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A Behavioral Risk Metric

Perth Leadership Institute's predictive framework assesses human factors in management and "an individual's innate ability to generate profit," says founder E. Ted Prince

By Katherine Heires August 3, 2018

Behavioral risk is not just an academic pursuit for Perth Leadership Institute. The Gainesville, Florida performance-improvement firm has developed behavioral, leadership and financial assessment programs, along with a related framework and training that can help put individuals as well as teams and companies on the path to profitability, says chief executive officer E. Ted Prince.

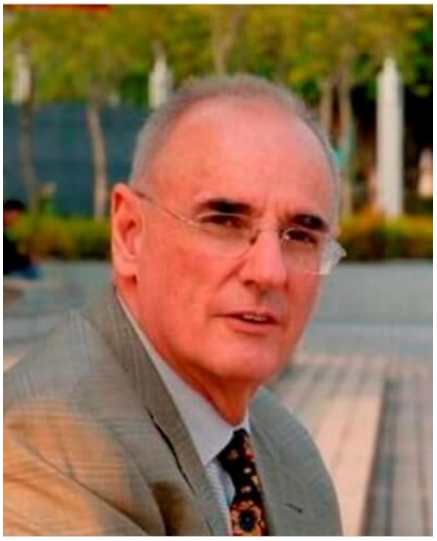
"Risk managers need to understand how training in behavioral finance, along with the framework we've developed to assess an individual's innate ability to generate profit, can help them build a behavioral risk profile and rate individual decision-makers," says Prince, who founded the research institute 15 years ago and is the architect of its . Leadership Outcome Model. They can then integrate this information into their own risk frameworks, he says.

These capabilities are important, Prince claims, because the 2008 crisis and ensuing recession "showed that traditional risk frameworks have limited worth."

He is quick to add that he does not advocate that risk managers dispense with those frameworks, but rather that they understand their limitations.

"The problem is that when you look at the numbers in traditional risk frameworks, you are looking at lagging indicators," Prince says. Perth's behavioral framework aims to address this issue by assessing and accounting for the human element in the here and now – that is, the behavioral risk factors displayed by those leading a company or team.

Prince believes that such knowledge could have brought management limitations and critical risk factors to light more quickly in troubled tenures such as those of John Sculley at Apple (and Steve Jobs' first go-round as CEO before that), Marissa Mayer at Yahoo and Jeffrey Immelt at GE.



Perth Leadership Institute developed a behavioral science framework for "the real world," says CEO Ted Prince.

Major corporations turn to Perth Institute, Prince says, to assess the effectiveness of their leadership teams. The behavioral assessments aim to provide a prediction of financial outcomes at the individual management or group level, based on the specific behaviors of the leading players and their teams. Perth positions this offering as "a new model of risk" that links directly to financial and valuation outcomes. The assessment and training program is offered in two-day or slightly longer sessions and can be followed by post-training coaching.

Perth's Genesis

So how did this program come about?

Prince gained considerable management insight while serving as CEO of several start-ups – including Boston software company Clearstory (formerly INSCI Corp.) and Computer Power Group of New York – and sitting on some 20 boards of directors. But it was when he worked as the U.S. partner of an Australian venture capital fund, and having to recruit a CEO for a software company, that he learned a great lesson.

Working with a head-hunter, he identified someone who he thought "had everything; he was personable, narcissistic, but a natural sales guy." Several months later, he noticed that the CEO office was twice the size, with new and expensive furniture, despite a strict budget. It was a sign that the CEO was running the company into the ground. "The company eventually got sold to a competitor for a pound," Prince recalls.

He began to think about a way of testing individuals to determine their innate propensity for driving a company to profitability.

“When I started out, I assumed that all of this had been done before by others,” Prince says.

This was back in 2002, the year that Daniel Kahneman, a psychologist, won the Nobel Memorial Prize in Economic Sciences – shared with Vernon L. Smith – for his work in behavioral economics.

Beyond the Academics

Prince, who has MA and PhD degrees in political science from Australia’s Monash University, came to see a connection between his behavioral interests and those of academicians studying behavioral economics and cognitive bias, including the premise that individuals often make unconscious decisions that defy rationality.

He decided to incorporate some of the new thinking into his program, though he has developed his own proprietary research and related psychometric testing to assess personality traits, abilities and attitudes – with the assistance of Neil Voorsanger, an expert in psychometric design and a Perth Leadership Institute partner. That took behavioral science a step further to focus on identifying behavioral drivers or signs that can signal a propensity for revenue generation.

“This is work that behavioral scientists might have developed, had they ever worked in the real world” and had to contend with shareholders and the constant demands for stock-price appreciation, Prince asserts.

Cognitive Biases

Prince chose to focus on two cognitive biases in particular: status quo bias and illusion of control bias. These are two of the 100-plus biases that academics have identified and studied that he believes can most strongly predict behavioral risk tendencies.

“Together they measure your value-adding capability and your resource utilization potential to a business,” Prince says, adding that when reviewed together, they produce a metric called a financial signature.

Psychometric questions posed to program participants – sent via email a month before Perth Institute training – are designed to reveal their level of have status quo bias, which can indicate to what degree they are innovators or disrupters of the status quo.

“The majority of individuals are not,” Prince notes. However, actual disrupters are high-value adding, capable of producing a high gross margin for a business. Prince puts a number on this assessment and then relates it back to a company’s income statement.

Illusion of control bias is a proxy for an individual’s propensity to spend money. A number assigned to that assessment helps to indicate how much an executive spends relative to a company’s revenue. “This allows me to identify big spenders like Elon Musk or Jeff Bezos rather quickly,” Prince says.

An analysis based on the two biases produces a two-dimensional rating for program participants and a more nuanced behavioral risk assessment.

Rating on one scale “would be too simplistic,” Prince says. Individuals can be high-risk in one dimension and low-risk in another; combining the two is more accurate for predictive purposes.

Putting Assessments Together

Prince explains that program participants receive three assessments. The financial signature reveals one’s innate behavioral tendencies, based on 35 questions. Another measures an individual’s financial mission or current revenue-producing tendencies, based on 48 questions. The third is a measurement of their company’s financial mission, based on 30 questions.

These metrics can help to predict not just an individual’s revenue producing tendencies, but also whether a team or company is on a path to make or lose money, and how well the person is aligned with the group.

“We look at two big things – the two cognitive classes – but overall we look at eight individual behavioral dimensions and trace them 48 ways,” Prince says.

The final scores place participants in one of nine financial signature categories, which are readings of their behavioral propensity to generate or consume capital.

A great challenge in all of this, Prince admits, is the fact that when some program participants receive their assessments, they can get defensive. But those who are agile will take the information and start to change their behavior – which Perth’s training and coaching program aims to help them do.

Other Applications

With his program based on behavioral and psychometric science, Prince has joined an expanding universe of thinkers and businesses seeking to relate these lessons to financial and risk management. (See Behavioral Finance and Risk Reconsidered)

Wealth managers, for example, incorporate such factors in gauging clients' risk appetites and preferences. Lenders in under-served or emerging markets where traditional credit scores are not available rely on alternative data indicators, such as mobile phone records and social media activity, to guide their decisions.

Looking to expand its reach, credit-scoring and analytics leader FICO has partnered with EFL Global, which on its website says that it has "10 years of experience applying psychometrics and behavioral science to loan repayment." "We are still in data gathering mode to further evaluate the effectiveness" of such techniques," says FICO senior director of scoring and advanced analytics David Shellenberger.

A Canadian start-up, Distill Analytics, applies psychometrics to profile management teams during quarterly earnings calls. Quantitative hedge funds factor this form of alternative data into trading algorithms.

"In the Right Direction"

Behavioral finance expert Hersh Shefrin, Mario L. Belotti Professor of Finance at Santa Clara University's Leavey School of Business, says that looking at behavioral biases as a sign of one's ability to generate revenue "is a move in the right direction." It can be helpful to risk managers in assessing management teams, as "there can be strong tensions between executive decision-makers and the risk managers who advise them. Some of this tension will be due to personality differences."

"My sense is that organizations will function more smoothly if these differences are identified and acknowledged explicitly, rather than downplayed or ignored," says Shefrin, who is the author of "Behavioral Risk Management: Managing the Psychology that Drives Decisions and Influences Operational Risk."

However, he sees limitations in focusing on status quo bias and illusion of control bias: "Risk appetite is not just about the person. It's about the circumstances the person finds themself in. The same person in one set of circumstances can be very conservative but will take huge risks in another kind of setting, so it's complicated to assess."

Shefrin says to keep in mind that risk appetite is influenced by multiple factors – genetics, hormone levels, neurological activation, to name a few. "There needs to be careful study of how strong are relationships among the various variables being measured and to what degree there is cause and effect."

Prince, not surprisingly, is convinced of the validity of his proprietary framework and believes that not just risk managers and corporate boards can find value in it, but also private equity and venture capital investors.

He envisions, in five years' time, every company having a behavioral risk metric that they will not have to calculate themselves or attend a leadership program to determine. "It will come up on the Bloomberg terminal and will tell them that XY CEO just got fired," he says, and depending on whether or not the CEO was a revenue generator, will adjust to show a rise or fall in behavioral risk.

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