HOW LEADERSHIP DEVELOPMENT CAN ADDRESS FINANCIAL AND CREDIT CRISES

Must Account for the Risk Behaviors of Leaders

Abstract

This paper draws together two strands which many leadership development professionals and business leaders might not have seen to be connected, namely market risk assessment/prediction and leadership development programs.

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Executive Summary

The current credit market crisis reveals a basic problem in leadership development, that is, the lack of programs to develop business acumen, particularly for the executives who are charged with the responsibility for risk, and especially the quants. It is highlighting the vulnerabilities of executives in both financial services companies, and companies generally in assessing and predicting levels of market and systemic risk. This White Paper from Perth Leadership Institute shows the link between behavior and financial risk and how leadership development programs can incorporate mechanisms to address it.

The vast majority of leadership development programs are based on either or both personality and competency assessments and approaches. However in neither case does the approach have any direct link with financial and market risk and market outcome. Research shows conclusively that personality assessments are not correlated with leadership outcomes. This is why most financial services companies tend to hold these approaches in low esteem, since they do not address the central issues of financial risk assessment and prediction.

Traditional approaches do not attempt to assess or develop business acumen. They tend to equate technical expertise and academic intelligence with business acumen, a very basic error. They tend to focus on a high level of learned and book knowledge as against the intangibles of business acumen and real-world outcomes. As a result, leadership development programs, particularly but not only, in financial services companies have led to a divorce between market risk and executive behavior, as distinct from executive learning and credentials.

This paper draws together two strands which many leadership development professionals and business leaders might not have seen to be connected, namely market risk assessment/prediction and leadership development programs. The link is indeed a tight one. Modern scholarship and recent developments in behavioral finance are opening up new ways to think about this connection and how we can use this knowledge to actually alleviate the potential for future problems.

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In order to address this problem, companies need to partly decentralize the organizational structure for managing risk and move from the current Boffin model of risk, in which a centralized, technical approach is adopted, to a partly decentralized model, which the White Paper terms the Rug Merchant Model, in which business acumen rather than business education or mathematical skills becomes the key qualification for being a member of this broader group that manages risk.

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Part 1 The Problem - Leadership Development and Market Risk

Traditional Leadership Development Approaches do Not Address Market Risk

The vast majority of leadership development programs are based on either or both personality and competency assessments and approaches. However in neither case does the approach have any direct link with financial and market risk and market outcome. Research shows conclusively that personality assessments are not correlated with leadership outcomes. This is why most financial services companies tend to hold these approaches in low esteem, since they do not address the central issues of financial risk assessment and prediction

Furthermore, while compliance approaches may result in legal and process transparency, they do not result in any more transparency in the behavior of the decision-makers that actually create, develop and distribute the products that lead to financial risk issues – that is the traders, investment banking professionals and other players in the financial markets.

Traditional approaches do not attempt to assess or develop business acumen. They tend to equate technical expertise and academic intelligence with business acumen, a very basic error. They tend to focus on a high level of learned and book knowledge against the intangibles of business acumen and real-world outcomes. As a result, leadership development programs, particularly but not only, in financial services companies have led to a divorce between market risk and executive behavior, as distinct from executive learning and credentials.

Where leadership development approaches have addressed risk, they have usually done it from a psychoanalytic perspective. Issues raised by the psychoanalytic approach include excessive narcissism, neuroses, risks in interpersonal functioning, and, sometimes, clinical risk. Team and individual coaching programs have usually focused on these psychoanalytic approaches to the exclusion of financial behavioral risk directly tied

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market risk and financial outcomes. Thus while they may be very good at assessing risks in interpersonal and social functioning, decision-making style and professional sagacity, they still do nothing to fix the basic problems that have contributed heavily to the existing and previous financial crises.

Market Crises Will Continue Past the Current One

The current credit market crisis is leading to an even stronger focus on leaders and leadership. It is showing the vulnerabilities of both CEOs and their staffs in assessing and predicting directions in the financial markets.

As a result, we have to view the current financial and credit issues as being more than market issues. *They are also leadership issues*. Both the senior business leaders of these companies, and the executives charged with the responsibilities of leadership development need to think long and hard about how leadership development systems and programs may have actually contributed to the crisis. More importantly, they will need to consider how these programs could alleviate the potential for them in the future.

The current credit market crisis is just one in a long line that stretches back from as long as humans have been able to record them. The conditions that led to it will continue to operate and we can confidently expect that there will be many more. This White Paper will explain what the common elements are in the genesis and development of these market crises, from a behavioral perspective.

The fact that future market crises will be inevitable should be a call to action on the part of leaders and leadership development professionals."

The fact that future market crises will be inevitable should be a call to action on the part of leaders and leadership development professionals. They need to consider the actions they can take to address the root causes of these crises which are in their control. Primarily, this includes the behavior and decision-making processes of managers and executives in their firms who are charged with the responsibility of assessing risk and of executing financial programs which are part of the overall financial risk system.

This paper draws together two strands which many leadership development professionals and business leaders might not have seen to be connected, namely market risk assessment/prediction and leadership development programs. The link is

indeed a tight one. Modern scholarship and recent developments in behavioral finance are opening up new ways to think about this connection and how we can use this knowledge to actually alleviate the potential for future problems.

In order to do this, senior business and human resources leaders need to learn about new developments in behavioral finance and leadership development and, to some extent, be prepared to unlearn some of the knowledge they have taken to be a given. It is only by

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preparing our minds for a fresh approach that we can generate the new and game-changing programs that will be needed to implement totally new ways to control market risk based on behavioral approaches.

Methods to Assess and Predict Systemic Market Risk Do Not Work

The last 50 years have seen the rise of new approaches to dealing with risk in financial markets. Broadly speaking risk approaches have undergone three phases:

- Phase 1 Conventional statistical risk approaches
- Phase 2 Game theory approaches
- Phase 3 "Quant" approaches based on methods from the physical sciences

The **Phase 1** approach relied on conventional statistical analysis to analyze markets and to draw inferences from them. It was based on conventional Gaussian approaches with predefined normal-like distributions. Experience has shown that conventional statistical approaches are of very limited utility in predicting the strategic, as distinct from the tactical, direction of markets and hence they have fallen largely into disuse for most real- world financial market risk analysis.

The **Phase 2** game theory approach was adopted in an effort to address the failures of conventional statistical approaches. Game theory approaches are still in use but mainly in the academic world rather than in the markets. They may be of use in ex post facto explanations of market movements, but again are of little to no use in predicting market movements and market risk.

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The **Phase 3** approach, commonly known as the quant approach, is widely used in financial services companies. Based on mathematical methods and concepts from the physical sciences, the quant approach develops algorithms within a dynamic context in order to exploit market inefficiencies and to profit from them.

In the short-term these methods can work well. They work best in working within the current market parameters and when fundamental market conditions do not change much. They also work well when most market players are using different risk assessment approaches.

However when market assessment and risk approaches come to be copied across most market players, these methods tend to break down in managing system and strategic, as distinct from non-systemic and tactical market risk. Stated differently, once most players use the same methods to assess risk – as has been the case in the last few years – and when risk assessment essentially becomes a mono-culture, then quant methods break down and become effectively of little or no value in trying to protect against systemic

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risk. This was demonstrated with crystal clarity by the failure of Long-Term Capital Management in 1998. LTCM was founded by Nobel Prize winners in economics and its methods were based on the quant approach.

The current credit crisis was also not predicted by the quants. It forms yet another case- study in the failure of Phase 3 approaches to assessing and predicting market risk.

All three phases of financial risk management have shared one common assumption. That is, that financial risk management is best assessed by technical experts who possess deep knowledge of various branches of mathematics and statistics. This corps of expert

analysts has been viewed as elite whose methods are not capable of being shared and used generally by their non-technical colleagues.

This implication of technical preciosity has led to the presumption that expertise and success in market financial risk management can derive only from a small group of people whose technical knowledge is rare and unique. We call this the **Boffin** model of market financial risk management.

The Boffin model entrusts the responsibility of risk assessment to technical experts who have PhDs in mathematics and the physical sciences which is seen as being able to generate insights that will accurately be able to manage market risk.

The Boffin model is a modern version of the theory that led the British to hire Latin scholars to run the British Empire on the assumption that these linguistic and classical skills would generate insights that would lead them to have superior success in managing unknown foreign peoples. It is also the same process that led to the view that psycho- analysts grounded in Jungian and Freudian theory would provide insights that could lead, variously, to solving mental and emotional problems in people and, most recently, that would be able to generate effective leaders based on these insights.

As we shall see, the Boffin model has effectively displaced other models of risk management which may well have been vastly more effective at assessing and

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predicting directions in financial markets. This conclusion has very important implications for leadership development, not only in financial services companies, but also other companies which need also to make predictions of market financial risk in order for their own businesses to have long-term sustainability.

A High level of Business Literacy May Actually Increase Market Risk

The reigning assumption in the corporate world is that high levels of business literacy will reduce market risk. By "business literacy" we refer to the possession of business qualifications such as an MBA or more technical skills in economics or finance.

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Yet a body of data is emerging which suggest otherwise. In his pioneering research, Jay Zagorsky[1] at the University of Ohio has shown from US census data that high IQ is directly correlated with income but, within certain IQ ranges is actually inversely correlated with wealth. Data from the Perth Leadership Institute suggest that possession of high academic or professional qualifications is inversely related to business acumen. This includes the possession of a business degree including an MBA.

Clearly the possession of an MBA does not confer any advantages in terms of an ability to make money for their companies otherwise we would see a systematic bias for MBAs to be more successful than non-MBAs in running companies. This is demonstrably not the case.

Many companies are conducting what they call "business acumen" courses as part of their leadership development programs. These are usually courses which teach basic

"Financial and non-financial services companies are both adopting this basically erroneous approach."

financial skills such as reading financial statements. These courses should properly be called "business literacy" course since they signally do not assess for business acumen or teach participants what it is and how to improve it.

Financial and non-financial services companies are both adopting this basically erroneous approach. However it does demonstrate that many companies are slowly becoming aware of the fact that they need to formally address business acumen in their leadership development approaches, even if they have not yet developed the right vehicles to achieve this.

The Quant Approach is a Major Contributor to Systemic Market Risk

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The role of the quants in the current market cycle has been major and its failure is increasingly evident. The Long-term Capital Management fiasco led to fears of systemic risk and breakdown and only intervention by the Federal Reserve Bank saved the day.

In the current crisis, quants also were a major contributor due to group think which led to all taking similar actions and all similarly failing due to the same factors. This group failure was exacerbated by analysts in the ratings companies, whose technical risk models, derived from quantitative methods of their own making, failed to anticipate the radical risk represented by the subprime sector in the first place.

In addition to group pressures, the quant approaches failed due to their reliance on psychological processes which were assumed to be analogous to social processes, an assumption which turned out to be invalid. In effect the quants did not integrate into their models behavioral approaches, specifically behavioral finance approaches, which could have revealed that the level of market risk was increasing rapidly as business acumen levels declined.

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The quants were not able to do this because they themselves were a ***key part of the group of players who had reduced levels of business acumen***, that is, they were not independent observers at all but a key group in the mix of players that caused the market problem in the first place.

The quant models assumed that they were independent spectators who do not affect market risk. What they and the leaders of many of the financial services firms have not appreciated is that their ***risk assessors are key actors in generating and exacerbating market risk***. As long as they continue to operate on this assumption, market crises, once corrected will return again.

"…the quants did not integrate into their models behavioral approaches, specifically behavioral finance approaches, which could have revealed that the level of market risk was increasing rapidly as business acumen levels declined."

In effect the Boffin model of market risk actually is one of the key causes of market risk and market crises. As long as financial services firms keep this model, they will continue to generate market volatility and systemic risk without ever actually realizing it.

Behavioral Risk Varies with the Business Cycle

Hyman Minsky predicted in his work several decades ago that business recessions are an inevitable occurrence and driven by human nature.[2] As the market becomes hotter, the level of risk taken by both companies and individuals moves to increasingly high levels. As market returns increase, more marginal players are drawn in who take even greater risks. At some stage there is a correction, the market shakes out and is reduced to the strongest players. Then the whole process starts again.

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It is clear that this process is closely related to the levels of business acumen. As markets become hotter, they increasingly draw in players who have less or no business acumen and take more risk. These players are not just private individuals and consumers. They are also corporate managers, executives and CEOs as well as those formally having the responsibility to assess and predict market risk.

A rising tide lifts all boats and so corporate managers increasingly feel that it is their skill that has driven their success rather then market factors. At its peak, the market has the lowest level of players, both individual and managerial, from the perspective of their business acumen. At this point, market risk is at its highest and the number of players with high levels of business acumen is proportionately at its lowest.

Once the market shakes out and reaches its lowest level, the aggregate amount of

business acumen of the players is proportionately at its highest level and therefore market risk is at its lowest level. At this point the process of introduction of players with much less business acumen starts all over again.

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Thus we can see that the level of business acumen varies directly with the market cycle. As the cycle builds to higher levels, there will be more players with low levels of business acumen entering the markets. These players will still appear to be very successful and they will incorrectly attribute their success to their own skills and business acumen instead of market factors. Once the correction comes, they will be shocked by the turnaround and their own demise.

"Only those who have relatively high levels of business acumen and those directly associated with them will be spared."

This process does not differentiate between players, including executives and managers, who have high levels of business learning, business education and technical skills. Only those who have relatively high levels of business acumen and those directly associated with them will be spared.

Indeed, the process will actually tend to lead to even higher levels of risk-taking amongst these groups since they wrongly assume that their market successes derive from these factors (business education, business learning and technical skills). So these groups will tend to take even more risk because they feel they are protected by their own business education and technical skills. Such groups will therefore have even higher impact failures than other groups who do not possess appropriate levels of business acumen.

These processes are sustained and amplified by group behavior in which peers watch the successes of their colleagues and are driven to take even greater risks because of competitive and peer pressures and also because of the importance of image to their market branding.

Leadership development models such as the Boffin model that are centralized and focus on technical skills will therefore tend to exacerbate these problems by going along with these assumptions. Thus leadership development programs will usually

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become part of the problem by adding even more to group pressure and by supporting a centralized model which in fact exacerbates aggregate market risk.

Lack of Financial Self-Awareness is the Single Biggest Contributor to Market Risk

Many, arguably even most, executives have reached their current high position at least partly due to some level of happenstance or luck. This can include being in companies that are doing well and from which they garner an image of success, even though it had little or nothing to do with them. This is known as the Halo Effect.

Included in this group are executives that have reached their position due to being in the right place at the right time, having the right mentor, backing the right horse and so on.

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Of course, executives who reach their high positions rarely attribute their success to luck. The vast majority will attribute their success to their skill and, in some cases, to their superior smarts and genius. However many of these executives will reach a high position in which they fail and which leads to their demise, in many forms.

By definition, executives who attend leadership development programs are still on their way up and still around so they will invariably have not reached such a defining moment when they undergo such programs. Thus the effect of these programs is usually to reinforce the conclusion that the success of many of these executives – but not all - is due to their own skill rather than to other influences. Recent books by Nassim Taleb underscore this phenomenon.[3]

In the financial services industry in particular, this phenomenon results in senior leaders being reinforced in their belief that they have reached their level of financial performance due to their own skills and knowledge, rather than having being the unwitting beneficiary of the process in which a rising tide lifts all boats. This translates into managers and executives believing that they have mastered the elements of risk assessment and prediction when in fact nothing could be further from the truth. The Boffin approach

tends to strongly reinforce their confidence in their own skill in managing risk, even if they do not have any.

Most companies unconsciously promulgate the Boffin school of leadership in areas other than market risk assessment and most senior executives; whether or not they participate in such programs, go along with the thesis since it is much more comfortable to do so. The result in financial services companies in particular is to weaken the strength and validity of risk assessment and prediction approaches. In denying the role of luck, they

are also denying the role of other factors, including their very own lack of self-awareness, which is actually the greatest risk factor of all in risky market environment.

"Leadership development programs which do not attempt to counteract the phenomenon of

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Leadership development, through formal programs or informal approaches, perpetuates this systematic weakening of risk assessment by not teaching leaders about this phenomenon. Leadership development programs which do not attempt to counteract the phenomenon of denial of luck are in fact inadvertently adding to the market risk faced by their company by not teaching their people about the role of their own self-denying behavior in increasing market risk.

Leadership development, whether formal or informal, needs to systematically introduce the topic of the role of business acumen and luck in financial behavior so that market players can objectively understand how their own behavior actually increases market risk so that they can implement mechanisms to counter-act this in their programs.

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The current credit crisis owes much to the assumption by executives in the financial services companies in particular, and companies in general, that their formal risk assessment processes were technically sound and that their own executives were not part of the process that generates risk.

In effect, lack of self-awareness of business acumen or luck on the part of executives who play any part whatsoever in the development, distribution or marketing, and the acquisition of financial products is itself a major contributor to the generation of high risk levels in the market.

Furthermore, this process is not just one that impacts financial services companies. Buyers of their services including companies that invest in their products, use them for financial advice (hedging, M&A, financial structuring etc.) also will be subject to the same phenomenon and will also be adversely impacted by their lack of awareness of this factor which will lead to them facing increasing systemic risk through their acquisition of financial services and products from financial services firms such as derivatives, CDOs and the like.

In effect, corporate consumers of financial services products generated by the financial services industry will themselves be as much as a contributor to the heightening of market risk because of their lack of financial self-awareness as will those financial services players who develop market products and distribute them.

…Leads to Financial Derailment for Executives

Marshall Goldsmith has recently published a book entitled: "What Got You Here Won't Get You There".[4] This is the restatement of a widely held thesis in the leadership education community that states that once you start getting near general management levels, you need to radically change your style to get any further, even to the point of doing things in the opposite way you did them before you started reaching such exalted heights.

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We can all agree with this proposition. However it has not been one that has been applied in the strictly financial and risk assessment area. Roughly stated, we can restate the Goldsmith proposition in the following way:

"...the more financial services professionals that apply the same risk approaches at senior levels as they did at more junior levels, the more market risk will increase,

In the risk assessment area, the financial behaviors that were effective at a lower level will be ineffective at your new level. This is akin to the Keynesian Error of composition in which more savings actually leads to less investment, not more.

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In the market risk world we can restate this as saying that the more financial services professionals that apply the same risk approaches at senior levels as they did at more junior levels, the more market risk will increase, rather than be reduced. One implication of this is that the more quants there are in any market, the more market risk will increase.

The reason for this is that they are all using the same models which do not take into account the impact on market risk of the people whose job is actually to assess it. In other words, the less these managers take into account their own impact on the system, the

more market risk will actually increase.

This is an area in which all companies, but *particularly financial services companies*

need to educate their staff, right from the junior professionals to the most senior ones, and particularly these charged specifically with the responsibility of assessing and predicting market risk. If this is not done, then market risk will continue to increase in the cyclical way we have described earlier and the system will regularly experience financial and credit crises.

The immediate implication for executives who are not aware of this is that they will

likely fail when they get into a more senior position when the market hits problems.

"Lack of financial behavior self-awareness will lead to the financial derailment of the many

Lack of financial behavioral self-awareness will lead

to the financial derailment of many senior managers and executives.

This will continue to lead to wasteful loss of otherwise talented executives and a loss of good human capital and corporate memory, with its

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attendant effects of inadvertently again increasing market risk. Leadership development can address this major problem by ensuring that this issue is formally addressed in leadership development programs and interventions and in executive retreats and seminars on market risk.

...And to Valuation Derailment of Companies

When financial derailment of executives occurs, it will often tend to lead to valuation derailment of the company. This occurs due to the ouster of the CEO and much of the executive team and the accompanying management disruption. Since the CEO may have been fired as an example, rather than having been the true reason for the company's valuation problems, there can be no guarantee that the next person will do any better, at least over the longer-term.[5]

Thus financial derailment of executives due to low levels of business acumen can easily lead to valuation derailment of their companies. And if this occurs across a number of companies in an industry, say financial services companies as is happening now, this can also lead to increased levels of systemic risk.

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It will also lead to changes in the competitive landscape as companies adjust to the differing levels of business acumen of the incoming executives. In effect, the levels of business acumen of the executives of the companies that constitute an industry drive the relative competitive positions of the industry's players. Those who have high levels of business acumen do better than those who do not. Thus the financial derailment of executives can lead to a chain of effects stretching up to the valuation derailment of companies and changes in competitive positioning of the companies in an industry.

Changes in an industry structure due to differing levels of business acumen of its corporate players may lead to more or less risk depending on the level of maturity of the industry and how many of the companies have high or low levels of business acumen. In a mature industry, more often this will lead to increased risk as innovative managers are screened out; witness the auto industry in the US. What we can say though is that levels of business acumen are intimately linked to industry structure, market maturity and the overall level of market risk.

Financial services companies need to understand these links in order to do their jobs better. Only by understanding these links can they become better at their core job, managing and profiting from market risk.

Part 2 The Solution – A New Financial Behavioral Approach

Firms Need a Behaviorally-Based Approach to Risk

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It must be clear from the foregoing that the lack of financial self-awareness is a key driver of market risk for both financial and non-financial services companies. The imperative is that companies address this issue as a way to reduce overall risk. In so doing they will reduce the level of systemic risk in the system and these actions will tend to reduce overall systemic risk.

We need to formally distinguish between tactical and systemic risk. Current risk approaches are quite efficient at addressing and leveraging tactical risk issues. This is where the quants and technical players have been quite effective. However it is in the area of systemic risk that current approaches have not been working.

Leadership development needs to be able to show the link between behavior and its impact on tactical and systemic risk. It needs to show which types of financial traits and business acumen tend to be more highly linked with the increasing of systemic risk and how behavior also impacts tactical risk. In providing these insights to both executives and technical players, companies will be showing the key players, who develop, market and

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distribute financial products, how these issues are linked and helping to reduce overall risk levels.

In implementing this approach, firms need to address the sensitive issue of the role of luck in career development and in financial outcome. Only by understanding this issue in a clear-eyed and clinical way can market players begin to understand that they are not independent observers but in fact key actors in the creation and management of market risk. This will lead to the development of new approaches to the management of tactical and systemic risk which can also be incorporated into the models of the quants.

"Only by understanding this issue in a clear-eyed and clinical way can market players begin to understand that they are not independent observers but in fact key actors in the creation and management of market risk."

It is also essential that leadership development address the issue of group behavior by financial and risk analysts to show how much of this behavior is due to irrational group factors. This can help compensate for the problem of ***mutually assured destruction*** – where all market risk players follow each other in a destructive cycle of risk-taking simply because everyone else is doing it and achieving such high levels of short-term returns that they can not resist the pressure to follow the herd.

Market players need to understand the group dynamics that impel risk into inevitable destructive cycles in order that this process can be moderated or even tamed.

Based on a Different Organizational Structure for Risk Assessment

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Earlier this White Paper has argued that much of the problem with the current approach to risk assessment is that it is based on the Boffin Model – a highly restricted class of technical experts is chosen to assess risk. The business acumen characteristics of this caste is assumed rather than known and statistically it is likely that only about 15% of them will possess the financial traits that enable them to assess and predict risk with relative levels of effectiveness.

The Boffin model, centralized as it is, is at the basis of the market risk problem. When the boffins fail, systemic risk results. Moreover the Boffins are not independent observers as they like to believe but an integral factor in the creation and amplification of market risk through the medium of escalating group behavior.

The Boffin model of risk is highly centralized and thus has all the usual concomitants associated with centralized approaches, namely that all eggs are in one basket and the lack of financial behavioral diversity results in a monoculture of financial behavioral types. They are therefore resistant to different financial behavior traits and influences, which means that they systematically filter out different behavioral assessments of market risk.

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However, while the root problem is one of centralization of risk assessment, the cure is not decentralization either. Based on financial behavioral approaches we can be sure that most people will not have the best financial behaviors to assess and predict risk. So the psychological attributes necessary for better risk assessment are still unevenly distributed. This means that any new model must be somewhat decentralized, but concentrated on these with better market risk and business acumen characteristics.

There are inevitably problems in this identification process. Some technical people with less business acumen will need to be included since they deal better with tactical and short-term risk. However this should occur only if they have been schooled in the principles of financial self-awareness and have enough leadership agility to be able to absorb and respond effectively to their own vulnerabilities in the area of business acumen.

We call this model the ***Rug Merchant model***. Rug merchants are very practical people who live by their wits, with their own, not other people's money. The ones with lower levels of or no business acumen quickly get filtered out. The remaining rug merchants form a loose and decentralized collaborative that shares their market assessments.

"An MBA will not be able to be a rug merchant unless he has had real-world success in managing a rug merchant business. If he comes in with just an MBA, he will only be of use in sweeping the rugs."

In other words, to participate in market risk assessment in the Rug Merchant model you first have to prove that you have high levels of business acumen. For rug merchants, formal qualifications are generally useless and suspect if they do not reflect real world experience in being a rug merchant. An MBA will not be able to be a rug merchant unless he has had real-world success in managing a rug merchant business. If he comes in with just an MBA he will only be of use in sweeping the rugs.

The Rug Merchant model recognizes that there are innate differences between people in their ability to assess and predict risk. It ensures that all market players are schooled

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in the principles of behavioral financial and financial self-awareness. It is not fully decentralized but is a community of players who have developed enough financial self-awareness to be able to include this variable in judging the validity or otherwise of their own market risk assessments as well as those of others in the market.

It is imperative that leadership development programs include this content in order to have a strategic impact on market risk and its associated outcomes, financial derailment of executives and valuation derailment of companies and institutions. Only by doing this can leadership development have a strategic impact on addressing market risk.

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Behavioral Finance Opens Up a New Approach to Leadership and Financial Risk

The traditional response to the above critique might have been that, while it is true, there are no models that demonstrate the link between behavioral and financial outcome. While this might have been the case some years ago, it is no longer true. The emergence of a discipline of behavioral finance opens up a new perspective on this linkage and work by the Perth Leadership Institute has expanded this understanding so that we can not only describe and model this link but also use it for the predictive purposes of financial and market risk assessment.

Traditional finance and economics rested on the fundamental assumption of rationality. Behavioral finance and economics have overturned this assumption to examine what happens when financial actors are either not rational or not totally rational, that is under conditions of what is called mixed rationality.[6] These disciplines have demonstrated that economic actors often make decisions for entirely irrational reasons, but are not aware of this fact.[7]

Until fairly recently, the assumption of mixed rationality was applied only to consumers. The literature tacitly assumed that executives, that is corporate economic actors, still acted rationally. But the incongruity of a notion in which humans act irrationally as consumers while they act rationally as managers has become clear.

Today behavioral finance is starting to recognize that corporate executives, right up to the very top, are just as likely to act from a motive of mixed rationality as they are as consumers. And like consumers, they are just as likely to be unaware of it. However it is still the case that most academics, if not business people, assume that there is asymmetry between the behavior of consumers and that of executives, that is, that the former tend to be irrational and the latter tend usually to be rational.

> ***"Behavioral finance has been almost totally ignored by traditional MBA programs and business educators."***

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A major problem is that these findings and their implications have still not filtered into either business education or into the general consciousness. Behavioral finance has been almost totally ignored by traditional MBA programs and business educators. So the academic consensus is basically that people with high intelligence and a high level of business learning, including a high level of some type of technical expertise, will be rational players.

Nor have the findings of behavioral finance found their way into leadership development approaches and programs. Technical experts and quants have been assumed by companies to be rational players when in fact they are, at the very least, equally prone to mixed rationality as anyone else.

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This has been amply demonstrated in the current credit crisis, not only with quants, but also all financial services companies including the ratings companies. This has reinforced the already strong tendency of these companies not to focus on business acumen in managers generally because it has been assumed that their quants and technical experts have enough already to go around for everyone.

Despite the conceptual advances that have been made by behavioral economics and behavioral finance, they still embody a basic flaw. That is that their conclusions only apply to groups of consumers or groups of executives. Behavioral finance and economics as they exist today can only apply their findings statistically at the group level.

These disciplines have not yet developed a model which allows the fundamental insight of mixed rationality to be applied at the level of a **particular** individual. Thus these disciplines can explain why markets act irrationally and predict that they, and the executives behind them, will continue to act in that way. But they cannot link the behavior of a particular executive or particular executive team and predict financial outcome because there has been no model of mixed rationality that can be applied at the level of the individual executive.

New Research Allows Assessment of Financial Self-Awareness at the Individual Executive Level

The research carried out by the Perth Leadership Institute[8] fills this gap. Its model identifies and models the financial traits and styles of individuals so that they can be measured and their impact predicted in terms of financial outcome and thus market risk.[9]

In effect this model, the Perth Leadership Outcome Model (PLOM) is a model of mixed rationality which describes the financial behavior of various degrees of rationality of individuals.[10]

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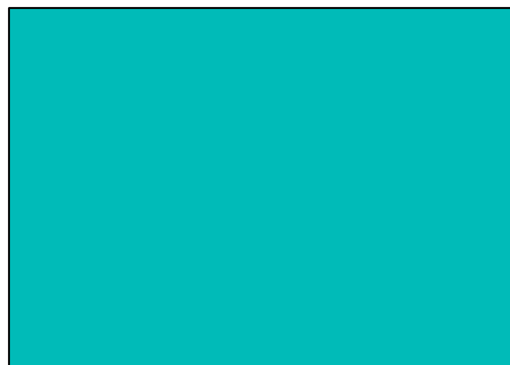
PLOM essentially identifies the level of business acumen possessed by an individual executive or by a group of executives and can predict, other things being equal, the financial outcome of their financial decisions, in terms of the market value of their unit or enterprise. In effect, PLOM identifies and measure the propensity of an individual to create or to consume capital. It accomplishes this through online assessments which operationalize the model and allow the

various financial traits to be measured psychometrically.

This research reveals that business acumen is distributed very unevenly. Only about 15% of the executive (and therefore probably the general) population have a sufficiently high level of business acumen that will lead to the creation of capital, as distinct from its



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consumption. The majority of executives and managers will either not create capital or they will consume it. The proportions of these last two groups in the population are approximately equal.

It turns out that what behavioral finance terms “mixed rationality” is the same as business acumen. The less rational the player the lower the level of business acumen. The higher the level of rationality, the higher the level of business acumen.

On this measure, most executives, around 85%, will make decisions which are skewed toward the less rational end of this spectrum. In other words, some irrationality in executive financial decision-making is part of human nature. When these executives get to be leaders of organizations they will make many or at least some somewhat irrational decisions and the level of financial risk for the company and the level of overall market risk, will increase.

The job of leadership development is to maximize the number of leaders who have high business acumen and minimize those who lack it, at least so far as their responsibility for market and financial risk is concerned. They need to increase the level of business acumen in the financial culture to improve the bottom line.[11] If they fail at this, overall market risk will increase and we will have a higher number of market financial crises, like the current one.

Companies Should Integrate this Approach into Leadership Development Programs

Leadership development programs have primarily been seen as preparing executives and emerging leaders for the non-financial aspects of leadership. These aspects include their

social and interpersonal functioning, their

“So leadership programs in most

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professional work habits and processes and their decision-making styles and approaches. All of these aspects are key leadership issues and executives who rise to the more senior positions need to not only understand them but also

master them in order to become functional and effective leaders.

However leadership development programs have not been seen as primarily preparing executives for the financial, P&L and financial risk aspects of their positions. As we shall see below, these have been seen as mainly technical issues because of the dominance of the Boffin model. So leadership programs in most companies have largely ignored the factor that leaders need also to possess as leaders, that is to accurately assess and predict risk and increase the valuation of their unit or enterprise.

This issue is of importance not just to financial services companies. This gap in leadership development cuts across all companies, in all industries and at all levels.

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Virtually all companies suffer from the consequences of this gap, namely leaders who are typically unprepared for the financial and profitability aspects of their role, as distinct from other aspects.

But the issue has most impact in financial services companies because they lead other companies in developing financial services and products that virtually all other companies consume. Gaps in the skills of the leaders of financial services companies – at all levels – affect all other companies through the mispricing of risk and over-consumption of risky financial products which not only increase the overall costs of consuming companies, but in extreme cases can lead to corporate failure and systemic issues.

"Gaps in the skills of the leaders of financial services companies – at all levels – affect all other companies through the mispricing of risk and over-consumption of risky financial products which not only increase the overall costs of consuming companies, but in extreme cases can lead to

Leadership development and human resources professionals have been largely unaware of this issue, even in financial services companies that one would presume would understand the issues better. Yet the link between leadership development and financial risk has never been more on show than in the current credit crisis.

Leadership development and HR people need to do more to understand this risk and to implement programs to help address it. There is a way to do this as this White Paper explains. But in order to start the process, leadership development – on both the HR and the business sides of the house – needs to understand the existence of this link, its importance, and to formally assume the responsibility for addressing it through the programs they develop and control.

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Integrating Business Acumen into Leadership Development Programs is a Must for Addressing Market Risk

The providers and consumers of financial services products all have a common interest in addressing the market risk issue. Both are equally involved although the financial

services providers need to take the lead in addressing the market risk issue. But we all live in the same financial ecosystem and all companies will be affected when market risk leads to economic corrections producing negative or no growth in the economy.

In another White Paper, we have set out the requirements for implementing business acumen programs in companies, see http://www.perthleadership.org/Documents/Business_acumenWP.pdf. But we would recommend the following to companies interested in trying out or adopting the approach set out here. These are:

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1. Assign someone in leadership development to research the issue and set out an approach for a pilot at the minimum.
2. Conduct a pilot with business executives that involves formally assessing their levels of business acumen and provide follow-up coaching.
3. Carry out a pilot on a team to assess the likely financial impact of the team and its market risk characteristics (will it add to or subtract from the overall level of market risk).

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