

# THE COMPETITIVE EDGE

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## DAMNED BY DELUSIONS

Like lemmings, the executives of Fannie Mae, Freddie Mac, and now Lehman Brothers and Merrill Lynch have led their companies over the cliff into the sea of ruin. More to follow. The cost to us taxpayers will be over \$1,000 billion. That's probably about \$10,000 out of your pocket.

The country's credit markets are in a mess. Trust is in short supply. To get loans will be more difficult and more costly. If we are lucky, the new rescue plan will work and this thing will have a soft landing next year. If we are not lucky...but I digress. The point is this: the crisis should remind us that the penalty for bad decisions can be catastrophe; delusions lead to bad decisions.

The current crisis arose because too many people were deluded by too many bad decision frames, frames which blinded them to the likely consequences of their actions.

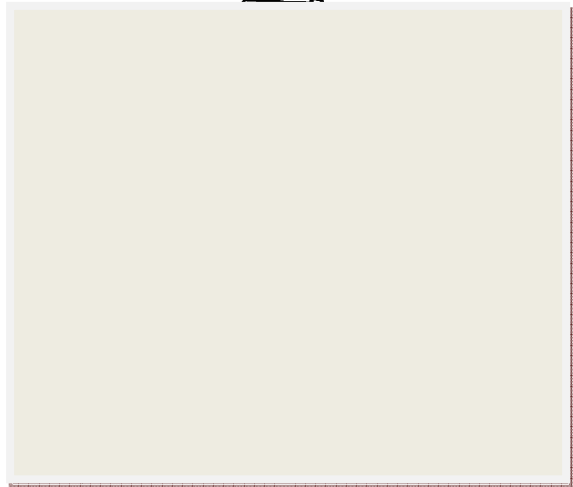
- The Federal Reserve under Alan Greenspan kept interest rates too low for too long, creating an environment of easy, cheap credit. The Fed was blind to the potential for excess this created.
- Banking executives were deluded by the belief that new ways of selling off risk would allow them to discard prior prudence in lending. They believed their math wizards, who were themselves deluded into thinking their mathematical models were reality when, in fact, their models ignored completely the most serious real risks.
- The executives at Fannie Mae and Freddie Mac were probably deluded by their belief that their excessive risk taking could be sustained.
- Home buyers were deluded into thinking they could get in over their heads because home prices would continue to rise. They ignored all the alarm bells sounded by Economics 101 that price increases could end.
- Congress was deluded into thinking it was fine for Fannie Mae and Freddie Mac to loan out 50 times their capital, when 10 times is prudent. But then, it seems, Congress is often deluded.

The message from the credit mess is clear: check your assumptions. For any important decision, make sure your assumptions are valid. Note the number of people in the current credit mess who made decisions based on bad assumptions.

Don't follow their lead over that cliff. Identify all key assumptions related to your decision. Challenge them. Is there supporting evidence? Is it out of date? If an assumption is weak or false, change it.

It can be difficult. People are more comfortable with old beliefs and mindsets, right or wrong, than they are with change.

Difficult as it is, you must remove bad assumptions to make good decisions. So, toss out the cherished falsities.



### **No Delusions at Southwest**

Last month, Southwest Airlines reported a profitable second quarter, continuing its long string of profitable quarters. Meanwhile, other airlines reported dismal results. Southwest's operating efficiency is legendary. Its business model is designed to generate low-cost flights. But Southwest did more. It recognized three years ago that fuel prices were likely to go up. To protect against such cost increases, Southwest purchased futures contracts covering 70% of its fuel requirements through 2010. These contracts provided Southwest with fuel at the equivalent of \$50 per barrel, half the current price. No other major airline was as aggressive in hedging, typically protecting only 25% of fuel cost.

Was Southwest lucky or smart? Smart. The futures contracts were an insurance policy. If fuel costs had declined, Southwest would have covered the contracts and purchased fuel in the current market. The cost of the futures contracts would have dinged earnings a little, a small price for avoiding a big risk.

Other airlines were deluded into thinking that fuel costs would rise only moderately. They fell into the trap that many executives do in thinking about the future behavior of costs that are uncertain. They extrapolate too much from the past, are overly influenced by the most recent data, and use too narrow a range of estimates for future costs. Most people are terrible at estimating uncertain quantities, such as the future price of aviation fuel or future home sales.

The trap of bad estimates can be avoided only by using a well-structured, self-correcting process for estimating the uncertain quantities. The process must go beyond trend following and must correct for the estimation errors people tend to make. It seems likely that Southwest is using such a process to avoid being deluded about future fuel prices.

If a significant part of the cost in your business is related, directly or indirectly, to one or more commodities, you would do well to consider hedging those costs and to base your hedging decisions on good estimates of the likely range of prices for those commodities in the future.

### **No Delusions About the Downturn**

Your strategy for the next two years should be based on the assumption of an anemic economy. Don't be deluded into thinking the economy will rebound. The credit crisis and high energy costs are still working their way through different industries. The poor economic climate means prior assumptions need to be reviewed and often revised. Three major ones to consider:

1. Assumptions about capacity. A common tendency is to shrink capacity in a downturn. Dow Chemical has consistently done the opposite, adding capacity that it uses to gain share when the cycle turns up again.
2. Assumptions about how to improve competitive position. You may be in a position to gain customers from competitors in a weak market by well-targeted adjustments in price and services.
3. Assumptions about prices. With the downturn, sensitivity of demand changes. This means that your optimum price changes. In a weak economy, the cost to serve certain customers may rise to the point that you lose money on sales to them. Pricing policies may need to be adjusted, but in a manner that preserves relationships with customers you do want to keep because they will be profitable later.

If you sail into the weak economy basing decisions on assumptions from a strong economy, expect trouble. View the weak economy through the lens of opportunity and you will like the results.