McKinsey&Company

DECEMBER 2009

McKinsey Quarterly

STRATEGY PRACTICE

# Dynamic management: Better decisions in uncertain times

**Companies can't predict the future, but they can build organizations that will survive and flourish under just about any possible future.**

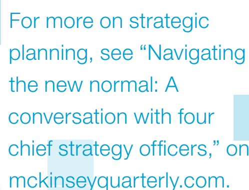
Lowell Bryan

**The economic shock of 2008,** and the Great Recession that followed, didn't just create profound uncertainty over the direction of the global economy. They also shook the confidence of many business leaders in their ability to see the future well enough to take bold action.

It's not as if we don't know how to make good decisions under uncertainty. The US Army developed scenario planning and war gaming in the 1950s. And advanced quantitative techniques, complete with decision trees and probability-based net-present-value (NPV) calculations, have been taught to MBA students since the 1960s. These approaches are extraordinarily valuable amid today's volatility, and many well-run companies have adopted them, over the years, for activities such as capital budgeting.

Here's the challenge: coping with uncertainty demands more than just the thoughtful analysis generated by these approaches (which, in any event, are rarely employed for all the business decisions where they would be useful). Profound uncertainty also amplifies the importance of making decisions when the time is right—that is to say, at the moment when the fog has lifted enough to make the choice more than a crap shoot, but before things are clear to everyone, including competitors.

For more on strategic planning, see "Navigating the new normal: A conversation with four chief strategy officers," on mckinseyquarterly.com.



Over the past year or so, progressive strategists have been undertaking noble experiments (such as shorter financial-planning cycles) while dropping the pretense that they can make reasonable assumptions about the future. My sense, though, is that achieving truly dynamic management will prove elusive for most organizations until they can figure out how to get their senior leadership (say, the top 150 managers) working together in a fundamentally different way. The knowledge, skill, and experience of these leaders make them better suited than anyone else to act decisively when the time is right. Such executives are also well placed to build the organizational capabilities needed to surface critical issues early and then use the extra lead time to gather intelligence, to conduct the needed analyses, and to debate their implications.

The specifics of how companies should build these muscles will of course vary. Well-run organizations—particularly those accustomed to using stage-gate-investment approaches for activities such as oil exploration, venture capital investment, and new-product development—may find that moving toward a more dynamic management style requires a few relatively small, though collectively significant, shifts in their operating practices. Others may find the necessary changes, which include migrating away from rigid, calendar-based approaches to budgeting and planning, more wrenching. What I hope to do in this article is to lay out some core principles that will help either kind of company make the passage of time an ally rather than a challenge.

## Focusing on pivotal roles

A ship has a captain with a single mind. The "captain" of a large, complex modern corporation is likely to be dozens, if not hundreds, of people. Aligning those pivotal leaders so that they can steer the company in response to changing conditions is a major challenge for most organizations.

An essential first step is simply to define who occupies the pivotal roles. Some companies may have just a few; others 20, 150, or even more. On the one hand, the smaller the number, the easier it is to have the intensity of interaction needed to make critical decisions effectively and collaboratively. On the other hand, the number must be large enough so that the people involved in decision making can collectively access the full spectrum of knowledge embedded in a company's people and its relationships with other organizations. You'll never get perfect coverage, but if you wind up saying with any frequency, "We're flying blind on this topic without perspective from *X*," it's a good bet that you've kept the group too small.

Since determining what to do under uncertainty usually requires careful debate among many people across the entire company, you need processes and protocols to determine how issues are raised, how deliberation is conducted, and how decisions are made. You also need to clearly lay out the obligations of managers, once the debate and decision making is over, to put their full weight behind making the resulting actions successful.

I wish there were one-size-fits-all protocols for getting the smart, talented people who occupy pivotal roles (and who are accustomed to making decisions through a hierarchy) to work effectively with colleagues in collectively steering the ship. But the hard truth is that what works in one organization and among one set of individuals may not work in others. Since the move toward more dynamic management changes power relationships and the prerogatives of senior executives, a company's organizational, cultural, and political norms have a major influence on the ease of transition. (The more hierarchical and less collaborative the organization, for example, the bigger the challenge.) The best I can do is to suggest a few general approaches—whose implementation often looks quite different in different types of organizations—for helping the individuals occupying pivotal roles to work together in new ways.

### Learning by doing

If you require managers to use decision-making-under-uncertainty techniques (such as scenario planning, decision trees, and stage gating) to make actual decisions, they will quickly learn how to think differently about the future. And if you have them apply these tools in teams involving executives from diverse corners of the organization, they will gain a greater appreciation for the power of collective insight in volatile times, when information, almost by definition, is fragmentary and fast moving.

### Workshop-based adult-learning techniques

Executives can develop new mind-sets and skills, particularly to improve their ability to manage through the ambiguity and complexity inherent in today's environment. Some companies have made progress by developing case studies based upon potential decisions they will shortly be facing and then using facilitators and friendly colleagues to get leaders used to surfacing and debating alternative courses of action. Others have found war gaming useful for illustrating the cost of basing decisions on seemingly reasonable assumptions when events are moving quickly.

### Performance measurement

Companies need to hold their managers not just individually but also mutually accountable for their actions. This means evaluating how effectively executives contribute to the success of others. For example, how effective are executives at identifying the company's critical issues, even when such issues fall outside their areas of responsibility? And how proactively do executives provide their colleagues with intelligence, knowledge, and advice? Peer-assessment techniques often are invaluable in measuring collaborative behavior.

## Just-in-time decision making

Much of the art of decision making under uncertainty is getting the timing right. If you delay too much, opportunity costs may rise, investment costs may escalate, and losses can accumulate. However, making critical decisions too early can lead to bad choices or excessive risks. And making hasty decisions under time pressure or economic duress allows little room to undertake detailed staff work or to engage in careful debate. Here are a few suggestions for companies trying to create competitive advantage from their ability to manage the passage of time decisively.

### Surfacing critical issues

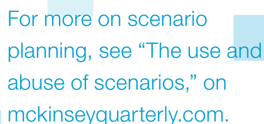
Most companies are accustomed to identifying major internal issues, such as whether to build a business, divest an asset, or lay off people. What's harder—and has become increasingly important over the past year or so—is the early surfacing of opportunities and threats arising out of external events such as dramatic shifts in demand, competitive behavior, industry structure, regulation, or the macroeconomic environment.

A commonsense approach to identifying such issues early is to poll, regularly, all of the company's top managers to get them to identify critical issues they see emerging. Each manager should provide a rationale for why any issues raised are critical. A small team of senior executives should review all such issues, designating some as critical and highlighting others for continued tracking. As time passes, some of these other issues may become critical; others may become less relevant and disappear from the list.

One challenge: many managers are reluctant to surface emerging issues early, because they fear being perceived as someone who is weak, or who cries wolf. A well-designed performance-management system, though, can ensure that the personal risk of surfacing critical issues late is much greater than the risk of raising them too early.

## Performing the necessary staff work

If a critical issue is surfaced early, there is usually time enough to use proven problem-solving approaches to making decisions under uncertainty. Decision trees, for example, help managers think about the structuring and sequencing of their decisions. Probabilistic modeling is useful for understanding the economic consequences of potential outcomes. Breaking big decisions into smaller, well-sequenced ones (the goal of stage-gate investing) helps organizations move forward without taking excessive risks. And building scenarios helps you gain perspective on your critical issues. If a particular decision produces favorable outcomes under all scenarios, it becomes a "no regrets" move justifying bold action. On the other hand, if a particular scenario is improbable, but the negative consequence (if it happens) is large, you need to build contingency plans.


For more on scenario planning, see "The use and abuse of scenarios," on mckinseyquarterly.com.

If companies tried to make all or even most of their important decisions in this way, the costs could be prohibitive, and there wouldn't be enough management bandwidth available to do anything but debate issues. Employing a materiality test, such as whether 1 or 2 percent of a company's future earnings are at stake, is therefore vital. In a typical large company, this may mean no more than two or three dozen such issues in any given year.

## Changing how decisions are made

Few companies are organized to get just-in-time managerial alignment for even a few issues a year, let alone two or three dozen. Gaining alignment among pivotal decision makers requires them to spend time together (in person, by phone, or in videoconferences) to surface emerging issues, share information, debate issues, and make timely decisions. How much time is needed for such meetings will, of course, vary with the company and its circumstances but is likely to be in the range of two to three days a month.

The only way to make this happen is to redesign the corporate calendar, along with corporate processes and protocols for how the meetings are conducted (including their length, decision-making roles, and required attendees). The redesign should encompass the creation of processes that enable the rapid surfacing and formal designation of issues considered critical. In addition, some companies have found it helpful to create a situation room—a physical place manned by support staff and connected electronically to people who can't be physically present—to serve as a hub to mobilize the information needed to enable debate to take place in real time among the appropriate decision makers.

## Rethinking corporate budgeting processes

Everything I've been describing flies in the face of management practices that have proven invaluable at many companies for nearly a century. However, fixed annual planning and budget processes are antithetical to timely strategy setting and decision making.

Yet it's important to recall why we have them: they enable the efficient delegation of authority between managers and subordinates. In return for the freedom to make decisions and allocate resources, the subordinate contracts through the budget to deliver expected results. The managers of a large company make tens of thousands of operating decisions every day, and if all of them required constant deliberations up and down the chain of command and across the organization, it would grind to a halt.

Jettisoning budgeting, therefore, is hardly an option—though it may have seemed reasonable at points over the past year, since most of the budgets produced in late 2008 for 2009 proved worthless (as did most companies' earnings guidance to stock analysts). What this underscores is a basic problem with budgets: if developments in the marketplace are sufficiently different from the assumptions used in budgeting, managers can't make their numbers no matter what they do. At best, by the time these developments have surfaced to the top, most of the lead time needed to address the emerging issues has been exhausted. At worst, the company faces a crisis after being weakened by the hidden costs of all of the short-term actions (such as maintenance cutbacks for manufacturers or excessive risk taking for financial institutions) undertaken by managers endeavoring to make their numbers.

So what's the answer? Many better-run companies have already adapted the budgeting process to make it more flexible. A large number use a base case, an optimistic case, and a pessimistic case to allow for a range of outcomes. More important, a significant percentage of companies now use rolling budgets to keep their plans current. These approaches aren't foolproof—many companies fall into the trap of using too narrow a range (such as plus or minus 5 percent), and even companies that use rolling budgets usually do so only by making small incremental adjustments, quarter to quarter, to the base case. Nonetheless, in a relatively stable environment, these approaches are a significant step forward.

But even rolling budgeting may not be enough to prepare you for a macroenvironment where you are unsure whether you will be seeing, over the next couple of years, a rapid return to global growth, an extended period of anemic growth, or a double-dip recession.

One alternative: move to a semiannual budgeting and financial-planning cycle where you make budget "contracts" for a 6-month, rather than annual, time period and undertake robust, scenario-based financial-contingency planning for the period from 6 to 24 months in the future. That approach allows companies both to continue using budgets that hold people accountable for the immediate future and to shift toward contingency budgets at

**Related articles**

"Leading through uncertainty"

"Setting strategy in the new era: A conversation with Lowell Bryan and Richard Rumelt"

"How managers should approach a fragile economy"

"Strategic planning: Three tips for 2009"

the end of 6 months should the circumstances warrant a change of direction. I believe many companies will find that a semiannual budgeting process works better than either an annual approach, which is based upon an unrealistic year-long budget-contracting horizon, or a quarterly update, which requires almost continuous rebudgeting.

Another valuable and potentially complementary approach is to have even 6-month budgets and the results reported against them automatically adjusted for "uncontrollables." That is, to improve accountability you can restate both budgets and results after the fact to remove, automatically, variances caused by macroeconomic uncontrollables such as interest rates, commodity prices, and currency movements. This approach can help senior leaders eliminate uncontrollable losses and windfall gains, thereby holding managers accountable for their performance in the marketplace rather than for whether the macroeconomy makes them lucky or unlucky.

Finally, many if not most companies will also find that they need to carve out discretionary budgets and staff to support just-in-time decision making. These budgets should be sufficient not just to support the needed staff work but also to provide the resources needed to begin implementing the decisions until they (and their financial implications) can be formally built into budgets.

Companies can't control the weather, but they can design and build a ship, and equip it with a leadership team, that can navigate the ocean under all weather conditions. Organizations that become more flexible and skillful at making critical decisions when the timing is right have enormous opportunities to capture markets and profits from companies that persist in managing as if the future business environment is reasonably predictable.

**Lowell Bryan** is a director in McKinsey's New York office. Copyright © 2009 McKinsey & Company. All right reserved.