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The Leadership Blind Spot:

a simple lesson with game-changing consequence

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Whether you are leading a household, a business, a nation or you are managing your investment portfolio (or even your health!)… there is a concept that will not only allow you to move towards your goals with greater confidence, but thinking deeply about this will redefine the whole way you approach life.

The lesson arises from the design that we see in nature all around us, in fact it can be applied to every facet of life.

It is the key insight that underpins and defines the concept of 'sustainability'… and when it comes to trying to predict the future success of someone's career, one of its key components proved a greater predictor of success than even talent, IQ, hard work or social ability…

But first, so that we may properly unfold these lessons we need to look at the design we see in nature…

Many decades dedicated to the deep study of natural ecosystems, has resulted in a deep array of insights into how ecosystems both survive and thrive.

> *An ecosystem is a community of living organisms (plants, animals and microbes) in conjunction with the nonliving components of their environment (things like air, water and mineral soil), interacting as a system.*
>
> *Tansley (1934); Molles (1999), p. 482; Chapin et al. (2002), p. 380; Schulze et al. (2005); p. 400; Gurevitch et al. (2006), p. 522; Smith & Smith 2012, p. G-5*

If we step back and broaden somewhat our conception of an 'ecosystem' we will realise that everything in the world whether it be a living organism like an animal, a societal construct (like a family or a business), or even a financial market, is essentially an ecosystem within a larger ecosystem in some way shape or form.

With ecosystems you can't understand one of its variables in isolation of the broader system of which it is a part (for example, it's hard to understand a child until you step back and understand the child's family, community, culture and experiences which have helped to form him or her).

As you can guess, ecosystems can get very complex very fast and can get very difficult to predict in certain situations – their study and analysis is a lifetime endeavour in its own right. However, one of the key learning's that we have has to do with the key elements that give rise to ***the long-term viability and success of the system.***

Essentially, we can gauge the longer-term success of a system by understanding its characteristics in terms of its (1) efficiency and (2) resiliency.

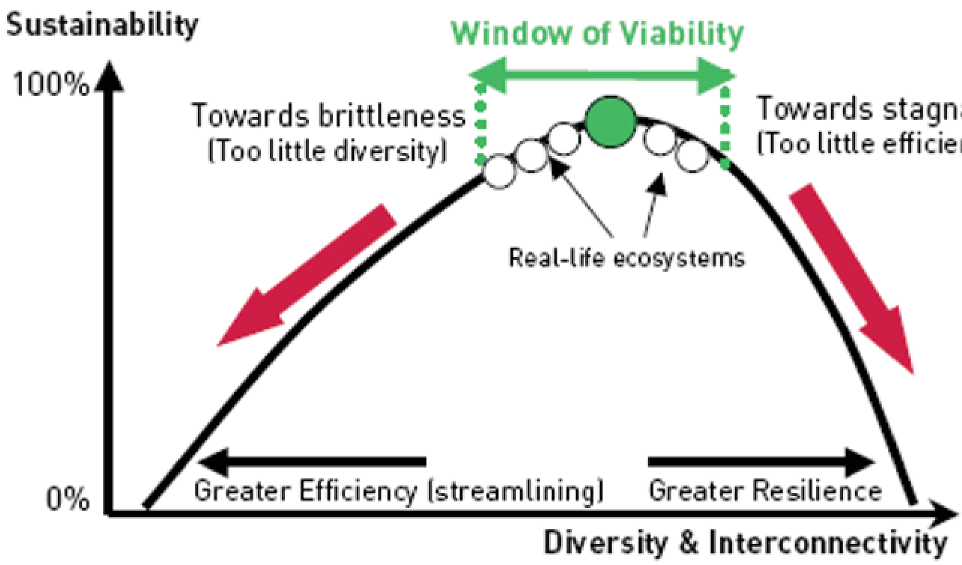
> ***Efficiency –*** *1590s, "power to accomplish something". In mechanics, "ratio of useful work done to energy expended."*
>
> ***Resilience -*** *1620s, "act of rebounding"; "to rebound, recoil"; "to jump, leap"*
>
> *www.etymonline.com*

In other words, efficiency is the ability to 'productively do stuff', resiliency is the ability 'to bounce back (or adapt around) a disturbance'.

In a business setting, efficiency would equate to becoming more 'streamlined' and focused in what you do so as to maximise profitability in the short to medium terms from a less diversified revenue source – this would be done often by investing significant amounts of capital into plant, equipment and personnel etc (being significantly 'invested' makes you more committed to the productive activity that the business pursues). Resiliency in a business setting would be to diversify your income sources and to operate in a manner that maximises cash-flows, minimises debt and prioritises staff-multiskilling so as to become more adaptable and innovative when unexpected challenges befall the business.

The problem with these two dimensions is that in order to become more 'efficient' you often become less 'resilient'… conversely, in order to become more 'resilient' you often become less 'efficient'.

The main point to realise is that nature does not select for maximum efficiency, rather it selects to ***balance*** efficiency with resilience.



Source: Bernard Lietaer, Robert Ulanowicz, Sally Goerner; "Options for Managing a Systemic Bank Crisis" (2009), Institut Veolia Environment.

Decades of study of natural ecosystems has resulted in some very sophisticated mathematical understandings of how even these two key character traits interact and balance with each-other… essentially, natural systems that both survive and thrive over the longer-term typically balance the need for both resilience and efficiency in a ratio of approximately 2 to 1. In other words, nature does not select for maximum efficiency, rather it seeks to prioritise resiliency over efficiency in an optimal manner.

A system is likely <u>to survive and thrive over the longer-term</u> IF it tends to be roughly 2/3 resilient and 1/3 efficient.

…and here we are introduced to the key blind spot that we see amongst leaders, generally speaking the majority of leaders we have observed or worked with tended to have this ratio reversed, that is, to be 2 parts efficient and 1 part resilient.

- In **business** it often expresses itself in an overly-cyclical business model, lack of true diversity in revenue streams, inability to adapt/innovate/overhaul its business model in a timely manner, limited abilities to be able to handle a significant unexpected setback etc.
- In a **household** it will often express itself as a bias towards a single income dependency or over-indebtedness or insufficient insurance in place or insufficient savings or an unwillingness towards continued education (productive skill-set development).
- Within a **nation** it will express itself in a 'growth model' driven by debt or an artificially depressed currency or an outsized dependency upon servicing a particular segment of the broader global economy
- Within an **investment portfolio** it might be an over exposure to equities &/or property with a 'buy & hold' (i.e. roller coaster ride) approach to investment management.

The Growth Paradox…

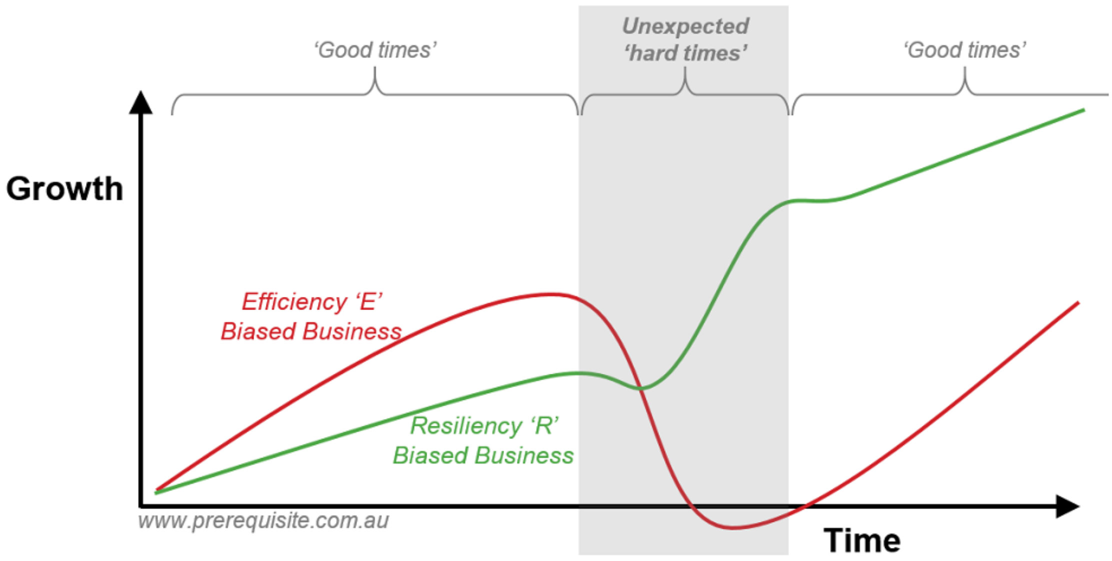
This bias towards 'efficiency' might appear very productive during the good times, but when unexpected disturbances occur (i.e. like a Global Financial Crisis or similar) then the survival of the system is threatened or significantly impaired.

This brings us to a significant paradox in systems performance dynamics… quite simply, over the <u>*medium to short terms*</u> growth is maximised by focusing on *efficiency*… but over the <u>*longer-term*</u> growth is maximised by biasing the system towards *resiliency!*

How can this be??

Lets take two businesses, calling them 'E' and 'R'.

Business 'E' is overly biased towards *efficiency* (see red line in diagram top of next page), business 'R' seeks to optimally balance towards *resilience* (see green line in diagram top of next page)…



During the 'unexpected tough times' the *efficient business* gets hammered (even to the point sometimes that its very survival might be challenged), whereas the *resilient business* is able to adapt and even significantly expand/capture market share (due to its 'efficient' competitors getting flogged). The resilient business has the cash and the adaptive business structure to be able to expand whilst everyone else has run out of cash and is contracting. Over time the resiliency-biased business will grow significantly larger and stronger than its efficiency-biased competitors.

Obviously this illustration is a little on the simplistic side, but it demonstrates the principle nonetheless.

> *"The slow way is the sure way" …Jerry Savelle*

An example of two investment portfolios…

Just like in a business setting, it is often the same for an investment portfolio…

Exhibit 3: Low volatility may potentially improve compounded returns

High Volatility Investment		
	% Return	Hypothetical Growth of $10,000
Year 1	6%	$10,600
Year 2	-30%	$7,420
Year 3	30%	$9,646
Year 4	10%	$10,611
Year 5	5%	$11,141
Yearly Average	4.2%	$11,141

Low Volatility Investment		
	% Return	Hypothetical Growth of $10,000
Year 1	4%	$10,400
Year 2	-4%	$9,984
Year 3	9%	$10,883
Year 4	6%	$11,536
Year 5	3%	$11,882
Yearly Average	3.6%	$11,882

Source: Eaton Vance, September 2013. Hypothetical chart is for illustration purposes only and not meant to represent the performance of any fund or predict future performance. Alternative hypothetical scenarios can generate different results in which the high-volatility investment outperforms the low-volatility one.

The above table show two hypothetical investment return profiles, the first on the left would be analogous to our “efficiency biased” business above, the portfolio on the right analogous to our “optimal resiliency biased” business. It shows that the hypothetical outcome that the ‘efficient’ portfolio from $10,000 grew to $11,141 over the 5 years, whereas the ‘resilient’ portfolio grew to be worth $11,882… and just like the business example above, which investor do you think slept the best at night? Which investor was able to operate with a higher confidence that they would achieve their future goals & objectives??

Longer-term success is better predicted by this quality…

A few months ago there was a widely circulated TED talk given by a Wharton researcher that outlined studies that forecast performance amongst corporate salespeople, students & teachers in challenged school systems, and West Point cadets (West Point is the US’s preeminent Military Academy)… in all of these settings the character trait of ‘resilience’ (or ‘grit’) had a demonstrably higher ability to predict success than IQ, work ethic, social ability, or talent.

So whether you are running a business, a household, a nation, your own career or even an investment portfolio – there is significant merit to stewarding things in a manner that is biased towards resilience on balance.

There is much more that needs to be explained on this topic, it should also be noted however that there are ways to develop things in a way where both efficiency AND resiliency are promoted at the same time (i.e. efficiency & resiliency don’t always have to pull in different directions to each-other), but those discussions will need to wait for future articles.

At Prerequisite Capital Management (PCM) the principles and the lessons outlined above cut to the very core of how we have built and established both our business and the investment portfolios that we manage for clients. In addition to more general financial advice & coaching, we also help clients to more appropriately design their insurance strategies to ensure that their families, their incomes, their businesses and other important things are sufficiently protected in a cost-effective manner. Please feel free to contact us to arrange a free (obligation free) consultation.

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