

Love Those Dogs

Leading behavioural economists now believe that investing in your dogs, or poor performing units, could bring far better returns than investing in your stars, or best performing units. Will the same argument work for IT?

In their pursuit of maximum shareholder value, senior executives routinely consider which of their companies' businesses should be nurtured, which neglected and which sold. For most, that puts just one strategy in play: a heavy investment in the corporate "stars" (programs, business units, people and products that earn superior returns) and the starving or selling off of the underperforming "dogs".

In IT, much the same thinking can be seen at work as companies throw big dollars at enterprise and mission-critical systems while leaving the "shadow IT departments" kennelled within business units famished. The same dynamic is at play in companies that persist with delivery models that do not deliver full value, fail to leverage their data assets or leave much of their ERP capability untapped through poor configuration while they channel scarce resources into major systems.

In short, if companies were people, and underperforming resources were really dogs, the courts would be overwhelmed with prosecutions brought by the RSPCA for neglect and cruelty. And most executives would eventually be brought up on charges. After all, this conventional approach to maximizing value by grooming pedigreed lines while neglecting the mongrels is so ingrained in management practice as to make questioning it almost sacrilegious.

However, what if this conventional approach is so wrong as to be muddleheaded? What if corporations would be better off short-changing their stars and nurturing their dogs? That is a question a team of consultants from Booz Allen Hamilton thinks worth considering after applying the new field of behavioural economics to questions of value creation, and pondering its applicability to IT.

"The strategy of loving your dogs may be intuitively difficult to swallow for many, but it is supported by an economic field of study - behavioural finance - that has come into vogue over the last decade," note Harry Quarls, Thomas Pernsteiner and Kasturi Rangan in a recent paper called, fittingly enough, Love Your Dogs.

Clearly there will be plenty of cases where it is best to let sleeping dogs lie. But sometimes, rather than leaving the poor creature, ribs showing through its mange, chained all cowed and bedraggled to the Hills hoist, it might be better to bring it in from the cold. With a bit of care and attention, a thorough worming and an intensive bout of obedience training, some dogs might just have a chance to become man's best friend.

Why Smart Investors Make Dumb Mistakes

Behavioural economics is essentially about applying methods from social sciences like psychology to economics to illustrate how, and why, people make financial decisions. It rests on the precept, as put by economist James Montier, that "not only do investors make mistakes, but they do so in a predictable fashion". The theory seeks to explain why day traders, for instance, routinely display overconfidence by trading with high turn-over but low returns. And why, as noted by Nobel Prize-winning economists Amos Tversky and Daniel Kahneman, people are likely to overestimate the similarities between a small group they know and the larger population, and hence make faulty predictions of the behaviour of markets and prices. Irrationality occurs even with highly trained specialists, such as professional investors or, as Kahneman puts it, when "people who are explicitly trained to bring [rational] thinking to problems don't do so, even when they know they should".

"There are many different flavours of it but I think the main flavour is that fundamentally, people are myopic," Quarls says. "You know, when somebody looks at something they probably use past history as a guide to the future, and so therefore if things are doing very badly, they assume that it will continue that way, and if things are doing very well, same assumption, they assume that things will continue that way. What happens is that if things are doing badly, usually there is some intervention, but people don't build things to their expectation. Then secondly on the top side, gravity usually takes hold: you can't maintain those high levels forever and so therefore you tend to underperform relative to expectations."

Love Your Dogs uses the theory to demonstrate how corporate managers typically rely on accounting metrics to inform business decisions even though such metrics are based on past performance, which is generally a poor predictor of the future. "Thus, when performance is assessed over time, greater shareholder value can be created by improving the operations of the company's worst-performing businesses. The way to thrive is to love your dogs," the authors insist.

In the way fund managers can earn superior returns by identifying and buying undervalued "market dogs" (in this case value stocks), corporate leadership can learn to identify "value assets", hold and nurture them, and produce superior performance. This in turn will ultimately lead to an increase in shareholder value, they say.

Their analysis of 25 years of US stock price performance produced three simple rules for corporate leaders:

1. Fixing your dogs can yield unexpected levels of shareholder value, even when their key financial indicators lag behind those of other business units.
2. Improving operations is an important management lever for adding shareholder value. Starving dogs is not a strategy for creating shareholder value; in aggregate, there is more potential value in helping the dogs thrive.
3. Buying and fixing someone else's dogs will produce more shareholder value than buying stars.

"Adding value to an overvalued business is a tall feat, especially on top of the premium that acquirers typically pay for a controlling interest in an enterprise. It is no wonder that two-thirds of acquisitions fail to add value for the acquiring shareholder. The right dogs, on the other hand, could offer a company focused on operations wonderful acquisition opportunities," the consultants write.

"Although behavioural finance is used by a growing number of fund managers to guide their purchases, another potential application has largely gone unnoticed: its use as a guide to corporate strategy decisions. The same kind of behavioural analysis can help corporate executives better understand and manage their own 'portfolios' - the businesses or business units that make up their companies. Executives who understand behavioural finance will capture more shareholder value from businesses that have previously been regarded as unworthy of much attention," the authors say.

Savings from ERP Overrated

As to whether the theory is equally applicable to IT, Quarls gives a qualified "yes", telling CIO magazine that although he does not believe anybody has yet examined the IT portfolio specifically from a behavioural economics perspective, some IT-focused consultants within Booz Allen Hamilton are starting to give the question serious consideration. However, he says in an environment where "huge over-calculation" of savings from ERP implementations is common, there are clearly some neglected systems that might be worthy of such considerations.

"It depends how you measure performance in IT, because while people attempt to measure internal investments on IT, I think most of the analysis that I have seen is very suspect," Quarls says. "People tend to assume the savings could not have been got in any other way, so they bring every saving

possible into an IT project, as opposed to saying: 'I could have got most of the savings anyway and it's only the incremental 20 or 30 percent that really require an IT solution'. So especially around ERP you see huge over-counting of savings in those ROI calculations. But clearly there are some that I would call 'neglected systems'."

Systems come in three "flavours" in Quarls's mind: strategic, tactical and transactional. Transactional systems tend to get all the attention because that is where all the money is, yet there are key strategic and tactical systems that could probably thrive and return significantly better value "than you would ever see in a transactional system" if only they were not starved of money and resources. "Systems like pricing systems - you know, systems to optimize pricing, systems to optimize supply change management. Not the big ERP systems; I am talking tactical strategic systems that people tend to starve where you can go in and actually tweak them and spend a couple of million dollars, and see multiple returns on investment for those systems."

However, Quarls also urges caution, noting that the world is full of IT projects in which organizations have invested heavily without gain because the systems proved to be "value destructors".

Still, Dwayne Prosko, principal consultant for Booz Allen Hamilton's IT Strategy Practice, who has given the issue serious consideration, is adamant that there will be cases where corporations are better off short-changing their stars and nurturing their IT dogs. In fact, he says, the consultancy believes IT executives must constantly be making choices about which parts of their IT applications and systems portfolios should be nurtured and which should be starved.

It is all about ascertaining the value levers. For instance, everybody got onto the ERP bandwagon to achieve Sarbanes-Oxley compliance or greater control of transactions, accounts payable and chartered accountants, but moving to ERP drained the budget. While an ERP system may have been necessary, it is not necessarily value adding. So why not ensure a "safe space" in the budget where you can invest in systems that can let you leverage far greater value than a typical ERP system?

"We have seen situations in several industries in which IT applications/systems portfolios are too heavily weighted towards back-office administrative systems that do not add value to the business and are not weighted towards customer-facing value-added systems," Prosko says. "In some cases the customer-facing systems have become 'dogs'. IT managers would be well served by focusing on these dogs of their IT portfolios to get better value out of them."

That would mean devoting greater resources and effort to the customer-facing part of the portfolio, such as upgrading the systems to more modern, open source platforms, improving performance by removing inefficient code and replacing it with rewritten modules, and modernizing the user interfaces by bolting on Internet-based portals.

In another example, Prosko consulted to a financial services company running a number of "shadow IT organizations" - within accounting and finance groups and parts of its claims functions - featuring very inefficient, ineffective use of IT resources, IT labour and IT systems, and extremely "sub-scale" types of operations. Bringing them all into a more centralized, shared services type of organization let the consultants fix some of the inherent problems in their IT organization and processes to bring them up to par with everybody else.

Finding the Dogs to Love

What kind of strategies should CIOs adopt to identify and love their dogs? Prosko says his experiences have left him in no doubt at least two of Quarls's three simple rules also apply to IT. That is, fixing your dogs can yield unexpected levels of shareholder value and improving operations is an important management lever for adding shareholder value. Since a large part of a firm's SG&A spend is in the IT area, it is vital that IT managers get the most out of their IT spend. This means all parts of the systems portfolio and infrastructure components must be operating effectively and efficiently.

"It is important to fix the IT dogs because there is very little appetite for new IT projects, especially multimillion, multi-year projects," Prosko says. "We have seen several examples in the last few years where companies are willing to hand over pieces of their IT applications portfolios to outsourcing companies that will commit to improving the 'dogs'. For example, these outsourcing companies commit to decreasing the number of system bugs and errors, improving the processing speed, and upgrading the infrastructure to newer, more modern platforms."

As a result, CIOs should take a very holistic view of the IT systems portfolio, Prosko says. For example, they should start by cataloguing all of their application systems and quantifying the total cost of ownership (TCO) for each of those applications. A TCO view of the portfolio requires CIOs to quantify the amount of labour, hardware, software, consulting and telecommunications needed to run and support the application. Then, armed with this information, the CIO can group each application by the business process that the application supports.

"Seeing the TCO by business process will highlight the imbalances in the portfolio such as the high TCO, low-value applications (that is, it will show the dogs). The CIO can then focus on either decreasing the TCO, increasing the value, or both," Prosko says. "We have seen this work in several industries. I've recently worked with a major telecommunications provider in which we recommended they turn off and retire several parts of their portfolio and focus their energies on a few forgotten parts of their portfolio that would add more value, such as customer-facing portals to handle Internet enquiries on a new mobile phone plan. The result was the IT organization was able to provide more customer friendly Internet-based portals. This resulted in more traffic to the mobile phone business unit," he says.

Booz Allen Hamilton has also done some analysis around the ERP area that suggests there can be a payoff from examining the amount of effort or amount of IT ERP spend in each area. For instance, Prosko says, a refining operation might compare the amount of throughput at a refinery against the amount of ERP spend. Looking at such data points across a company can help to identify which global sites are doing well and which are underperforming.

"We try to take a very holistic four-walled approach and look at all of the costs that are associated with an IT area. And if it is an ERP area, that not only includes the hardware and the software spend but also includes the labour, telecommunications, consulting and so on.

"There's an idea of a kind of total cost of ownership that we try to pick up and you're looking for the ones that don't compare very well to their peers within their company. So we would look at, say, total cost of ownership for the ERP program per the number of transactions that are going through that system, if it is an accounting transaction, or maybe more of a business metric might be the amount of IT spend per barrel of oil produced or barrel of oil refined, for example."

You can also compare the ERP spend in a country like Australia to the ERP spend in a country like Canada, Prosko says. Again in a refining operation, if both country's operations are a similar size from a refining perspective, you would expect their ERP spend to be similar. If spending in Canada were "off the charts" you would want to dig into that more.

"It really is about fully utilizing what you already have in place," Prosko says. "What you are allowing your business to do or your shareholders to do really is defer some types of investments that they might think they need to make on the IT side. They may be looking at a new \$100 million IT program because they feel that their IT is underperforming or getting old, but we can look at some of these areas and basically defer such big investments."

Prosko, like Quarls, has done a great deal of work in the global energy arena. He says if you think of each region or each country as a portfolio or as the data point, it can quickly become very clear which ones are the dogs and which of those dogs need more attention.

"There are a number of different ways that we have sliced it," he says. "One way that we sliced it, as I talked about, was that we took a look at an IT operation for a refining business unit across multiple regions and found some that really were dogs and ones that were operating really, really well. We tried to

take the best practices from the ones that were running well and apply those to refining business units that weren't running so well," he says.

"[The latter] primarily tended to be in Europe because they were a bit more sub-scale in the sense that they weren't taking advantage of the entire, say, UK-Europe footprints. They would have an IT organization for the refining operations in France, and they wouldn't share a whole lot of resources or expertise or capabilities with the refining guys in Germany for example, even though they are right next door," Prosko says.

"So it caused a lot of sub-scale type situations there, whereas if you looked at countries like Canada and the United States, Canada tended to leverage the scale the US guys had so they weren't trying to build their own capabilities and build their own systems or make something too specialized for Canada because they realized that right next door they already had these capabilities - and refining is refining. Whether you do it in Australia or whether you do it in Canada it is basically the same practice, so why try to reinvent the wheel?"

You Can Talk It, But You Have to Walk It

Prosko says overall, CIOs should never lose sight of the fact that there are two ways they can add value. The first is through those financial transaction processes that keep the corporation out of trouble. Introducing those is fine but will encourage business units to see you as the "back office" and will inhibit efforts to align closely with the business units. "What CIOs have to do is get involved in what I call front-office processes; they have to be very involved with the businesses and help them understand how their under-leveraged systems can add a lot of value.

"I think there are two types of CIO: I think you see people that are managing corporate affairs and you see people that are business partners, and usually you see greater value leveraged from the people that are business partners. The problem is that it is easy to talk about it. It seems every CIO I have ever talked to says that they are a business partner, but really making it real is something different," Prosko says.

"What distinguishes those that make it real is the number of times they are proactive rather than reactive. There are very few of those. I think they are mostly reactive and they're falling behind the business and they're so busy trying to serve corporate needs around the financial transaction, they are never proactive along the lines of: 'Hey, if we spend \$500,000 here, I think we could deliver an extra \$10 million of value'."

In this sense behavioural economics can give CIOs a framework that can help them get those dogs off their leash and give them a good run.