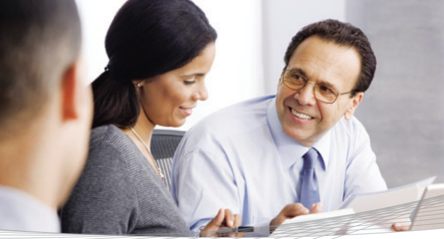

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The Bulletin

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Is Your Organization an Early Mover?

An "early mover" is a firm that quickly recognizes a unique opportunity or risk and uses that knowledge to evaluate its options either before anyone else or along with other firms that also recognize the significance of what's developing and seize the initiative to either capitalize on the opportunity or reduce the risk. Early movers have the advantage of time, which brings with it more options for decision-making before market shifts invalidate critical assumptions underlying their strategy.

Failing to attain "early-mover status," as we've defined it, can be fatal in today's complex business environment. Boards should ensure their companies are focused on the attributes that make for early-mover status.

Don't Confuse Early Movers with First Movers

Our use of the "early mover" distinction is broader than the traditional focus on "first-mover advantage," which typically refers to the initial significant occupant of a market segment. A marketing concept, first-mover advantage is often gained through technological leadership, entry into a space with room for only a limited number of profitable firms, and the creation of significant switching costs.

When a first mover cannot capitalize on its advantage, it leaves the door open for another firm to gain second-mover advantage. There is a body of knowledge around first movers and second movers and the advantages and disadvantages of each. The transition from mainframes to minicomputers, from minicomputers and workstations to personal computers, and the current transition from personal computers to notebooks, tablets and smartphones are illustrative examples.

With respect to the iPod, Apple was nowhere near being the first mover in the portable media player space – it just saw what others were doing and made its products better. However, when it comes to the iPhone and iPad, Apple was very close to being a first mover in both cases, considering the unique combination of features and functionality these products offer.

While first movers are also early movers, it is not necessary to be first to be early. The context for early movers is also broader, focusing on a wide range of opportunities and risks related to the ongoing validity of an existing strategy, as opposed to entry into new markets.

The "early mover" concept relates to detecting early signs of market shifts affecting the validity of an enterprise's critical strategic assumptions and making decisions on whether to act on those signs. Thus, an "early mover" can include a second mover. Apple, for instance, was an early mover with all three of the aforementioned products: iPod, iPhone and iPad. Therefore, the dichotomy we speak of is not "first" versus "second." Rather, it is "early" versus "late," with the market deciding what "late" means. The stakes of being an early mover can be as high as preserving the company's right to play.

Driven by both the desire to create enterprise value and the need to protect enterprise value, early movers take risks like any other successful company. They understand that changes in the business environment could alter the assumptions and risk/reward considerations management initially considered when making a strategic decision. Early movers get it: They know that things happen that can alter the fundamentals on which their business model is based. They understand the value of an early warning capability in a rapidly changing world.

Companies with the awareness, resourcefulness, agility and discipline to position themselves consistently as early movers have competitive advantage. This leads to superior longer-term enterprise value performance. More important, these firms are more likely to survive a major market shift than their less aware and less nimble peers. In contrast, companies that lack early-mover attributes risk paying a steep price as the speed of business increases.

We define the attributes of an early mover using three R's – RECOGNIZE, REACT and REFLECT. We discuss each below.

Recognizing Opportunities and Risks

RECOGNIZE means an early mover is able to discern quickly the opportunities and risks that really matter. This means the company does four things well:

1. It understands the critical assumptions underlying both its strategy and business model for seeking opportunities and undertaking risks.

2. It applies effective scenario analysis capabilities to evaluate situations arising from an event or combination of events that could invalidate one or more of its critical assumptions.
3. It gathers intelligence on competitors and markets, focusing on the most important drivers that show the scenarios of greatest concern are either developing or have occurred.
4. It distills information in a timely manner regarding its assumptions, scenario analyses and intelligence gathering, and reports the insights obtained to decision-makers and the board of directors.

Note that the focus on early movers is on strategic matters. All airlines moving in unison to raise prices is an operational matter, not a strategic matter. The pervasive decline of the housing market that precipitated the financial crisis is an example of a strategic matter. The timing in which market participants recognized *and* reacted to the impending decline in housing values before the crisis crested made a huge difference in terms of their reputations and their standing within the industry today. The crisis demonstrated that companies with an effective early warning capability are more likely to be early movers in a changing environment. We illustrate below.

The pervasive "volume and speed" lending business model that led to the subprime debacle was built on several assumptions – one was that residential housing prices would not fall dramatically across *all* major U.S. markets. Looking back, it is evident this assumption was flawed. Low interest rates, large inflows of foreign funds, lax underwriting standards, and the dramatic growth in the shadow financial system fueled a housing bubble of massive proportions. Once U.S. housing prices peaked and began declining in mid-2006, defaults began to escalate, real estate values continued to slide, and financial institutions and investors were forced to write-down the value of their subprime assets. The rest is history.

However, some firms recognized early the vital signs that the end was coming. What did they do that other firms did not do? The Senior Supervisors Reports of 2008[1] and 2009[2] provide insight into this question. According to these reports:

- **Time to act is a valuable asset in managing risk and opportunity** – Best-performing financial institutions were able to identify severe deterioration in housing prices a year or more ahead of their competitors. As a result, they had more time to evaluate the risks and formulate options for reducing and/or hedging their exposure.
- **Aligning assumptions with market realities makes a difference** – Firms that fared best during the crisis had more adaptive processes, which allowed them to alter their underlying assumptions rapidly to reflect newly changed circumstances. For example, they had a wide range of measures to provide different perspectives on the same risk exposures to offer more early warning insight about evolving conditions and create enterprisewide transparency. They also focused in-house expertise to conduct an independent assessment of the credit quality of assets and evaluate key risks and assumptions inherent in their asset portfolios. Some even tested asset values in selected markets and identified a steep decline in housing prices.
- **Undue reliance on the past in predicting market behavior may result in strategic error** – The financial institutions that emerged from the crisis most successfully were more willing to challenge underlying forecasting methodologies, consider multiple views of the future to test the robustness of the business model with "what if" scenarios, and think in terms of ranges and probabilities rather than in absolutes. For instance, some identified weaknesses in the historical assumptions underpinning their Value at Risk (VaR) measures, particularly with respect to the scale of shocks or market volatility they might face.
- **Depth and breadth of enterprisewide communication about early warning signs must not be constrained by silos** – The degree to which senior management receives timely, quality information has a huge impact on recognizing what matters. Firms not constrained by a hierarchical and "siloed" organizational structure were more likely to have a centralized function (e.g., an integrated risk committee or asset/liability committee) serve as a conduit across silos and lines of business, and to share quantitative and qualitative information more effectively. As for the firms that did not fare well in the crisis, their hierarchical structures tended to filter information moving up the management chain. This resulted in delays and distortions of the message, as well as an absence of timely discussions about market conditions between business lines and senior managers.
- **The board of directors must be engaged to understand risk and uncertainty fully** – A key weakness in governance in some firms stemmed from a disparity between the risks they took and those their boards thought they were taking. The Senior Supervisors Group noted that only rarely did it see firms share with their boards (and senior management): (a) robust measures of risk exposures (and related limits); (b) the level of capital the firm would need to maintain after sustaining a loss of a stated magnitude of the risk measure; and (c) the actions management could take to restore capital after sustaining such a loss.

While financial services provide the context for the above lessons, the lessons apply to any industry. They point to reasons why some firms recognized the vital signs early and others did not, positioning them to become early movers to exit an obsolete strategy. Companies that got a head start by as much as 12 to 14 months in reducing their exposure to the financial crisis ended in the strongest position.

[1] *Observations on Risk Management Practices during the Recent Market Turbulence,* Senior Supervisors Group, March 6, 2008, http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

[2] *Risk Management Lessons from the Global Banking Crisis of 2008,* Senior Supervisors Group, October 21, 2009, http://www.sec.gov/news/press/2009/report102109.pdf.

Reacting to Significant Opportunities and Risks

Recognition, however, is not enough to attain early-mover status. REACT means that an early mover acts on the significant opportunities and risks it recognizes. In this context, an early mover possesses three attributes:

- It fosters an organizational culture that facilitates consideration of the impact of changing market realities on critical strategic assumptions.
- It stimulates and encourages the necessary managerial intuition and ingenuity to translate information regarding the reality of altered strategic assumptions into actionable revisions to strategic and business plans.
- It seeks organizational resiliency; that is, the ability and discipline to act decisively on revisions to strategic and business plans in response to changing market realities.

Having knowledge of either an emerging opportunity or risk but not undertaking a process to convert that knowledge into hard choices and actionable plans is as useless as having no knowledge at all.

REACT is not as simple as it sounds, however. It implies the absence of "blind spots" spawned by such dysfunctional behavior as "tone at the top" issues, an unengaged board, a myopic, short-term focus on "making the numbers," lack of transparency, an unbalanced compensation structure, or a "warrior culture." A reward system based primarily on the volume of loans generated, without regard for the quality of the loan portfolio, may result in the failure or inability to act even if management is aware of the risk of an unacceptable concentration of bad loans with financially distressed customers.

So what factors likely had the greatest impact on whether a financial institution separated itself from the herd? The 2008 and 2009 Senior Supervisors Reports provide some insight:

- **Heavy dependence on uninterrupted access to secured financing markets greatly increased vulnerability** – Many firms took advantage of market opportunities to obtain short-term – even overnight – financing for assets that should have been more appropriately funded with long-term, stable funding. By overdosing on excessive short-term wholesale financing of long-term illiquid assets – and, in many cases, across geographical borders – these firms exposed themselves to a disruption of the secured financing market. Once the music stopped, it was difficult for them to withstand market stresses absent deposits and sovereign and/or central bank support. Faced with uncertainty about the value of specific instruments and mindful of the higher volatility of assets generally, lenders demanded substantial cushions, or "haircuts," on the assets they were willing to finance. By contrast, the firms least affected by market developments had the discipline to resist excessive short-term funding. Often, a firm's ability to react to emerging opportunities and risks is directly related to its business model. If an organization has leveraged itself so much that it is left in the untenable position of limited options, it doesn't matter what it knows about the market. It may have no other option than to continue its present course, for better or worse. This is not a good place to be.
- **Achieving balance between risk appetite and risk controls was crucial** – Best-performing firms promoted continuous dialogue between business areas and risk management functions and aligned compensation and other incentives with the goal of balancing risk appetite and risk controls and short- and long-term performance. They were more likely to accomplish this balance if an established risk committee met frequently to discuss all significant enterprise exposures and involved executives from key business lines and independent risk management and control functions as equal partners. This equality of partnership supported a propensity to react if the warning signs were clear, largely because management encouraged an enterprisewide approach to risk management and enhancement of control structures (both firmwide or at the business-unit level) to keep pace with the growth of risk-taking over time.
- **Survival hinged on executive management's involvement and board oversight when the firm's viability and reputation were at stake** – Firms that fared best in managing the crisis had senior management involvement and an active board. In developing a firmwide plan, senior management did not rely on the business lines to make decisions individually.
- **Establishing incentives for business lines to avoid unacceptable balance sheet growth and capital impairments engendered necessary discipline** – The firms that most successfully endured the crisis deployed rigorous internal processes requiring critical judgment and discipline in the valuation of complex and potentially illiquid securities. They sought to use market-aligned values consistently across the organization, creating internal pricing mechanisms providing incentives to control activities driving unacceptable balance sheet growth and capital impairments. Other firms had weaker controls over their potential balance sheet growth and liquidity and failed to create incentives for business lines to manage risk. For example, they continued to price the super-senior tranches of collateralized debt obligations at or close to par despite contrary market evidence. These firms relied too passively on external views of credit risk from rating agencies when valuing their exposures.
- **Imbalances between risk and reward in the compensation structure created "blind spots"** – Firms experiencing the most difficulty in managing the crisis permitted historical compensation arrangements that evidenced insensitivity to risk and skewed incentives to maximize revenues. Schemes for measuring individual performance often failed to take into account true economic profits, adjusted for all costs and uncertainty.

Once it is evident that market fundamentals are changing, REACT requires an open, disciplined culture that stimulates targeted communication to focus management on identifying options for decision-makers and to make the best choices consistent with the enterprise's appetite for risk. As noted above, open dialogue and engaged directors are vital to this process. REACT also requires the ability to convert decisions into actions, requiring change management to align behavior.

Reflecting on Failures to RECOGNIZE or REACT

RECOGNIZE and REACT are hard. Often, companies do one or the other, but not both. That is why there are so few early movers in an industry – all players within an industry rarely move quickly in response to a changing business environment. Our definition of an early mover tends to differentiate firms to some extent. We have defined an early mover as an organization that understands its critical strategic assumptions, monitors those assumptions over time, and is resilient when assumptions are no longer valid. However, it doesn't always work out that way. Surprises hit reputable companies and opportunities are missed. The question is, "Why?"

REFLECT means that an early mover learns from experience, especially when it fails to RECOGNIZE or REACT. In this context, an early mover does two things. First, it encourages admission of errors and learning from them. Second, it commits to continuous improvement, as evidenced by the ability to internalize lessons learned by converting them into process improvements.

The speed and complexities of business will lead to occasional errors in judgment, either in terms of being completely surprised by events or recognizing those events are possible or inevitable, but failing to react on that knowledge. When that happens, companies aspiring to be early movers seek to learn from their mistakes.

Summary

Early movers possess early warning capability. They are informed, meaning the right people obtain the right information at the right time and have the right tools in place to analyze the company's options. While they may be early to react or may decide not to act at all, they are usually early to see significant market shifts because they have organized capabilities to watch for them. Sometimes, they may choose to defer a decision and learn from the actions of others, while they watch and then exploit opportunities not seen by others.

Failing to attain "early-mover status," as we've defined it, can be fatal in today's complex and rapidly changing business environment. Attaining this status on significant issues affecting the strategy over time can lead to superior longer-term enterprise value performance.

Want to Know More?

Protiviti has published a white paper titled, *Performance/Risk Integration Management Model – PRIM^2: The Convergence of Corporate Performance Management and Risk Management*. Whether a company is rapidly growing, focused on establishing sustainable competitive advantage or improving its bottom line, it must consider how an integrated approach and discipline to deploy strategy while also managing the associated risks will improve its probability of achieving strategic objectives. To support this white paper, Protiviti is publishing its "Early Mover Series," with the first issue titled, "Analyzing Strategic Risk." The PRIM^2 white paper and all issues in the "Early Mover Series" are available at **www.protiviti.com**.