Oxley. Indeed, it seems we haven't learned much from that period and have set ourselves up for the current -- even more serious -- economic decline.

I've known Syd for 12 years and worked on consulting projects with him. There are few people in Corporate America today who understand what drives CEOs and Directors as well as Syd.

He's about to release his new book, which he co-authored, called Think Again: Why Good Leaders Make Bad Decisions and How to Keep It From Happening to You. It's published by Harvard Business Press and is coming out next month.

I caught up with him earlier this week to discuss the current market environment, what caused it and what we can learn from it. The following is a transcript of our discussion.

(Note: I will also be writing an upcoming RealMoney article, where Syd discusses specific investment recommendations based on his research.)

Jackson: As someone who teaches and consults with CEOs and Boards, what surprises you most about what we've lived through in the last 12 months?

Finkelstein: There are three things that stand out to me. Number one: Why are there no people protesting in the streets? I find it hard to believe that people are so passive. We've all been witness to a high-jacking of the economy by many corporate executives and boards in the name of higher profits without adequate risk-protection.

Now, our government is deciding in its wisdom to dole out potentially trillions of dollars in our money -- without clarity on if it will work. The average person is losing his job and half of his 401k. Maybe we don't understand it; maybe it's a generational thing. We should be more upset and demanding more accountability.

We did a panel discussion recently at Tuck. There was an economist talking about the bailout and why TARP made sense. There was an investment person talking about potential return on investment for taxpayers with TARP. I talked about everyday people's reactions to what was going on. The bonuses which are considered Standard Operation Procedure on Wall Street are so far removed from the man-on-the-street. There was a major disconnect that still exists and needs to be bridged.

As a professor, I've given a lot of talks in my career, but I can tell you I've never had such a strong reaction as to that talk. Staff people, students, regular people from Hanover [New Hampshire] all came up to me...
afterwards. It touched a nerve with them. There are real people struggling out there now and just can't relate to the fantasy world of expected bonuses and $87,000 area rugs.

The second thing that strikes me about what's going on: Where are the shareholder activists? It's been astonishing to me to watch the growth of these activists in the last 10 years (including what you were able to do at Yahoo! (YHOO Quote - Cramer on YHOO - Stock Picks) using the Web). But where is Carl Icahn now?

The sad part of the activists' success in the past few years is that our Boards of Directors are so inept that we have to rely on outsiders to correct the problems which should be solved by management and boards within their own companies.

The third thing I notice is how little the so-called experts know about what we're living through. This is concerning for someone proud of America and our economy. Nobody really knows if TARP is the right answer, or how to make banks lend, or whether we should buy up toxic assets. As you can guess, I meet a lot of smart people from business, academia and government at Dartmouth and I can tell you that nobody knows what will work. And yet we're betting hundreds of billions of dollars on this.

Jackson: Well, who's to blame? Is one group more to blame more than another.

Finkelstein: Look, none of us is innocent. From people wanting to buy a bigger house than they could afford, to mortgage brokers, to the press, regulators, and even business schools. We've all got our fingerprints on this.

But is one group more deserving of blame? Yes, the corporate boards ultimately let these companies get in way over there heads on their watch. This wasn't malfeasance. It wasn't illegal. It's just that they didn't provide any oversight. They're supposed to ask questions and not just go along. They decided it was o.k. to accept high risk and high leverage.

I don't mean CEOs get a pass for driving their businesses for big bonuses. However, our system of governance is most to blame.

Jackson: Why do smart leaders make bad decisions?

Finkelstein: The way people actually make decisions is not at all how textbooks say we do and that's what this new book is all about. We don't identify a set of alternatives and weigh them with a best expected value in their head.

Jackson: We're not "rational economic beings" like economists argue?

Finkelstein: No, and we've known that for some time now. The data just do not support that view. We have evolved to make very quick decisions to get along in life. We generally make one plan at a time at the moment. We then run with that solution.

Jackson: Sounds like TARP.

Finkelstein: It's exactly like how TARP was developed. The role of emotions is paramount to making decisions. We have emotional tags tied to each decision we make. Some tags are stronger than others. Our brain remembers the tags that are most positively or negatively charged. We look at these tags with the most emotion when making current decisions and it shapes the choices we make. All this operates at the subconscious level. These processes have been developed by our brain over time and are very useful -- most of the time.
Problems occur when we start to face situations in our current environment which don't match situations we've faced in the past. We need to be conscious of our decision-making process and not succumb to past emotional choices.

There are four red flags we talk about in the book to be on the watch for in real-time, when facing new types of problems: (1) misleading experiences when we think we've encountered a similar situation in the past but misjudge its similarities to the current situation, (2) inappropriate attachments when we are making decisions about a group or people with whom we have past ties, (3) misleading pre-judgments when our past decisions color current decisions, and (4) inappropriate self-interests when we have different personal interests than the stakeholders we represent.

**Jackson:** Do these red flags apply to Dick Fuld [former CEO] of Lehman Brothers?

**Finkelstein:** Sure. With Dick Fuld, the biggest thing he did that ended up hurting Lehman was believing he could fix the mess instead of selling the company sooner. No suitors were willing to take a chance. He'd driven down his negotiating power. John Thain [former CEO of Merrill Lynch (acquired by Bank of America (BAC Quote - Cramer on BAC - Stock Picks)) -- leaving aside his interior decorating decisions -- saw the writing on the wall sooner and sold Merrill at a premium when he could.

Fuld also fell prey to misleading experiences. During the Long-Term Capital Management (LTCM) crisis in 1998, there was global uncertainty about what would happen and Lehman and Fuld got themselves through that. He came out looking like a hero. His experience taught him that he could do it again -- and there were lots of people in the press, earlier in 2008, who agreed with him. He was over-confident. He assumed this time was similar to LTCM. But this crisis was far more severe.

Another red flag about Dick Fuld is the attachment story. He was credited with rebuilding the firm when it was spun out of Shearson in the early 90s. He thought of himself as a founder -- as if he was a Lehman. His over-attachment caused him to not want to sell. John Thain had no such attachment. He was looking to sell out at the highest price.

**Jackson:** Most would say President Obama is smart. He appears to have surrounded himself with talented people. He has enormous goodwill from the American public. What are the biggest lessons he should take from your work in order not to squander the opportunity he has?

**Finkelstein:** He appears to have the right management style with what we've found works. He delegates with appropriate oversight without micromanaging. That's a real art. He also pays attention to the importance of symbols and customs. A lot of leaders have no clue about just how important it is to pay attention to the symbolic things that people always remember. He also appears to engender real debate without getting bogged down by analysis paralysis. I think his biggest risk is that he listens too much. At end of the day, there's only one leader and he has to decide.

I would also advise him, if he asked me, to never give up the high ground on values -- the fundamental values of what you believe in. He's come to power with a lot of high hopes. Compromise is important and part of the political process, but he's got to stick to some fundamental principals.

**Jackson:** I was struck by what you said in the book about pattern recognition. Hedge funds have gotten their share of the blame for the current mess. Many funds built quantitative models with bright PhDs in math, computer science and physics to predict the future. When the world changed, their models were found to be worthless and resulted in billions in losses and redemptions. If you were advising a hedge fund picking up the pieces now, how do you do pattern recognition correctly?

**Finkelstein:** A lot of people in hedge funds attribute their success to their genius -- on the way up. You think they're doing the same now? Arrogance is an incredible warning sign for later tragedy. Every one of their quant
models was based on a set of assumptions. You have to understand those assumptions and whether your model is based on limited data.

The world changed. Going forward, they have to build new models and ensure they are monitoring and updating their assumptions as they go in a dynamic fashion instead of remaining static.

**Jackson:** You point out the risks of an over-confident leader. Shouldn't leaders be self-confident though?

**Finkelstein:** No one has ever been successful without self-confidence. Of course, you need a balance. It's tough but you need to find it. You have to be confident, willing and able, but you have to stay open to alternative points of views.

But again, boards play a big role in reining in out-sized egos. There are a lot of safeguards you should be aware of that we discuss in the book: avoiding yes men and ensuring a high quality of debate in group discussions. But there's no replacement for good governance. Boards need to be much more assertive.

**Jackson:** How do you do that? The SEC can't mandate assertive boards?

**Finkelstein:** You're right. Outsiders can't make it happen. It has to come from the boards themselves who are often self-perpetuating. You and I worked on a tool for boards to use to identify early-warning signs of problems. It wasn't a very successful tool because we found that most boards don't want to hear about the problems they have. No bad news is good news. And there's an army of consultants and search companies to always come around and compliment you.

However, the evidence of the last 12 months is clear: If boards don't do a better job identifying early-warning signs, their companies will fail. I guess that's my hope, that boards become afraid enough so that they'll make the necessary changes themselves. The government cannot regulate good governance. We're talking about quality of decision-making and interaction here. You're not going to be able to put something like that in a Sarbanes-Oxley.

**Jackson:** How should CEOs and boards safeguard themselves against killing their companies?

**Finkelstein:** Do you have high-quality debate in your management team or board or are you an "imperial CEO" who has driven away anyone with a different opinion than you? Are you surrounded only by "yes men" or a bunch of weak consultants telling you what you want to hear?

Boards need to be regularly monitoring the strategy of the company against a set of predetermined yardsticks. It should be like a well-run venture-backed company: *You don’t get your next round of funding until you hit your metrics. Is the board regularly discussing the risks facing the company and are they working on mitigating the risks?*

Finally, each director -- no matter how much they like their CEO or other members of the management team -- has to constantly remind themselves that they are the last backstop for shareholders and for other stakeholders. Don't let a stellar career go up in smoke because you didn't ask that extra question. Understand what the company does for customers, and exactly how that translates into profits and shareholder returns. That's one thing that no board member can outsource.

**Jackson:** Thanks, Syd.

*Think Again* from Harvard Business Press will be available in February.
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