

Beyond Fear and Greed:

Capitalizing on Opportunities in the Current Crisis

By
Paul B. Carroll and Chunka Mui

Warren Buffett says his guiding principle is to “be fearful when others are greedy and greedy when others are fearful.” There’s certainly plenty of fear out there, and thus plenty of opportunities to get greedy. Greed, however, does not necessarily translate into wealth. In this article, we draw on our two years of research into more than 2,500 major corporate failures and our related consulting work to describe the landmines that companies are mostly like to hit as they try to capitalize on the turmoil that has roiled many markets since the summer of 2008. We also lay out a process for stress testing new business strategies, ensuring that greed does not send you down the wrong path and increasing the chances that you’ll pick a highly prosperous road.

The Opportunity

Even more than most economic downturns, what has been dubbed The Great Recession is fundamentally changing the business landscape. Many companies, long venerated, are falling by the wayside. Many others, not generally thought of as leaders, are emerging in dominant positions.

Little-known Golub Capital has raced past mighty GE Capital in lending to small businesses. New York Life got aggressive and leapfrogged AIG, Hartford Financial Services and Lincoln National in sales of life insurance and annuities—New York Life’s share of the U.S. market has jumped to 5.4% from 3.6%. Two builders, Toll and Lennar, are on a land-buying spree, taking advantage of others’ weakness. In one major deal, Lennar bought back land it sold in 2007, paying 18% of the earlier price.

Numerous markets will stay depressed or at least uncertain for several more quarters, or even years, so the change has just begun. Where companies will end up depends on their strategic choices in response to the crisis.

History is replete with success stories about those who made the most of recessions. Several of the “robber barons,” including Andrew Carnegie and John D. Rockefeller, took advantage of the Panic of 1873, which occurred after the bursting of the post-Civil War railroad bubble. They bought competitors at fire-sale prices and built empires. Southwest Airlines expanded rapidly in the recession in the early 1980s. Although it was a small upstart at the time, Southwest became a major force by the end of the decade, and CEO Herb Kelleher soon became a household name. After 9/11, while other airlines cut back, Southwest lowered fares and stepped up advertising to gain market share. It is now the most successful in the industry. Similarly, in the early 1980s, Intel was skating on the edge of bankruptcy. Yet it responded to horrible problems in the memory-chip market by making a bold move into microprocessors, where the company soon won a near-monopoly in the personal-computer market. Since then, Intel has consistently invested in additional capacity during downturns. In the process, it has outdistanced IBM, Sun, Motorola, Advanced Micro Devices and many other formidable competitors—making heroes out of Gordon Moore, Andy Grove and other Intel CEOs.

As Grove has said, “Bad companies are destroyed by crisis. Good companies survive them. Great companies are improved by them.”

A study of 400 companies in the last recession, by Diamond Management & Technology Consultants, buttresses his claim about the potential for improvement. It found that above-average performers increased their stock-market value by a total of \$350 billion

and improved their gross margins by 20 percentage points by the time the recession ended in 2004.

There are, however, also plenty of examples of strong companies that pursued the wrong opportunities in a crisis—the poorer performers in the Diamond study shed \$200 billion of stock-market value in the last recession. And this recession has been far trickier. There's a saying on Wall Street: Buying stocks in the kind of scary market we've seen over the past year is "like catching knives." You can buy stocks—or whole companies—but you might lose a hand in the process.

Look at Bank of America's decision to buy Merrill Lynch. BofA CEO Ken Lewis thought he got the deal of a lifetime, but now the combination is being referred to as one of the worst in memory. The mortgage-backed securities owned by the combined company may lose more than \$100 billion. Meanwhile, BofA's middle-class culture is having trouble absorbing Merrill's white-shoe brokers. Merrill's CEO, John Thain, has already lost his job, and BofA CEO Ken Lewis is very much on the hot seat.

Yet problems can be spotted ahead of time. Our two years of research into 2,500 major business mistakes of the past quarter-century and our work with consulting clients let us see, for instance, that the BofA-Merrill deal was wrong-headed. In our blog (www.devilsadvocategroup.com), we wrote in September 2008 that the BofA-Merrill deal seemed a lot like the fiasco involving Green Tree and Conseco that we covered at length in our book, *Billion-Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years*. Green Tree built a house of cards in much the same way that the sub-prime lenders did recently, then was purchased by Conseco. Conseco soon filed for bankruptcy protection, in the third-largest bankruptcy in U.S. history to that time. Digging into the details, it seemed that Merrill had played the role of Green Tree, while BofA was in danger of playing the role of Conseco, and that's certainly how things would have played out without government intervention. Even with the unexpected government help, BofA is in for a rough time. We also wrote on our blog that clothing retailer Steve & Barry's didn't seem to have a sustainable business model. Steve & Barry's was losing money on the sales of its inexpensive clothing but camouflaging the losses with onetime payments from mall operators to open stores in their facilities. The only way to sustain the fictional profitability was to keep opening stores. But how long was that sustainable? Obviously, not long enough. Private-equity firm Bay Harbour Management went ahead and bought Steve & Barry's out of bankruptcy for \$168 million—then announced three months later that it was liquidating the retail chain.

The question is, how do you identify and eliminate the clearly bad ideas and just focus on the ones that give you a chance of major success? To put it another way: If someone writes a front-page piece in the *Wall Street Journal* about you in two years, how can you make sure you're treated like Andrew Carnegie, Herb Kelleher or Andy Grove and not like Ken Lewis or the folks at Bay Harbour?

In this paper, we will lay out a process that will make it far more likely that you receive Andy Grove treatment.

The Starting Point

The place to begin is by assembling an array of possible ways to take advantage of the current uncertainty. These could be acquisitions. These could be moves to expand organically into new markets. These could be operational exercises to negotiate more favorable terms with suppliers, bring in fresh talent, change pricing or promotions, and so

on. On the flip side, this could mean taking a hard look at marginal businesses or untenable organizational issues, and acknowledging that the time has come to address them. This could mean divesting assets, reorganizing businesses, clearing out dead wood among employees, etc.

Our sense in discussions with numerous executives is that many have a short list of such strategic moves in their hip pockets, waiting for the right circumstances. It is important, however, to also take a systematic look to make sure that all plausible options are considered. There are no lack of suggestions on how to be thorough. We've seen lists of suggestions from Diamond, McKinsey and Accenture on where to cut and where to invest, and plenty of other firms are out there with ideas, too.

Once you have a good list, you should do a preliminary vetting and build business cases for at least your half-dozen best ideas. Doing so will help combat the tendency to become too set, too soon on a single possibility. Setting ideas in opposition to each other will help insure that only the best survive.

So far, so good. What we've described probably differs little from your normal processes. But now comes the hard part: separating the wheat from the chaff.

Our process begins by looking at whether your strategy is one of the seven that, according to our extensive research, most commonly lead to failure. They are: 1) attempts at synergy; 2) moves into adjacent markets; 3) financial engineering; 4) consolidation of an industry; 5) rollups; 6) the leveraging of what is expected to be a breakthrough in technology; and 7) "staying the course"—essentially, continuing to try to build the traditional business even though the industry may be changing. These seven strategies aren't always going to fail. Far from it. These strategies can also produce notable successes. Still, anyone pursuing one of these seven strategies needs to be aware of the red flags that we list in our book that can signal that the strategy is headed toward disaster. You should also run through the "Tough Questions" that are listed in the book and that are associated with each of those red flags.

We'll go through three of those seven strategies at some length here because they are the most likely to be pursued during the sort of recession we've experienced. The three are: moves into adjacent markets; consolidation; and staying the course. We'll also go through several mistakes that popped up frequently, regardless of the strategy being pursued.

Dangerous Strategies

Adjacencies

When companies succeed by moving into markets that they see as adjacent to their core markets, the reasons tend to be all over the place. But, when companies fail, they tend to do so for one of four reasons.

First, companies are making the move out of desperation, more because they're fleeing their core market than because they've found some great opportunity elsewhere. This will often be the case in a recession, as companies scramble to find some lifeline. Blockbuster, for instance, should have noticed this red flag before offering to buy Circuit City for as much as \$1.35 billion in the spring of 2008. It's true that Blockbuster has a tough road ahead, because of competition from Netflix and because movies will increasingly be downloaded digitally, not rented at a neighborhood store. But that doesn't

mean it made sense for a renter of movies to think it should start selling electronics equipment—something we said on our blog, at the time of the offer, long before it became clear that Circuit City was headed for bankruptcy court and now liquidation. Blockbuster is lucky that the purchase never happened.

Second, companies may overestimate the strengths they bring to that new market. This is the mistake that Hicks Waldron made as CEO at Avon in the mid-1980s, when he decided that what he called the company's "culture of caring" prepared it to operate retirement homes and manufacture medical equipment. Waldron had been a senior executive at GE, had turned around liquor maker Heublein and had been the favorite to be CEO of R.J. Reynolds after it acquired Heublein. He had also, memorably, faced down Donald Trump when Trump had the odd idea that he should buy Tiffany from Avon so he could knock out the wall that separated its flagship store from Trump Tower in Manhattan and make Tiffany part of the Trump experience. But Waldron's idea flopped. Medical equipment and retirement homes were not, in fact, adjacent to Avon's traditional door-to-door cosmetic sales. Avon began selling off all its acquired businesses, taking hundreds of millions of dollars in writeoffs, and Waldron soon retired.

Third, companies may underestimate the complexity of the new market. In the late 1990s, Laidlaw, for instance, thought its experience in operating school buses meant it could manage ambulance services. Laidlaw found, however, that ambulances were really a highly regulated medical business, not a transportation business. Laidlaw took more than \$1.8 billion in writeoffs.

Fourth, companies may overestimate their hold on customers. This has happened repeatedly and in many industries. In financial services, for instance, Sears incorrectly assumed in the 1980s that its customers would buy stocks through Dean Witter and would hire realtors from Coldwell Banker, both of which Sears bought so it could set up financial-services boutiques in its stores. Customers, however, felt no need to buy financial tools at the same place where they bought power tools. Sears sold the businesses in the early 1990s, having wasted years of management time that could have better prepared it for the onslaught known as Wal-Mart. Ed Brennan, who was the youngest CEO in Sears history when he took the reins in the 1980s, was pushed into retirement when his strategy cratered.

Consolidation

When consolidation moves fail, it's generally because companies focus too much on the opportunities being acquired and not enough on the problems at the operations being purchased. It's now clear that BofA made this mistake in acquiring Merrill Lynch. BofA's Ken Lewis was so convinced of the benefits of being a financial supermarket (just at the time that Citigroup is unwinding its supermarket strategy, while taking huge losses) that he agreed to buy Merrill after an hour-long conversation with Merrill's CEO. Lewis didn't take the time to understand thoroughly just how troubled Merrill's portfolio of mortgage-backed securities was, and it turns out that those securities were incredibly toxic. Lewis also glossed over potential problems that we highlighted at the time and that several Wall Street Journal stories have since said are occurring—BofA's brokerage operations have a very different culture than Merrill, so friction has occurred and many top people have left. We believe there is another shoe to drop, as well. BofA has said it welcomed the opportunity to move into investment banking through the acquisition. Yet BofA had tried investment banking on its own and ran away from that market, kicking and screaming. There is every reason to think BofA will have trouble making a go of investment banking this time around.

There are three other potential problems with consolidation strategies:

First, consolidation moves may fail because they produce so much complexity that they produce diseconomies of scale. US Air was solidly profitable until it purchased Piedmont in 1986 to become a truly national carrier. But US Air was unprepared for the jump in size, which led to \$3 billion of losses over five years. Among other problems, US Air's information systems broke under the stress. On payday, armies of secretaries often had to type checks manually.

Second, companies may assume they'll hold on to all customers, even though defections are inevitable. Many retailers made this mistake when they decided they could switch to, say, everyday low prices from a strategy of occasional, steep discounts, only to find that customers hated the switch.

Third, if a company assumes it should be the buyer, it isn't considering all its options. Often, it's better to be the seller. We wrote at the time that Yahoo was making this mistake when it declined to take Microsoft's money and run earlier this year—and CEO Jerry Yang's intransigence looks far worse now, of course, with Yahoo shares trading at less than a third of the price Microsoft offered and with Yang's replacement as CEO.

Staying the Course

The tendency in a recession is for all but the healthiest companies to hunker down and just try to survive to the other side. But staying the course can be misguided for one of three reasons:

First, people tend to see the future as a variant of the present even when great change is about to happen. The CEOs of the three major U.S. car makers, for instance, went to Congress in November 2008 to ask for a loan based on the idea that they would continue on their existing paths as they tried to bring high costs under control. They didn't seem to realize that they had an opportunity to completely reset their costs by hacking away at the excessive number of brands they offer, the dealer networks they use, and so on.

Second, people often evaluate the economics of a possible new business based on the economics of the existing business, not realizing that the profitability of the existing business is fading fast. This is the mistake that Kodak made throughout the 1990s when it couldn't quite bring itself to switch to digital photography. That new business offered gross margins that Kodak estimated at 15%, while the traditional business of selling film, paper and chemicals carried margins of 65% to 80%. Delaying the switch would seem to be a no-brainer. Yet the change was going to happen whether Kodak liked it or not, and Kodak misplayed the situation by continuing to invest heavily in a dying business while ceding many of the new opportunities to others. Just in the past decade, Kodak has shed more than two-thirds of its employees and lost more than 90% of its stock-market value.

Third, people may be ignoring some of their options—much as can occur when companies try to consolidate an industry. Pillowtex, for instance, continued its strategy of investing heavily to make its U.S. plants the most efficient in the country, even though, by the mid-1990s, it should have been clear that manufacturing of towels, blankets, pillows, etc. needed to be moved offshore to countries with lower wages. Pillowtex filed

for bankruptcy protection twice and liquidated in 2003, wiping out the thousands of U.S. jobs that the company had hoped to protect.

A recession can, in fact, be a great time to reconsider all options and straighten out problems with product strategies, with distribution networks, with wages and benefits, and so on. But companies have to be willing to rethink everything if they're to get long-term good out of a crisis.

Common Pitfalls

Leaving aside the particular strategy being pursued, our research found that companies were most susceptible to seven errors.

First, people tend to underestimate the complexity that comes with scale. While it is perfectly reasonable to argue for some economies of scale, i.e., that some overhead costs will drop as a percentage of the total business, companies often don't account for the fact that when they double in size they aren't just doing precisely the same thing twice as many times. They may be dealing in different markets, with different customers, different sales channels, and so on. This extra complexity is what tripped up US Air's consolidation strategy after it purchased Piedmont.

Second, people tend to overstate the increased purchasing power or pricing power that comes from growing in size. Doubling or tripling in size feels like a real achievement to those inside the company, but the outside world may not notice. If the company remains a small part of the industry, it still isn't going to get much additional purchasing, pricing, or other power. Loewen Funeral Homes Group increased in size by a factor of 100 in a bit more than a decade, owning more than 1,100 funeral homes by 1998. But the company never accounted for more than 5% of the U.S. market, so Loewen never achieved its goal of being able to dominate suppliers. The company filed for bankruptcy protection and was sold at a distressed price.

Third, people tend to overestimate their hold on customers. Companies sometimes talk themselves into truly strange ideas about their tight relationships with customers—only to find out that customers may well head next door when you put a new name on the door, change the pricing strategy, alter the product mix, etc. A study found that 80% of executives believe their company has the best product in the market, and that 8% of customers agree.

Fourth, people tend to rely on semantic games to rationalize sweeping strategic moves. Any strategy that relies on a turn of phrase—such as saying that railroads were really in the transportation business, not the railroad business—is open to challenge. This is the mistake that Avon made when it decided that its “culture of caring” qualified it to run a medical-equipment company and retirement homes, even though they had nothing to do with Avon's core cosmetic sales or its door-to-door sales force.

Fifth, people tend not to consider all options. We all live under the imperative to grow. We all understand that the survivors are the ones who are rewarded and remembered. Yet, certain attempts at growth are just a waste of money. Even harder, sometimes selling the business makes more sense than to hang on and, in the process, fritter away the value of the business. Just ask Jerry Yang about this point.

Sixth, people tend to overpay for acquisitions. But you didn't need us to tell you that. There's already a wealth of information about the fact that businesses often overpay when buying other companies and, in spite of that, continue to do so.

Finally, companies often don't manage risks very well. As we've seen in the recent credit crisis, this is true even for companies that have elaborate processes for measuring and managing risk and that devote an incredible amount of brain power to understanding risk.

Part of the problem is that the institutional imperative to keep increasing earnings can overwhelm attempts to say no to risky opportunities. Citigroup, for instance, suffered from a real case of Goldman envy. Citigroup saw Goldman making gobs of money trading for its own account and felt it had to get into the game, too, if it wanted to keep generating healthy earnings increases—even though Citigroup didn't have the decades of experience that Goldman had and was thus putting itself in harm's way. Interpersonal dynamics can also make it hard to say no. At Citigroup, for instance, a powerful office was established to evaluate risks. It was run by a capable person with a good pedigree, and it seems his heart was in the right place. But he had come up through the ranks with the two executives who were responsible for finding risks that Citigroup could take on profitably, and he was friends with the two. The person whose job it was to say no actually would wait outside his friends' offices for 45 minutes at the end of the day, so they could drive home together, according to the New York Times. As you can imagine, Citigroup's risk office didn't say no a lot.

The intricate models that underlie risk evaluation can also be a problem. That's partly because they are based on historical information, which, as we've learned, doesn't always predict the future well. Just because housing prices in the U.S. had never shown a sustained decline doesn't mean they couldn't, if conditions were right. Fannie Mae's risk models didn't even allow for the possibility of price declines, yet home prices plunged. The other problem with models is that they create a false sense of security. Numerous news articles have said that the executives running Wall Street firms—smart folks, all—didn't entirely understand how they could be making so much money off sub-prime mortgages and related securities. But the models prepared by Wall Street's so-called rocket scientists were so impressive that senior managers convinced themselves that someone, somewhere understood what was going on and was making sure that any risks were appropriate.

Our colleague Vince Barabba found an old line of his quoted recently about the danger of models. Vince—who has held senior strategy positions at major corporations, has written numerous books and has twice been director of the U.S. census—was quoted as positing Barabba's Law. It cautions: "Never say, the model says. . . ."

A Process for Making Viable Strategies Stronger, and Avoiding Strategic Mistakes

Our research found numerous instances where executives pursued bad strategies even though many members of the executive team or the board had a strong sense that trouble was brewing.

We'll say that a different way: It isn't enough to know that an idea is probably flawed. There has to be a method, agreed on ahead of time, for discussing possible problems and making sure they are given due weight. Otherwise, once a strategy starts to build

momentum it will steamroll any possible objections—just as Citigroup’s short-term earnings needs pushed aside any attempts to say that risks were too great.

A process that would have headed off a high percentage of the failures we studied is what we call a “strategy stress test.” Informed by the billion-dollar lessons derived through our research, the stress test uses debate, role-playing, scenarios and other analytical tools to bring to the surface not only all the problems that an executive team could already perceive, but also many that can be off everyone’s radar.

Armed with detailed information about potential problems, the executive team can improve the strategy or, in extreme cases, kill the idea before it costs a lot of money. The team can also use the information to negotiate a better deal, if an acquisition is involved, or to do a more thorough job of preparing for the integration of a business being purchased.

The stress test functions in a way that the team can tolerate. It doesn’t make the CEO or anyone else look bad. The panel that conducts the test acts as a trusted, confidential adviser who can, at least, preserve the jobs of the CEO, his subordinates and the board, while perhaps making lots of money for both executives and shareholders.

The stress test can be conducted quickly—in as little as a weekend.

The test provides three main benefits:

First, it creates a forum in which objections can be raised and addressed, before it’s too late. Often, it’s easy to see the problem. For instance, Blue Circle, one of the world’s largest cement companies, decided it should sell lawnmowers because cement is used in homes and, well, homes have lawns. It was easy to see that idea made no sense. The problem was that there weren’t any means for voicing objections once top management had set a general direction. Blue Circle stumbled so badly that it went into bankruptcy proceedings and was then sold.

Second, the panel makes sure executives understand all the assumptions they’re making. Florida Power & Light, for instance, decided it could take advantage of its strong brand and sell life insurance to its customer base—only to find that the utility brand didn’t extend far enough, because customers didn’t associate electricity with insurance. FPL, previously considered to be a very well-managed business, took a \$689 million writeoff to get out of the insurance business in 1991.

Third, the stress test panel makes sure that executives will notice if the environment changes and undercuts key assumptions. Motorola, for instance, conceived of its Iridium satellite telephone business in the mid-1980s, but it didn’t become operational until the late 1990s. In the meantime, cellphone service improved greatly—yet Motorola and Iridium didn’t see that all their assumptions about the potential market had been invalidated. Iridium was operational for less than a year before filing for bankruptcy protection. The system, which cost \$5 billion to build, had its assets sold for just \$25 million.

Blue Circle, FPL, Iridium and hundreds of other companies used their traditional strategy-setting processes to try to be careful about avoiding pitfalls, yet failed miserably, so it isn’t enough just to be aware and to try to be cautious. There needs to be a doublecheck, such as the stress test panel, that operates outside the normal strategy process.

Here's how it works:

A panel of three to five people is convened, led by someone who has credibility but hasn't been involved in the discussions that produced the potential strategy. That could mean an independent board member, a retired executive, a consultant, or, in the case of small businesses, an experienced friend. (It does not mean your investment banker, who has every incentive to push you toward some kind of deal.) The other panel members are chosen mostly for their expertise in asking different types of questions about strategy, marketing, and a range of other topics. Usually, it's a good idea to have one person with some familiarity with the organization and with the industry.

Once the panel is set, ideally it intervenes at three points in the strategy-development process.

The first panel review happens reasonably early in the strategy-setting process, soon after the strategic alternatives and their corresponding assumptions and stakeholders are identified and an initial course of action is chosen. At this point, the panel leads the executive team through a series of exercises designed to get them to debate each other and bring out all the tough questions. A key point: The debate is done through role-playing. That way, executives don't censor themselves out of fear that disagreeing with an option supported by the CEO could be a career-limiting move. After the debate, the panel produces a list of key assumptions, so the executive team can make sure it's comfortable with all of them. (The Blue Circle cement/lawnmower error could have been caught at this point.) The panel also produces a list of open questions where more information needs to be gathered before a decision is set in stone. (This is where the electricity/insurance assumption would have been tested and found wanting.) Often, gathering more information involves looking for what we call "history that fits"—while the tendency is to look for successful examples of strategies similar to the one being considered, "history that fits" involves finding examples of similar strategies that failed. Our database, with its 2,500 failures and counting, typically contains numerous examples of similar, failed strategies.

The second review happens when the strategy is more fully developed and the strategy team has a clear hypothesis on key issues such as business models, target markets, competitive forces and, critically, whether to build, partner for, or acquire the necessary capabilities. The panel reconvenes and examines the strategy in the context of the red flags associated with prior failures. It then stress tests each component. The panel, for instance, considers numerous scenarios to see how they might affect the choice. What if a key supplier goes out of business? What if the recession is longer than forecast? What if it's shorter? And so on. At this point, the panel considers what sort of margin of safety needs to be built into the strategy. Warren Buffett has long insisted on a belt-and-suspenders approach to his investing, and some research suggests that acquisitions shouldn't be pursued unless they work even if the numbers turn out to be 30% worse than projected.

The final review occurs when the strategy is complete, and the green light is about to be given. The panel convenes one final time to make sure that management has addressed all the concerns that have been raised along the way and hasn't just swept some aside (a very common occurrence). The final review is particularly important in situations where acquisitions are involved. In the course of assessing a specific acquisition, dealmakers often get caught up in the desire to complete a deal, sometimes making unstated compromises against, or even losing the connection with, the motivating strategy. The panel brings a fresh perspective to these issues, ensuring that potential red flags are articulated and examined. The panel also helps management con-

struct alarm systems, so executives will notice quickly if some key assumption is turning out to be untrue. (The alarm systems would have shown Iridium that it was headed toward serious trouble.)

Frequently, there isn't enough time to conduct an extended stress test, such as in the realm of mergers and acquisitions, where deals are opportunistic and time constraints are significant. For these situations, we've developed a short, intensive version of our review process. For more information, see our paper titled "Perfecting the Art of the Deal: Applying Strategic Stress Tests to Greatly Increase the Odds of M&A Success."

The stress test can even be applied to completed strategies, either as a method for building consensus or identifying implementation hurdles. In one case, a CEO of a major insurance company acquiesced to a review of a corporate growth strategy after it was adopted because the business unit executives responsible for a large part of the targeted growth expressed misgivings about its viability. The review found numerous assumptions that were, at best, dubious. For instance, a historical analysis revealed that no offering from any company in the industry had ever achieved the growth targets that the strategy required in the unit's target markets. It also required achieving a market share that even the company's best-performing products had never achieved. As a result of the review, the CEO eventually scaled back his expectations for the strategy, avoiding an over-investment in search of unattainable growth that would have crushed earnings.

Who Should Care About a Stress Test?

The CEO is the obvious candidate to apply the independent test, because he takes primary responsibility for major strategic decisions. By overlaying a formal review on the standard strategy development process, CEOs ensure higher quality while maintaining the option not to proceed. CEOs can also use the review process to build consensus among their management team and assure their boards of directors that the strategy is being subjected to rigorous analysis. Contrast this with the typical scenario where, as one CEO bemoaned, "the only thing harder than starting a major initiative is killing one." That's because CEOs usually expend considerable political capital to launch a major effort and, as a result, must maintain steadfast commitment or risk losing personal credibility.

The process can also be applied at almost any other level of the business. The board of directors should consider using it to broaden its dialogue with management and act as a doublecheck—lest directors be excoriated the way Lehman Brothers' board was after it failed to keep the CEO from running the company out of existence. A colleague who is on the Intel board says it uses a process like the stress test to structure discussions with the executive team, and it's hard to argue with Intel's success.

Executives below the CEO level can suggest this sort of process as a way of contributing to the broad discussion of strategy or as a way of protecting themselves from unrealistic expectations—the process brings to the surface potential problems, such as those that inadequate information systems can cause in a merger, rather than have them be glossed over and have unfair goals set for the CIO. Middle managers can use a variant of the process to vet their decisions.

Similarly, big private-equity investors can use the process as a doublecheck before buying troubled companies, so they don't end up like Bay Harbour Management, the

turnaround fund that thought it was grabbing a bargain when it swooped in to buy Steve & Barry's out of bankruptcy, only to be forced to liquidate just a few months later.

Even small investors can benefit from the sort of analysis that goes into the process because it helps spot problems with corporate strategy. On our blog (blog.devilsadvocategroup.com), we've used the process to identify likely winners and losers and have had a nearly unblemished record for the past three years. For instance, we wrote in 2006 that Oshkosh was pursuing a flawed synergy strategy when it decided to buy a maker of specialized construction equipment and combine it with Oshkosh's truck-manufacturing operations. Oshkosh paid \$3 billion in cash for the company. Even before the stock market fell apart last fall, Oshkosh's market value was less than \$1 billion.

Conclusion

If you can build more constructive contention into your strategy processes or into your investment analysis, you may still fail. After all, business is a contact sport. Companies win. Companies lose. But if you can catch your obvious mistakes—and our research found that almost half of strategy mistakes were obvious ones—then you'll be much less likely to fail and that much more likely to succeed.

You will catch some mistakes if you run through our red flags that indicate potential problems with various strategies—consolidation, adjacency moves, staying the course, and so on. You'll catch more potential errors if you also look at the mistakes that were most common, regardless of the strategy being followed. But, to really be safe, you can't just try to be aware of problems. You have to pursue something akin to our stress test to change the dialogue and make sure that you've carefully considered all potential problems, in a way that gives you a chance to improve or kill a strategic option without having anyone lose face.

If you can introduce more contention into the dialogue, you'll not only give yourself better chance of succeeding, but, despite the difficult environment, you'll also sleep better at night.

Paul B. Carroll and Chunka Mui are co-founders of the Devil's Advocate Group, an alliance of critical thinkers dedicated to helping business leaders increase the robustness of their strategies and increase the odds of success. They are also co-authors of *Billion-Dollar Lessons: What You Can Learn from the Most Inexcusable Business Failures of the Last 25 Years*. For more information, see www.devilsadvocategroup.com, or contact one of the authors at paul.carroll@devilsadvocategroup.com or chunka.mui@devilsadvocategroup.com.