

Leadership, Behavioral Finance and the Global Economic Crisis

Our work in the Perth Leadership Institute has focused on how leadership impacts financial outcomes. So as you can imagine, we have been following the financial crisis pretty closely.

We wanted to devote this newsletter to a retrospective on these events. We don't want to blow our own horn, but as you can see, we figure in this chronology because we have been predicting these problems for several years.



Author Dr. E. Ted Prince
Founder and CEO of
Perth Leadership Institute

Some things are better left unsaid. And sometimes it's pointless to write more because the work has already been done for you. So in this newsletter we are going to let past statements, from both ourselves and others, do the talking. We think you will find the narrative rather interesting.

The message: a few lone rangers saw it coming, but the vast majority was blindsided. Conventional paradigms prevented the masses from seeing what was really happening.

For some thoughts on what's to come from this crisis, see our last section, [So What Now?](#)

The Evolution of the Market Crisis and of Perth's Research

We will start with the following chronology just to set the scene, as they say.

1998 Beginnings of the tech bust

- Long-Term Capital Management bailout by New York Fed
- Asian financial crisis

2000 Tech bust accelerates

2001 Tech bust ends in market crash

2002 Market hits bottom

- Congress passes Sarbanes-Oxley Act to protect investors and prevent future crises
- Perth Leadership Institute incorporated to study linkages between leadership and financial outcomes

2003 Market starts recovery

- PLI commences development of formal model into linkages between behavioral finance and leadership

My sense is that this financial crisis is going to amount to a coming-out party for behavioral economists and others who are bringing sophisticated psychology to the realm of public policy.... a big, whopping reminder that the human mind is continually trying to perceive things that aren't true, and not perceiving them takes enormous effort.

- David Brooks, New York Times, October 29, 2008

2004 House prices accelerate

- PLI starts field research to develop formal psychological instruments to measure business acumen
- PLI starts publishing articles to draw attention to the linkage and its leadership and financial implications (Prince, E. Ted. "The Fiscal Behavior of CEOs." MIT Sloan Management Review, Vol 46, No 3, Spring 2005, p. 23-26.)

2005 Markets reach peak, housing prices peak

- PLI conducts beta studies for business acumen assessment instruments
- PLI publishes book on leadership and financial impact (Prince, E. Ted, *The Three Financial Styles of Very Successful Leaders*, McGraw Hill, 2005)

2006 First signs of housing slowdown

- PLI launches first formal assessment instruments for business acumen
- PLI steps up publications and speeches on linkages and major gaps in leadership development approaches in organizations worldwide

2007 Housing decline starts to accelerate

- **Credit starts to slow down**
- PLI signs first customers for financial impact leadership programs

2008 The 2008 Global Financial Crash

Most Never Saw It Coming...

"Those who cannot remember the past are condemned to repeat it."

George Santayana

"Stock prices have reached what looks like a permanently high plateau." Irving Fisher, Oct 17, 1929

"...a serious depression seems improbable.",
Harvard Economics Society, Nov 10, 1929

"It's impossible for prices to go down this year."
Gary Watts, Orange County Association of Realtors, Feb 13, 2006

"The idea that we're going to see a collapse in the housing market seems to me improbable."
John Snow, Secretary of the Treasury, Sep 20, 2005

"Housing is still the best investment, without question"
Stan Sieron, President, Illinois Association of Realtors, July 29, 2006

"I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms."
Alan Greenspan, Oct 23, 2008 in testimony to Congress

"I'll be the first to admit that we were sucker-punched, but we were not alone...."
Gary Dunton, CEO, MBIA, Wall Street Journal, Feb 1, 2008

**"Those who cannot
remember the past are
condemned to repeat it."**

- **George Santayana**

But Some Had It Figured Out

"...a population entirely composed of bad managers will produce a small amount of great track records...."

Nassim Taleb, *Fooled by Randomness*, Random House, 2004, p. 154

"...Simply people need to be blinded by knowledge – we are made to follow leaders who can gather people together because of the advantages of being in groups trumps the disadvantages of being alone...."

Nassim Taleb, *The Black Swan*, Random House, 2007, p. 192.

".....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....."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

".....The current economic environment is turning down dramatically. At this stage it is academic as to whether we will enter (or are currently in) a recession. Companies and individuals are now acting as if they already are....."

Perth Leadership Institute, [A Recession's Role In Transforming Leadership Development](#), White Paper, Feb 2008

The Failure of Leadership and Leadership Development

"There's no doubt that failed leadership is at the heart of the crisis on Wall Street. You can blame it on financial instruments, you can blame sub-prime mortgages, but the bottom line is that ... these leaders were in it for themselves."

Bill George, management guru and Fmr. CEO of Medtronic, BusinessWeek TV, Oct 3, 2008

".....we have to view the current financial and credit issues as being more than market issues. *They are also leadership issues.....*"

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

"...many leadership development programs simply do not have a close enough connection with their financial and P&L responsibilities..."

Perth Leadership Institute, [The Role of Business Acumen in Leadership Development](#), Sept 2007

"... it is difficult to find a CEO of a large company who doesn't have a carefully honed speech about the importance of developing next-generation leaders at every organizational level. And yet for most companies, the combination of eloquent statements and massive investments has not produced a sufficient pipeline of leaders... The very high rates of CEO turnover due to poor performance in recent years points to the problem: If companies were adept at developing leadership talent internally, it should be most apparent in the performance of senior leaders."

Douglas Ready and Jay Conger, MIT Sloan Management Review, "Why leadership-development efforts fail", March 22, 2003

".....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...."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

The Behavioral Finance Surge: Developing Business Acumen

".....My sense is that this financial crisis is going to amount to a coming-out party for behavioral economists and others who are bringing sophisticated psychology to the realm of public policy.... a big, whopping reminder that the human mind is continually trying to perceive things that aren't true, and not perceiving them takes enormous effort...."

"David Brooks, New York Times, Oct 29, 2008

"...The current credit market crisis reveals a basic problem in leadership development, that is, the lack of programs to develop business acumen ... 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..."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

"...PriceWaterhouseCoopers' annual CEO survey, found that organisations are first and foremost looking for senior executives with hard technical and business experience. People skills, whilst considered relevant, were not as high on their wish list..."

Bob Selden, Management -Issues, Is business acumen a substitute for leadership?, Feb 26, 2008

".....Traditional approaches do not attempt to assess or develop business acumen... 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...companies have led to a divorce between market risk and executive behavior, as distinct from executive learning and credentials....."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

".....Modern scholarship and recent developments in behavioral finance are opening up new ways to think about this connection [between financial risk and leadership development] and how we can use this knowledge to actually alleviate the potential for future problems....."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

Don't Confuse Business Acumen with Financial Literacy

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

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

"Financial literacy classes give people the illusion that they can successfully manage their finances. So rather than seek help, they end up making worse decisions."

Lauren Willis, Loyola Law School, "Why you can't teach money", Aug 26, 2008 for CNNMoney.com

".....The reigning assumption in the corporate world is that high levels of business literacy will reduce market riskYet a body of data is emerging which suggest otherwise."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

"Many companies are in fact implementing financial literacy courses to meet a need for business acumen and so often the response has been disappointing or worse."

Perth Leadership Institute, [The Role of Business Acumen in Leadership Development](#), Sept 2007

"....A High level of Business Literacy May Actually Increase Market Risk....."

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

Fixing the Problem

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

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

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

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

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

Perth Leadership Institute, [How Leadership Development Can Address Financial and Credit Crises](#), Nov 2007

The Lessons of the Bust

- You have to develop business acumen in leaders; otherwise you will get periodic and ever-more-serious financial crises.
- Don't confuse business acumen with business or financial literacy.
- Companies and governments need to focus on implementing business acumen – not financial literacy programs - if they don't want this to happen again.

So What Now?

- The current global and ultra-massive infusions of capital by government will have the impact of further increasing moral hazard. This means that we will have future financial crises like this, but probably even bigger. Count on these occurring within the next 20-30 years.
- In the meantime, however, the huge infusions of capital will at some stage result in significant increases in values of all assets classes including stocks, commodities and future exotic financial instruments such as derivatives and synthetics. Count on this occurring in the next 5 years.
- These value increases may or may not be sustained; no-one knows. We could see a Dow at 9,000 or much higher after 20 years. But in the meantime it will look like we have broken out of it and many people will go into the markets and lose everything again.
- The inevitable strengthening of regulation in the next few years will result in misplaced confidence that we will avoid another crisis and encourage a lot of unwise investment that will at some stage become worthless after a sharp rise and then fall of most asset classes.
- The increase in regulation will also depress innovation in financial products and services. This will push most financial innovation out of the US with a corresponding decrease in US global competitiveness. It will, however, not limit swings in asset values.
- Whatever innovation remains will be conducted in hedge funds, many of which will move their operations overseas to avoid high US corporate taxes and US regulation.
- Some companies will indeed start teaching business acumen to leaders, but the few wise companies who do this will be dwarfed by the many. The vast majority of companies will respond to the increase of moral hazard by taking risks which appear in the short-term to be working out, thus bolstering unwise leaders who erroneously believe that they are the drivers behind their companies' profits.

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For more information on the Perth Leadership institute and Perth upcoming events,
please visit us at: www.perthleadership.org

Perth Leadership Institute: 7208 West University Ave - Gainesville, FL - 32607 PerthLeadership@PerthLeadership.org
Telephone: 352.333.3768

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