

**LESSONS FROM THE EDGE OF THE ABYSS –  
BUSINESS SCHOOLS BEYOND THE BURST BUBBLE**

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## **1. INTRODUCTION**

**Last night, the USB was requested by the EFMD (the European Foundation for Management Development) to participate in its Business School Crisis Barometer project. This was not totally unexpected, because over the past two years, the topic that has reverberated around business school corridors, in business school conferences and in the associated literature most frequently has been the recent financial crisis – its origin, unique anatomy, the role played by business schools as a generating force and the lessons locked up for the business education industry in the aftermath of the meltdown.**

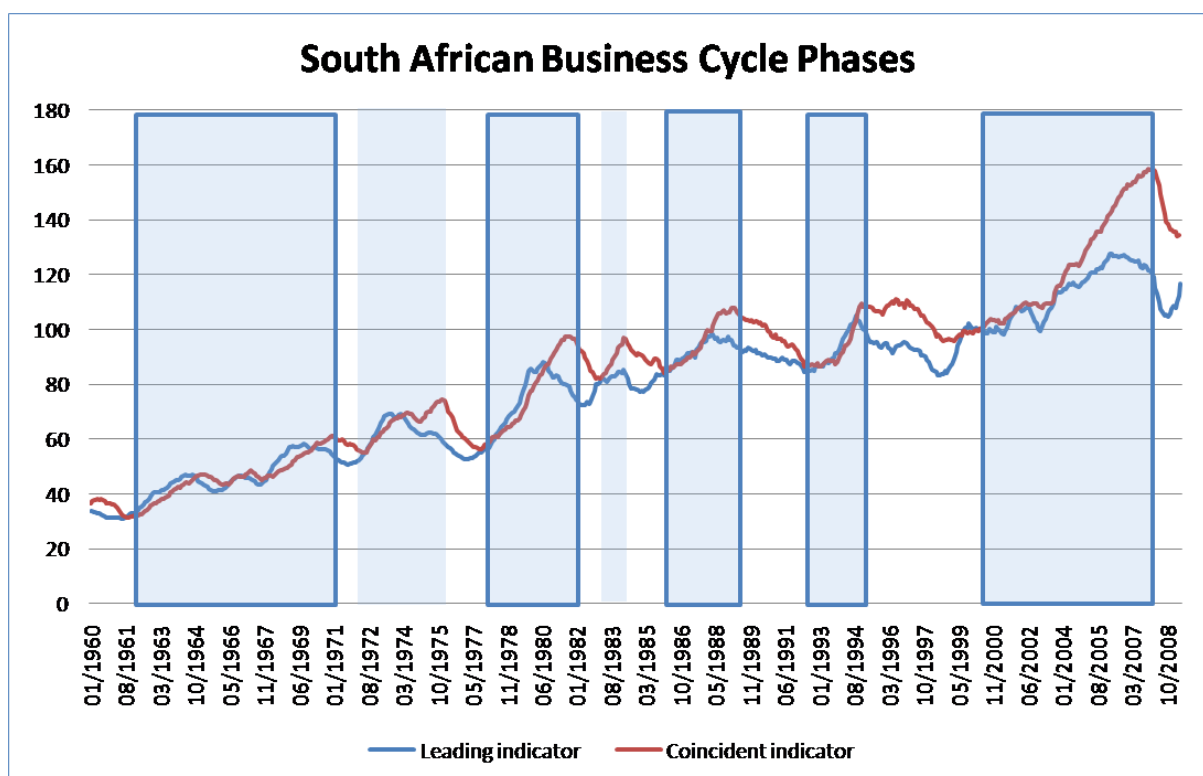
**The Queen of England set the tone on a visit to the London School of Economics by inquiring from the British Academy why nobody had noticed that the credit crunch was on its way. After all, economists understand financial bubbles very well – they know that the causes may differ, but that the anatomy is templated. The financial boom is generated by a trigger event, new securities emerge, financial innovations abound and cheap credit drives inflation in asset prices. Irrational investors appear, and massive overtrading and**

speculation occur in the absence of adequate financial controls. As leverage increases, fraudsters and tricksters have their day. Nagging doubts arise in the minds of more rational market participants – which leads to a selling flood in which marginal institutions, firms and banks fail in a panic sell-off, followed by debt deflation and a new base building leads in the recovery phase.

History holds many examples – Dutch Tulipomania in the 1630s with tulip bulbs as speculative asset, the Mississippi and South Sea Bubbles in property in the 1720s, the Great Crash in shares in 1929, the Global Crash of 1987 on the back of junk bonds and financial derivatives, the Dotcom bubble of the year 2000 and the recent Global Financial Crisis, blamed on cheap credit.

The Queen, however, has posed the wrong question. The end of the bubble was foreseen by many. I had attended several public addresses by Mr Tito Mboweni, where he warned South Africans that the good times were drawing to a close. Nassim Taleb observed "... the government sponsored institution Fanny Mae, when I look at the risks, seems to be sitting on a

barrel of dynamite, vulnerable to the slightest hiccup. But do not worry: their large staff of scientists deemed these events "unlikely". As a national warning, the South Africa leading indicators predicted the downturn as early as mid-2006 (see graph below).



What was not foreseen was the exact form the crash would take, the timing of its origin and its ferocity. These should be the focus of any study trying to comprehend the crisis and the unique lessons flowing from the burst. What then was unique about the end of this period of prosperity? Haldane of

**the Bank of England identifies three primary causes.**

## **2. DISASTER MYOPIA**

**The financial crisis was preceded by almost a decade of growth and increasing living standards stemming from a savings glut inducing a global "feel-good factor". For many of us the previous crisis had faded into obscurity and for many young, influential professionals (and consumers) it had the status of a myth. Those with good memories and nagging doubts, found solace in the speed and ease with which the economy recovered after the dotcom bubble exploded. It is a psychological reality that the longer the period since a rare event has occurred, the lower the subjective probability that it will recur – which appears to be rational in a Bayesian sense.**

**Risk analysts in financial institutions put their trust in Value at Risk models and other sophisticated instruments of stress testing developed since the October 1987 Crash without realising that owing to disaster myopia the market price of risk was too low, inducing a credit boom.**

Even if the feel-good factor is discounted, numerous authors have shown that a reliance on the normal curve for risk estimation leads to serious under-estimation of risk. Taleb draws our attention to events which are outliers beyond the realm of our regular expectations, carry an extreme impact and, after the fact, seem to have been predictable.

Rarity, extremeness and the illusion of retrospective predictability together define a Black Swan, which he argues, will become a more frequent future reality. However, most market participants appear confident that future returns will resemble those of the past.

And financial sector risks are not the only risks the world faces (although events in alternative domains will also play out in the financial domain). Consider the uncertainty of the outcomes and the enormous cost of the wars in Iraq and Afghanistan, terrorism, the threat of global warming, a new multi-polar world order looking for leaders, global pandemics, natural disasters causing world-wide destruction, and reputation risk.

**Other risks can be more subtle and better disguised – business and economic leaders seemingly focussed on short-term return horizons, vast differentials between the rich and poor (between countries, but also within countries), a society focused on money over achievement, charisma over character and the dearth of leaders willing to defy conventional wisdom and to shoulder the mantle of Sir Lancelot in defending that which is right, noble and true.**

**Let it be said, however, that world leaders, by putting aside political differences and acting together in unison and with laudable speed, probably in this instance prevented a more disastrous outcome.**

### **3. SYSTEMIC RISK**

**The ferocity of the crash was vastly underestimated, owing to the fact that some of the best mathematical minds in the world, employed to calculate risk for financial institutions, lost sight of the bigger picture and neglected or underestimated the risk to the system as a whole, rather than to any specific institution, instrument or exposure. According to the British Academy: "Everybody seemed to be**

doing their own job properly on its own merit. And according to standard measures of success, they were often doing it well. The failure was to see how collectively this added up to a series of interconnected imbalances over which no single authority had jurisdiction. This, combined with the psychology of herding and mantra of financial and policy goals, lead to a dangerous recipe. Individual risks may rightly have been viewed as small, but the risk to the system as a whole was vast”.

Asset portfolios represent financial networks with nodes defined by assets and links expressed as correlations. In a similar way, the global financial system is a network, with financial institutions as nodes and links defined by the interconnections between institutions. The evaluation of risk calls for knowledge of the risk of the counterparty, and the counterparty's counterparty and so forth, ad infinitum. Lehman Brothers was a particularly sensitive example of this phenomenon. To understand the full consequences of Lehman's failure (despite the 4 000 risk managers employed) would have called on a detailed comprehension of the full topology of the network. This brings us into the realm of the

intellectual landscape of the science of complexity of which Stephen Hawking said in 2001: "I think the next century will be the century of complexity".

If you extend the financial nodes in the global system to include the environmental, health, energy, social, economic, political and spiritual sub-systems, we only begin to perceive the systemic risk internalised in the "flat world" of the 21<sup>st</sup> century.

#### **4. MISALIGNED INCENTIVES**

The Financial Crisis again spotlights the principal-agency problem which is always with us, but becomes more pronounced in business cycle booms. Financial innovation has lengthened the chains of information and understanding from the investor (owner) to the borrower. Numerous possibilities exist to impair, modify or censor the correct information before it reaches the investor. Principal-agent problems operate on two levels – between risk-managers and risk-takers and between financial institutions and the regulatory authorities. In the boom period, power switches from the back to the front office and risk managers lose

**influence. This is amplified by the behaviour between competitors and also comes into play in the relationship between the bank and the regulatory authority where stress-testing at times takes on the character of regulatory camouflage, rather than systemic risk management.**

**From this agency problem stems the public onslaught on business schools (Harvard specifically) blaming the events on the shortcomings or warped characters of MBA graduates by arguing that:**

- managers suffer from a simplistic growth mentality relying on a business model immersed in the cycle of debt-fuelled growth**
- managers hide their actions behind a veil of secrecy**
- managers fail to comprehend the strategic imperatives of the new world**
- managers optimise over the short-term, leading to non-sustainable behaviour and externalities**

- **managers are lacking in ethical behaviour and easily succumb to greed**
- **managers fail to understand the complexity of the flat world (including the physical environment)**

**To conclude with the British Academy: "... the failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in Britain and internationally, to understand the risks of the system as a whole".**

## **5. CONSEQUENCES AND LESSONS**

**The USB has been working on the redesign of its MBA for some time now. Incorporated in the new degree – designed before the crash – you will find embedded aspects that some of the foremost schools in the world are only discovering as a result of the bubble. To name a few: a renewed and personalised focus on sustainable leadership which focuses on ethics, attitudes and values is high in touch-space and is constructed around integrated delivery of subject matter (as**

has been attempted in all subject areas), together with research centres that focus on Leadership, Coaching, Sustainability, Governance, Dispute Settlement and the Future. I have argued before that we have been sensitive to most of the issues that schools are criticised for today, not by being clever or by having better foresight, but simply by being exposed to the unique challenges that we face in a developing society with massive income imbalances.

However, there are more lessons to be learned from the crisis – for ourselves, but also for the global business school community.

For me two stand out – first we have to radically rethink how we address risk in our programmes. We have to move beyond standard deviations and normal distributions and consider new risk models, consider the ideas of Taleb, deal with systemic risk in financial markets as well as the risk exposure arising from global integration – the threat of the domino effect. Furthermore, we will have to pay attention to new sources of risk entering and affecting the world of business, as well as to the management of both internal and

**systemic risk, to ensure that risk is correctly priced. This may be difficult, but we owe it to the managers that we educate to have a realistic understanding of risk. I do not, however, see business schools become players in the field of educating technical risk management experts – this is well left to the financial engineers, auditors and actuaries.**

**As far as risk management is concerned we have to propagate the idea that we have to move beyond the mere formalisation of risk in terms of rules and procedures to evaluate and adjudicate on risk, accompanied by the externalisation of risk through utilising the expertise provided by third parties (auditors, regulators, credit rating agencies) to the personalisation of risk which implies leaving the measurement of and judgement around risk, to those individuals making the decisions. Employees should develop an ethos of shared accountability.**

**An element of the MBA programme that may need elaboration and rethinking is systems theory, or rather complexity theory. Complexity theory overarches the different business disciplines (and non-business disciplines)**

and provides a paradigm for understanding the mutual linkages and relationships between variables. As such it is useful to study financial institutions, their internal linkages, external linkages and linkages between all those institutions and phenomena that carry risk into the world that we manage.

Against the background of disaster myopia, there may be benefits in providing students with a sense of history, although whether by means of a formal course or just suggested readings is debatable. Knowing history prevents reinventing the wheel, and assists us in understanding and being at ease with change. It also illustrates how what is right for one place and one time, for one company in one set of circumstances will not necessarily work for others. It further assists us in separating business fads, from that which creates long-term value. Keynes, as always, provides guidance by advising: "Study the present in the light of the past for the purposes of the future".

Those who call for the abolishment of capitalism because of the crash may do well to remember that business cycles –

**gloom and prosperity – is not merely a capitalist phenomenon, but was an integral part of communist and socialist economic systems as well. Booms and busts appear to be a reflection of the human psyche – a process of creative destruction cleaning the economic system of that which is inefficient and overvalued.**

**The global crash will have an influence on the future of business schools and the organisations they support. In summary – one may see the economic system evolve in the direction of greater administrative authority and more and more complex regulations. One may see fewer MBAs becoming investment bankers – the new workplace may not be Wall Street, but entrepreneurial start-ups; for example the energy sector may be at the front end of the careers of the future. Business schools may migrate closer to their customers, to learn but also to advise. And dissenting voices from business schools may become more audible in the public debate of the future, sharing more concern about broader society and leading business thinking in its reconstruction phase.**

**In conclusion, do business schools then plead guilty to the charge of being responsible for the financial crisis? I think not. Our analysis of the crisis indicates that fingers can be pointed at financial engineers (frequently technical experts without an education in business and economics, but highly skilled in physics and mathematics), auditors, supervisors, risk managers, politicians, regulators and other functional specialists, usually not trained in business schools. The second-round business failures (GM etc) might have employed more MBAs.**

**Second, given the anatomy of a business cycle, and the role play by greed, there is no evidence to suggest that greed today is more widely dispersed among MBAs than it had been among decision-makers during one of the earlier bubbles. And if MBAs have to shoulder the blame for the burst bubble, they certainly also should be praised for the growth achieved in the golden decade preceding the crisis.**

**Blaming the MBAs seems like pursuing incorrect scientific methodology – instead of looking for falsification of the proposition (which abounds), the inquisitors look for**

**evidence of confirmation – only finding white swans.**

**For those 500 000 students enrolling for MBA programmes, we can unequivocally say that there is no crisis in business schools. It would be unwise, however, to close our eyes to the very pertinent lessons contained in this brief history of an exploded bubble. However, no MBA of the future will escape the pain of business cycles.**