Australia's Crisis of Uncertainty

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Many commentators acknowledge that the world is becoming a more uncertain place to live. Climate change, terrorism, food security, aging populations, systemic failures in financial systems, the list of significant realised and potential disruptions goes on. Increasingly we look to our governments to regulate, bail out, step-in or just generally save us. But what as a society are we doing to address the growing uncertainty that surrounds us?

2010 represents the year peak labour occurs (more people will leave the workforce than join it). This means that for many of us, a focus on superannuation becomes quite acute. Approximately 59% of these retirement savings will be invested in equities, equities that must perform with a minimum of downward volatility to ensure a prosperous retirement. As a consequence now, more than ever before, society worries about the management approach of executives trusted with the responsibility of steering the large corporates that form the platform of our retirement prosperity. A perfectly justified but unintended consequence of this attention is the pursuit of short-term certainty.

Retirees naturally want short-term certainty of returns from their superannuation funds or superfunds – they depend upon it. Fund managers, remunerated to provide these short-term returns, place pressure on executives to deliver them - after all, superfunds are probably their major shareholder and consequently do have a legitimate influence. The modern Australian executive therefore works hard to remove any volatility from their future short-term performance. Whilst they need to remain competitive in their respective markets, and provide ongoing growth trajectories for their organisations, the actual nature of the competition is tempered to some extent in Australia, simply through size. A large proportion of Australian industries are oligopolies (four big banks, two main miners, two major supermarket chains, etc.). Whilst there are also large construction players, construction in Australia is one of the few industries where real competition still occurs. Having said this, oligopolistic characteristics still exist within different construction markets. Certainly at the big end of town, the pressures described above are still in effect for the ASX listed construction companies.

An unintended outcome of an oligopolistic marketplace is that the focus of competition is on efficiency and effectiveness, not innovation. It is simply not worth the risk. How often do we see an organisation out-perform analyst expectations when reporting its results, with no impact on the share price? The market response is that the higher performance had already been factored into the share price, and whilst the performance is good, we already expected it to be good. Yet when an organisation underperforms to expectations, for example 5 per cent below projected growth, the market response is swift, and the stock may well have more than 15 per cent of its value wiped away, an arguably illogical response. Let us consider the effect of this type of dynamic for a minute. If you're a CEO, concerned with the future growth of your organisation, what is the reward for taking risk on more uncertain but potentially higher returning activities? If taking the risk pays off in terms of out-performance, the reward for doing so, under the short-term focus described above, is nothing. The punishment, should this risk produce a small negative volatility to performance (in the short-term) is out of all proportion. Let's also not forget that a high percentage of the CEO's remuneration package will be geared to short-term performance. So the probability is that you just don't take any risks where there is some uncertainty involved. You focus on activities around which you have the most certainty – those focused on efficiency and effectiveness.

Let me follow this logic a bit further. Many organisations pursue a policy of hiring for and promoting the best and brightest staff they can get their hands on. This is only logical. But what does 'best and brightest' mean in this scenario. It means those that are the best and brightest in providing efficiency and effectiveness in the organisation's operations, i.e. providing certainty on performance. So by default, the talent pool at the top of our major corporates begins to take on a particular worldview and approach to management. Furthermore organisations demand more of this style of employee, or at the very least the ability to develop them. Enter the Master of Business Administration (MBA), the key efficiency and effectiveness qualification for the modern executive. Whilst many MBAs are designed to high standards and the quality of the people who deliver them is also very high, the MBA is a response to a market need. Often built around the use of best practice studies all designed to provide knowledge on how to achieve increased certainty of outcome.

The result of all this is that we have a market environment unconsciously obsessed with short-term certainty, giving rise to an unintended preponderance of short-term focused executives, selected for their highly developed ability to deliver certainty around performance, taught by and demanding more educational qualifications that help them be better deliverers of certainty to all their stakeholders, including retirees whose superfunds are invested in the companies they manage. So what's wrong with a highly developed ability to deliver certainty? Put simply, nothing – so long as you are in a stable environment.

Thinking about Uncertainty

Professor James March (1991) conceptualised the way in which organisations adapt and learn as a tension between processes of exploitation and exploration. Exploitation processes develop to ensure efficiency and effectiveness in an organisation's operations. They are focused on the delivery of quality, cost management and control, through hierarchical silo-based structures that remove volatility. Change initiatives are large and deliberate. The focus is short-term and on the reduction of risk by breaking problems down into small manageable pieces. Put another way 'exploit' processes are designed for the management of certainties. Conversely processes of exploration involve potentially ad hoc changes in direction. The focus is more opportunistic, and long-term, structures are smaller and collaborative. The risk appetite is higher and as a consequence it is usually through these exploration processes that innovation occurs. 'Explore' processes assume an uncertain environment and as a consequence are designed for the holistic management of uncertainties. Young or start-up organisations are characterised by a greater degree of 'explore', due to the uncertainty involved in bringing a new product/service to market. Over the lifetime of an organisation, the balance gradually shifts from 'explore' to 'exploit' in response to the growing size of the organisation, the need to manage increased complexity, and the desire to remove uncertainty across the different aspects of its operations1.

Viewed through the lens of 'explore' and 'exploit', today's modern Australian corporate is geared to be almost totally 'exploit' – it has to be. This is the best way to respond to the needs of the organisation's various stakeholders as described above. This imbalance creates a worldview in the organisation, that I would argue kills off the organisation's ability to innovate and deal with uncertainty. This occurs in a number of ways, but most obviously where it relates to the introduction of what might be termed strategic innovations, i.e. innovations that are potentially disruptive to incumbent business models and require a few years of incubation.

[1] An exception to this can often be found in ostensibly family owned businesses, or businesses where the founder is still in control rather than employed professional managers.

This type of innovation usually falls outside the short-term business planning cycle, and therefore the objectives of professional managers. It is inherently uncertain, and so from the executive's point of view a threat to the delivery of short-term certainty – not an opportunity. Furthermore because the organisation is overwhelmingly exploit all investments in new opportunities need to be assessed through the 'Exploit' business planning and budget cycle. The result of this is that speculative 'explore' ideas are directly evaluated against 'exploit' ideas, i.e. cost cutting projects, IT refresh etc. In other words the uncertain 'Explore' project is measured and assessed against the high certainty 'Exploit' project in direct competition for typically finite funds. It is not surprising that the 'Exploit' project always wins. The risk/reward equation in the modern Corporate cannot lead to any other result.

Historically a circuit breaker for this problem was the discretionary budgets often allocated to senior executives, within which more speculative activities could be undertaken, without coming under the spotlight of the 'exploit' budget process. Indeed many senior executives used these funds for 'explore' purposes (often in the form of skunk-works projects). Over the past 15 years or so, (a period roughly equivalent to the introduction of compulsory superannuation and the socio-economic dynamic associated with it), these funds have been gradually whittled away through successive rounds of cost-cutting and downsizing to the point where only extremely incremental innovation can really be considered out of these pools.

In other words, in many Australian corporates, for an innovation to be successfully introduced it needs to be able to display an adequate level of certainty compared to other budget items, so that when it is considered for approval, the risk of not doing it is greater than the risk of doing it. Note that the opportunity associated with the innovation is usually removed from the deliberation, as this is uncertain.

It also means that organisations by default develop and apply tools that assume certainty in relation to new opportunities, rather than systematically reduce uncertainty. The use of best practice studies is an example of this approach. An idea that is new to an organisation can be presented as having higher levels of certainty because someone else has already done it. From an 'exploit' point of view this is great and assists the idea move through the budgetary process. From an 'explore' point of view however, this is fairly problematic. Firstly, for something to be the subject of a best practice study it would need to be at least five years old, so nothing particularly innovative there. Secondly, in introducing the idea, the actual uncertainty in relation to how this idea might behave in the new Australian context hasn't been 'explored', ironically increasing the risk.

As a consequence, we still have a significant proportion of projects that are described as being innovative, (even after the best practice study) that fail to deliver because the expected certainty of the result observed in the idea's original context couldn't be replicated. This provides a further reason for executives to avoid innovation if they can.

The other option for the organisation to gain new capability or market penetration is to merge or acquire another business. Again on one level this provides a feeling of certainty as many of the characteristics of the acquired entity can be measured. Unfortunately, like the best practice study, the complexity of implementing the merger often brings the organisation undone. A variety of studies conducted by both academics and through the large chartered firms show that between 50 and 80per cent of mergers fail to deliver on their projected benefits. The reason for this failure is usually attributed to soft issues such as culture, where the 'exploit' measures tend not to be effective.

The development of highly sophisticated 'explore' capacities (or capacities that are at least as competent as their 'exploit' counterparts) is something that is sadly lacking in Australian corporates. Furthermore it is a situation that is likely to get worse rather than better due to the socio-economic dynamics described in the first section of this discussion. This is something we should all be concerned about given the growing levels of uncertainty in our environment. Our ability to 'Exploit' has served us well and will continue to do so under the right circumstances. Without an 'Explore' capacity though one has to wonder how well we are prepared to deal with a changing future, or respond to an unforeseen one.

Reference

March, J. (1991) 'Exploration and Exploitation in Organizational Learning', *Organization Science*, **2**(1), 71-87