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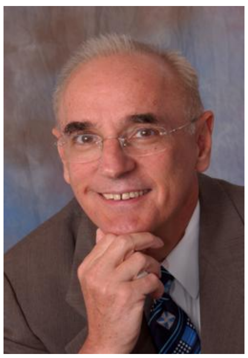
New Approaches to Improve Financial Leadership

What Do We Mean by "Financial Leadership"?

Leadership is commonly understood to be the ability to inspire loyalty and commitment from followers. Financial leadership could mean that a financial leader inspires the same loyalty. But clearly financial leadership means more than that. It also means the ability to achieve great financial results.



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By "great financial results" we must mean better financial results than most competitors. Yet it is demonstrably clear that most leaders are not great financial leaders, otherwise they would get great financial results most of the time. Nor would we have the multiplicity of financial failures we see in companies in both the developed countries and the emerging economies. What leads to effective financial leadership has become a key problem for all countries to solve.

Current Flawed Approaches to Financial Leadership Led to Financial Crisis

Financial leadership has a major problem. We saw it in the US with the financial crisis. Wall Street has the most highly qualified people in the world in terms of financial qualifications yet under its global financial leadership we have experienced the worst economic crisis since the Depression. And it wasn't just the Wall Street banks either. The leaders of most major companies in the US also experienced significant problems too.

"...most leaders are not great financial leaders…"

But isn't the possession of financial qualifications supposed to mean that you get better financial results than if you don't have them? Isn't having an MBA or accounting degree supposed to improve your financial performance and the financial results of your company? Shouldn't the possession of financial, accounting or economic qualifications improve your financial leadership and therefore ultimately the valuation of your company or organization?

What would happen if effective financial leadership had little or nothing to do with having good financial qualifications? Is it possible that having financial qualifications could actually make results worse, as appears to have been the case in the financial crisis in the US? If financial qualifications do not improve financial leadership, what other factors are important in achieving it?

"….Is it possible that having financial qualifications could actually make results worse….?"

Given the severity of the recent financial crisis we must examine these questions in detail. We know from history that financial crises happen very regularly and that the rise of a managerial class with high financial qualifications has not changed this. We have seen major crises in all of the developed economies in the last 50 years. The US has just had one. Japan is still suffering from the financial crisis it had in the 1980s.

As the old saying goes: "Those that ignore history are condemned to repeat it." If we wish to avoid the same problem, we will need to think beyond current approaches since these approaches have clearly not worked.

Conventional Models of Leadership Do Not Consider Financial Results

Of course, there are already models of leadership which are used by numerous Western companies. These models focus on interpersonal relationships and capabilities and on psychological competencies. These models form the framework for the leadership programs of the vast majority of Western companies that conduct leadership training.

However these models of leadership are based on personality theories that were developed in the early 1900s. These models were developed before the development of modern economics and they were developed by very early psychologists who had never had any business experience. So it should not be surprising that conventional leadership models are of little or no relevance in considering how to improve financial leadership. Indeed these models do not formally consider financial parameters and results at all.

Yet most, if not all, of the investment banks and companies that were responsible for exacerbating the financial crisis in the US had leadership programs that were based on these models of leadership. In retrospect it is amazing that the financial leadership programs of these financial companies did not incorporate any reference to the financial, behavioral and leadership factors that are directly associated with financial crises. Yet in many companies, that is the state of the art today.

The Current Financial Literacy Model of Leadership Does Not Lead to Sustainable Results

Large companies do have an informal model of financial leadership. This is based on the notion that financial success is aided by having financial qualifications, the higher the better. We can call this the financial literacy model since it holds that the more knowledge an executive possesses, the better his financial results and the more effective his financial leadership.

In this model, financial success is built on technical mastery of financial knowledge and disciplines and the ability to understand the financial and economic models underlying them. The higher this mastery, the more able is an executive able to undertake financial engineering in order to create the desired financial results.

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In the financial literacy approach, financial success often derives from being able to manipulate financial metrics in such a way as to increase financial results, even if the underlying operations and capital creation ability have not themselves been improved. Financial engineering approaches may lead to apparently great financial results in the short-term but usually lead to mediocre or even terrible results in the longer-term, again as we have seen in the financial crisis. In other words, financial engineering approaches do not lead to sustained value and capital creation, the criteria for good financial leadership.

US investment banks and companies generally in the West have followed the financial literacy model of financial leadership. But as we have seen, it was instrumental in leading to the financial crisis in the US and Europe, not to mention the rest of the world. These companies used deep technical knowledge to create models which ultimately led to the destruction of capital on a vast scale. Similar events, albeit less catastrophic, have occurred in the US and Europe over the last 30 years and more.

The lesson is that high academic qualifications in finance and economics such as MBAs and PhDs, not to mention undergraduate degrees, do not necessarily mean that the person who has earned them will be an effective financial leader. They may know a lot about the academic discipline but this does not mean in real life that they will generate positive financial results.

There is even a growing body of research which supports the notion that advanced financial and economic qualifications may actually be more likely to lead to capital consumption rather than capital creation, that is to bad financial outcomes. There are deep psycho-social reasons for this which we do not have time to explore here but are being probed by researchers including in my company.

New Academic Disciplines Offer New Hope for Better Financial Leadership

However there is new hope for dramatic improvements in financial leadership because of the emergence of new academic disciplines. These disciplines are behavioral finance and behavioral economics. Traditional economics and finance are based on the assumption that people act rationally when they make decisions. Behavioral finance and economics drop this assumption. Instead they start with the assumption that people are not always rational and make decisions based on what is called "mixed rationality" where some decisions are rational and others are not.

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The implication of these new disciplines is that a high level of knowledge often does not improve financial effectiveness and financial leadership because humans often have behaviors and make decisions which are not completely rational, no matter how much knowledge they possess. In other words, what drives financial decisions is not only knowledge, but also our behaviors, some of which may be irrational.

This fits well with what we actually observe; that executives and leaders often make poor financial decisions, even though they are smart, well-informed and have a high level of financial knowledge and qualifications. The reason is that they have unconscious financial behaviors that drive them in counter-productive directions that they themselves do not understand.

This is exactly what we see in the real world. We saw it in the recent financial crisis. We see it in market bubbles and financial excess. Thus these new disciplines provide a much more realistic foundation for improvements in financial leadership. Basically they teach us that in order to get good financial results and effective financial leadership we must understand financial behaviors in the real world, not just financial models in the realm of theory.

Good Financial Leadership Means Understanding Individual Financial Behaviors

Behavioral finance and behavioral economics have opened the way to a new approach to financial leadership. However they still have one problem. They can make predictions only at the level of the group and not at the level of the individual. The research by Perth has addressed this problem by showing ways to apply behavioral finance at the level of the individual so as to be able to make precise predictions at the level of the individual and the team about their likely financial performance and the financial outcomes of their leadership.

In this model, called the Perth model, we identify and measure the financial signatures of individuals and teams. This allows us to predict their level of business acumen, their potential financial performance and their impact on organizational and company valuation. This allows predictions to be made about the financial and valuation performance of particular management teams and companies and about who will be the winner competitively between companies in an industry.

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This is a revolutionary new approach to financial leadership based on a behavioral paradigm. It provides new ways to develop and improve individual leaders and teams and their level of financial leadership.

In the traditional model of leadership, the term "leadership" meant the ability to be a good leader, which is not very useful. It has been taken to mean leaders who have good interpersonal skills who are visionary.

The Perth approach introduces a totally new concept. In this approach, a leader is a successful financial leader if he increases the valuation of a company relative to its competitors. Even if he is a great "leader", if the valuation of his company declines relative to his competitors, he has failed the ultimate leadership test, namely that of creating more value than other similar companies.

In this approach, <u>leadership is valuation</u> and <u>valuation is behavior</u>, not merely financial assets or financial engineering metrics. This is because financial metrics are merely a symptom of behavior so we have to look at behavior first to understand the drivers of valuation.

The Perth approach is not just to be applied to top executives. The basis of its approach is that everyone in an organization, no matter what their level, has an impact on its financial results and its valuation. In this view, everyone in an organization, no matter their level or job role has their own virtual profit and loss (P&L) center. It is only by taking responsibility for one's own virtual P&L that an organization can be truly high-performing. In this approach, the most effective financial leadership is when managers lead their people to understand that they are all essentially virtual owners of the company, each with their own virtual P&L. In these conditions, the company maximizes its market value as a result of this effective financial leadership.

"…….**everyone in an organization, no matter what their level, has an impact on its financial results and its valuation…."**

In this model, good financial behaviors result in good valuation. Good financial behaviors are not just at the level of the senior executives who may or may not have good financial signatures but also from less senior staff who act as if they are owners and whose financial signatures are also capital-creating. An environment in which this occurs reflects effective financial leadership.

Financial Leadership is About Developing Higher Levels of Business Acumen

Our research shows that most managers do not have high business acumen and there is an urgent need to improve it at all levels of companies. Ultimately the need is to develop higher levels of business acumen in leaders and managers.

The recent financial crisis has demonstrated clearly that even in the global investment banks, the level of business acumen in leaders and managers was low. If US companies wish to avoid future financial crises and to maximize their own valuation they need to improve business acumen and financial behaviors within an effective environment of financial leadership. The financial signature approach does just that.

Recommendations

1. Introduce the subject of business acumen into leadership development programs.
2. Start a program to assess and develop business acumen.
3. Balance financial literacy programs with programs for optimizing financial behaviors.
4. Start training leadership development consultants in behavioral finance

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