Stumblers Case Study

At Ashridge we always have various research programs going on and I am currently working on the topic of "Corporate Stumbles", which we define as being when the CEO gets fired or leaves under a cloud, and the company loses 25% of its value relative to the local market index in the last two years before the CEO leaves.

Stumbles happen quite frequently. In our sample of over 250 of the top US and European companies, over 20% of companies experienced a stumble over a ten-year period, representing about 10% of CEOs.

So, what causes a stumble or, more accurately, what do we think increases the probability of a company and CEO stumbling? A few stumble because the market position they hold worsens and they are unable to do enough about it. eBay and Yahoo are good examples (remember when they were up there with Google?). A few more have severe operational issues in a core business – an example is Société Générale, who suffered a big hit when their risk management systems failed to stop a rogue trader losing 5 Billion Euros.

However, most of the sample follow a different journey to stumbling. They are ambitious and embark on a challenging strategy that goes wrong. The example of Morgan Stanley is a good illustration of a common five-stage process that these companies follow. The specifics vary – but these five steps appear to be common across many different stumblers.:

1. The Company feels pressure to change
   - In the case of Morgan Stanley, the CEO was John Mack. He had been a long-time leader at Morgan Stanley but left which it merged with Dean Witter. The merger, dominated by Dean Witter's strategy, did not go well and the organisation was <u>under pressure</u> to find a winning formula that could lead them back to profitable growth.
   - Mack decided to use Morgan Stanley's investment banking capabilities to become a second Goldman Sachs – a world class Investment Bank investing not only private clients' money, but also its own. It was a riskier strategy, but the market was attractive and Morgan Stanley had always been a competent Investment Bank
2. The pressure on the company requires a significant change in strategy
   - Morgan Stanley need to grow aggressively to catch up with Goldmans and the other leading competitor, JPMorgan Chase. It <u>changed its strategy</u> from a focus on selling financial products to retail investors to beefing up its Wall Street activities. It launched a private equity business and embarked upon significant growth in several areas – for example by investing in the financial-derivatives business, getting more involved in residential-mortgage finance, and taking more risk by trading with the firm's own capital; all this in early 2007…
3. The strategy change stretches organisation, exposing vulnerabilities
   - Risk management was relatively well developed at Morgan Stanley and in the Investment Banking unit, but the entrepreneurial culture meant that internal

rules were more likely to be bent than at a more mature competitor such as Goldman Sachs

   - As the financial crisis unfolded, anything other than rock solid risk management was a vulnerability for any investment bank, where huge financial positions were held and hedged against each other to reduce risk and generate margins.

4. The company fails to manage these vulnerabilities
   - Morgan Stanley actually spotted that the subprime mortgage market was overvalued and "shorted" it – i.e., it bet that the market would go down, as it eventually did. Unfortunately it hedged its short position with "safe" mortgage backed assets which proved not to be safe at all. A reasonable strategy was executed poorly. When the bank realised there might be a problem, there was a failure to take rapid action to sell these risky positions – perhaps because traders lower in the organisation wanted to see if they could minimise losses by waiting a bit. Exactly who was responsible is disputed by the various actors involved – but a decision like this should have been executed immediately it was made. Observers commented that a risky position like that would have been closed out immediately at Goldman Sachs – the pain would have been taken as soon as the decision was made.
5. The interaction of vulnerabilities with environmental shocks and bad luck leads to a stumble
   - The financial crash that rapidly unfolded as Lehmann's went bust later in 2007 resulted in the "safe" assets turning very, very bad and lost Morgan Stanley $9 Billion – a rather major stumble. Mack had to reverse the "catch up Goldman" strategy and move back towards a private banking model, in which Morgan Stanley manages others' money rather than its own – a strategy that is less profitable and exciting, but safer. He resigned as CEO and, although he was much respected and remained as Chairman, the stumble certainly cast a cloud over his tenure.

One way to reduce the risk of a stumble is to consider whether any of the five steps described above might be happening at your organization. If so, put in some extra checks to make sure you don't go astray – perhaps a more in-depth review of strategy or new blood into your team. The research may have been for large public companies, but anyone can stumble – whether you are the CEO of a large business, a business unit leader, or the head of a function in a smaller business.

We are not advocating that companies stop taking on ambitious strategies – but they do need to be objective about the risks involved and manage those risks. We are working on turning these stories into a guide for top executives and Boards – how to spot when your company is at risk of a stumble, and how to guard against it. The five stages can be tracked, and using our database of stumbles we can provide advice on when what a company is doing looks like it might increase the risk of a stumble and, most importantly, where the vulnerabilities might be. Knowing where the vulnerability is an important first step to addressing it.

If you are interested in knowing more about our research on the root causes of stumbles, or commenting from your own experience let me know at jo.whitehead@ashridge.org.uk