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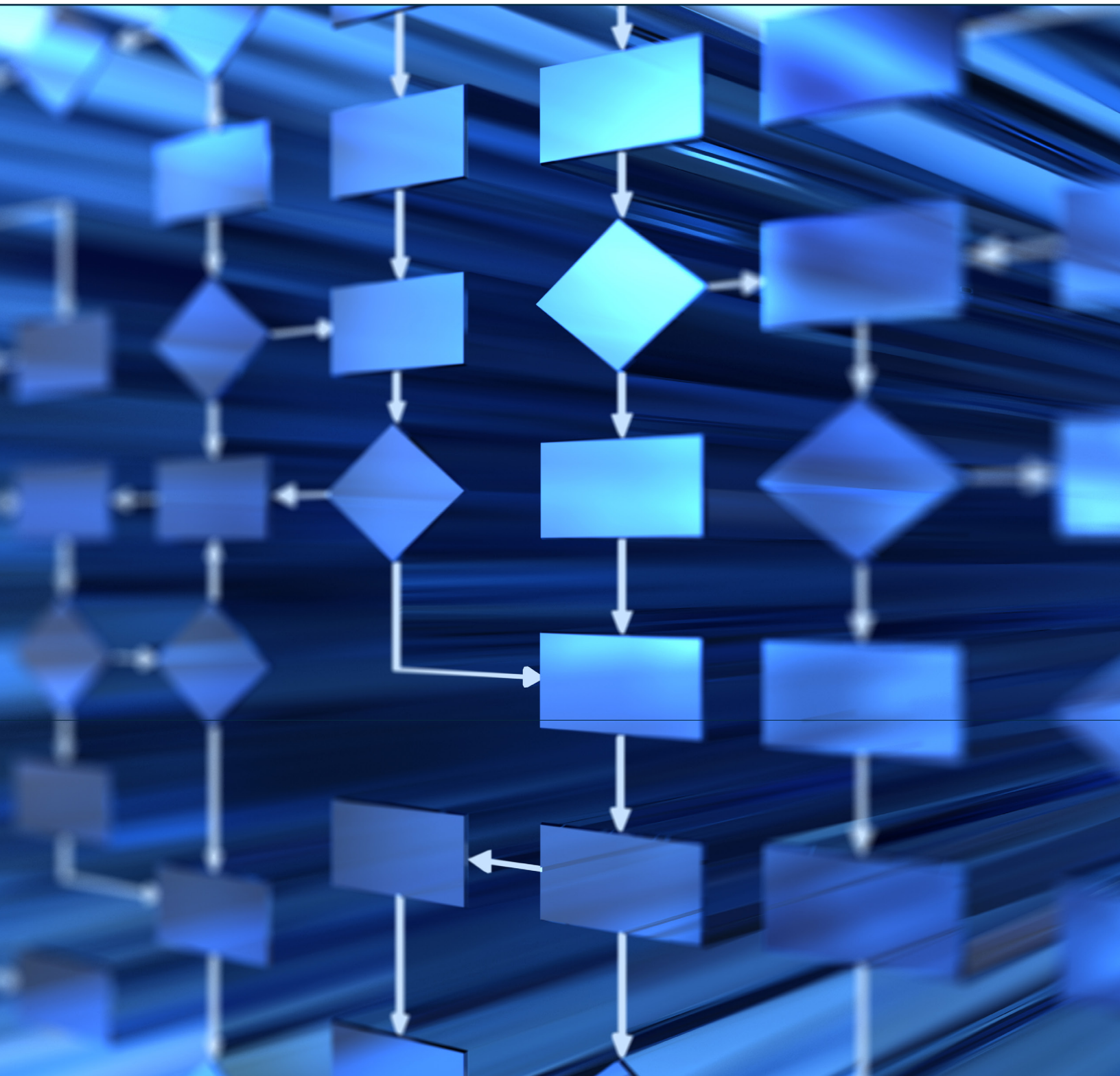
Downright Dangerous Decisions: Developing Strategy Amid Uncertainty



Downright Dangerous Decisions: Developing Strategy Amid Uncertainty

BY JAY BOWMAN AND BRIAN STRAWBERRY

An uncertain future does not mean an unknowable future.

As a songwriter once said, "Changes aren't permanent, but change is." The velocity of change over the past few weeks has ushered in a sense of uncertainty about the future that few have experienced in their lifetimes. This sense of uncertainty can often introduce dangerous tendencies in decision-making, which at its worst can lead to disastrous outcomes. Therefore, it is important to guard against this by reminding oneself that although things are uncertain, they are not unknowable. Differentiating between what is possible and what is probable has proven an effective means for developing a strategic response to the present reality and the likely future.

Avoiding Extremes

When there is heightened uncertainty, research has demonstrated two common responses by managers. The first is decision paralysis—or difficulty making decisions with confidence. This most often occurs in risk-averse organizations. Risk-averse managers tend to delay action in order to gather vast amounts of data or default to a "wait-and-see" approach. However, do not mistake this as a no-decision response. A decision to delay or do nothing is a decision in and of itself. FMI's postmortem of the Great Recession revealed that many industry stakeholders found their strategic decisions during that period to have been the right ones; but had they acted sooner, many of the unintended—and negative—consequences could have been minimized or avoided.

The above tendency is related to the concept of "normalcy bias," or the tendency for leaders to underestimate a disaster and assume the future will most likely resemble the past and again delay making critical, sometimes lifesaving, decisions. It is estimated that as many as 80% of people display this tendency during disasters. Managers who adopt a "wait-and-see" approach are believed to be most susceptible to normalcy bias. Those who do not will not only survive but also often thrive during disastrous events. For example, a study of 3,500 companies found those that took preparatory action ahead of the Great Recession significantly grew earnings before interest and taxes (EBIT) throughout and in the years that followed.

The second common response when there is a heightened sense of uncertainty is to rely on "gut instinct." It is the opposite tendency of those impaired by decision paralysis. Managers who make decisions on gut instinct are quick to abandon analytic rigor. Not only do they often fail to properly assess the situation or consider new data and information as they become available, but also they allow biases to affect their decisions. These frequently include "anchoring bias" and "confirmation bias."

Anchoring bias occurs when a manager overemphasizes an initial experience, observation or set of data and information. As new data and information are presented, it may be discounted or ignored. Confirmation bias is the unwillingness to consider data and information that are contrary to a belief the manager already holds. Together, these two biases can lead managers to hold fast to their decisions, even when the need to change is readily apparent.

Perform Due Diligence From a Scenario Perspective

Managers never have all of the data and information necessary to make a decision devoid of risk. Some degree of "best guess" or "gut instinct" is necessary, but some level of due diligence should inform decisions in a crisis. All good strategies begin with some form of situational analysis. This requires understanding what is precise enough and responding appropriately to new data and information as they are revealed. Consequently, strategy and decision-making in a time like this should be conducted on an iterative and recurring basis rather than at a single point in time.

With respect to the current crisis, there is a range of outcomes that may occur. However, some possible outcomes are more likely than others. A question to ask when developing scenarios covering a range of possible outcomes is: How do we balance what is possible with what is probable? Most scenarios are possible, but they are not equally probable. Ideally, your set of scenarios should be:

- **Limited**—no more than five
- **Anchored**—based on the key variables that will most likely dictate a future state
- **Distinct**—no scenario overlaps with another scenario
- **Objective**—frame a specific (vs. range) outcome
- **Focused**—specifically on the resulting impact on the organization, its clients/customers and competitors

When developing forecasts, FMI always considers multiple scenarios. Given the fluidity of the current crisis, we are sharing the range of possible outcomes used to assist our clients in developing their own specific scenarios and corresponding strategic responses. The potential outcomes we developed are based on the following economic assumptions:

1. **The disruption to normal economic activity could end within three months.**

   Has the reaction to COVID-19 in terms of closures, quarantines and similar halts to normal economic activity been appropriate? That is a question that simply cannot be answered today. There are pessimists and optimists on both sides of this question. Only time will tell if this pessimism was "appropriate, inadequate or excessive," as recently commented on by Howard Marks, co-founder of Oaktree Capital Management.

   There is evidence and historical precedent regarding recommended response stemming from similar epidemics/pandemics. Any guess though about when economic activity should return to normal—or what it was before things effectively came to a standstill—is just that, a guess. However, as expediency submits to experience and expertise, it may be reasonable to assume economic activity could return to normal within three months.

2. **Zero GDP growth means the same thing as "same as last year," but consensus forecasts suggest otherwise.**

   No doubt much of March will prove a disastrous month for the U.S. economy. The stock market has suffered historical losses, and it remains to be seen where the proverbial dust settles. At one point, the S&P 500 plunged 27% from a record high on February 19—the fastest and sharpest decline in stock prices from a record high since 1931. In addition, the volatility index (VIX) increased from 12 to 82 by March 16, and benchmark 10-year Treasury yields fell from 1.65% a month ago to an all-time low of 0.31% on March 9, before stabilizing at around 0.80%. Given this and the prognostications of various industry observers, forecasts for U.S. GDP in 2020 have been revised downward, most negative for 2020. If GDP were to fall to zero for the year, this means the same thing as "same as last year." This looks increasingly like best-case scenario.

Exhibit 1. U.S. GDP Forecasts

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	2020 (YR)
Dodge	-2.5%	-18.3%	+11.0%	+2.5%	-2.2%
Goldman Sachs	-9.0%	-34.0%	+19.0%	+10.0%	-6.2%
J.P. Morgan	-10.0%	-25.0%	+8.0%	+4.0%	-10.0%
NAHB	-1.6%	-11.1%	-4.8%	+3.3%	-1.6%
IHS Markit					-5.4%

Source: FMI analysis of various sources. March 31, 2020

Additional commentary:

- *IHS Markit*—"Currently, in the United States, just 5% of people telecommute, or work remotely. It is likely that this share could increase once the telecommuting model is broadly tested. According to our case study of the United States, a rise in the share of the population permanently working from home—from 5% to 15%."

- *J.P. Morgan*—"Active infections to peak around 10 weeks after the confirmation of cases in individual countries. The longer the duration of the interruption to activity, the deeper into the population of firms likely closures will occur, and the greater the feedback into consumer incomes and expectations. U.S. lockdown restrictions are gradually lifted in May, with a return to normal levels of mobility, mass gatherings and transport by June."

  Are these reasonable forecasts? Perhaps. Consider Howard Mark's recently shared opinion: "After we've learned more about the coronavirus and developed a vaccine, it seems to me that it is unlikely to fundamentally and permanently change life as we know it, make the world of the future unrecognizable, and decimate business or make valuing it impossible."

3. The impact on construction demand will likely be highly variable and not fully realized until later this year or early 2021.

It is uncertain as to the potential decline in construction spending put in place as a result of both COVID-19 and the Saudi-Russia oil price war. Assuming economic activity in the U.S. returns to normal or near-normal levels by the third quarter, FMI forecasts construction spending put in place to decline by 3% compared to 2019. This is two percentage points lower than what was forecast in the fourth quarter of 2019 (-1%).

During the Great Recession (2006-2011), total spending put in place in the U.S. construction industry declined by approximately 35%. However, this varied significantly by segment. For example, construction spending in the single-family segment declined by almost 80% during that same time period, yet construction spending in the power segment increased by almost 80%. In fact, eight of 19 segments experienced increased demand from 2006 to 2011. As has often been said, bulls and bears coexist in every economy.

Our recommendation is to view the forecasts much like you would a hurricane tracking map (i.e., cone of uncertainty). We are not forecasting the bottom end of the forecast. Rather this represents the risk that we believe is in the forecast. The top line represents our current forecast. The three scenarios we present are as follows.

- **Current assumed trajectory**—FMI's current assumed trajectory (i.e., Q1 2020 Outlook) assumes two quarters of negative GDP growth (i.e., Q2 and Q3), ending the year between zero and 1%. This triggers an official recession.

- **Extended economic disruption**—The extended economic disruption line assumes three quarters of negative GDP growth (i.e., through Q4 2020). Economic recovery would not occur prior to the presidential election.

- **Disruption to disintegration**—This scenario assumes a minimum of six quarters of negative GDP growth (Q2 2021) and would be equivalent to that of the Great Recession (i.e., December 2007-June 2009). Significant financial collapse must occur under this scenario.

4. **Residential construction is currently at risk of returning to near Great Recession levels over the next five years.**

Exhibit 2. U.S. Total Residential Buildings Construction Put In Place

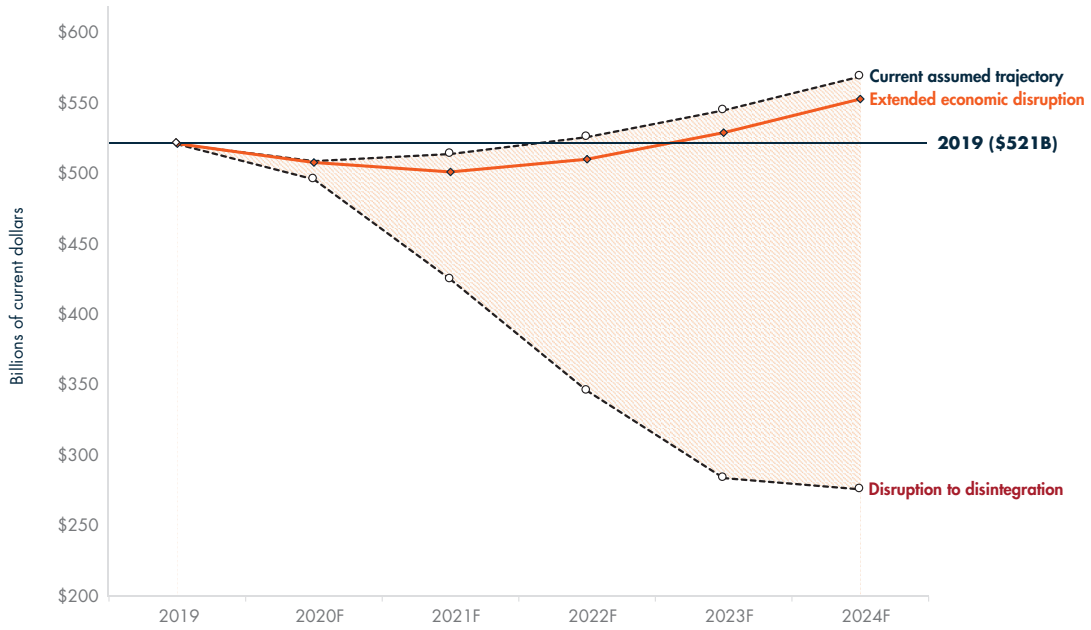
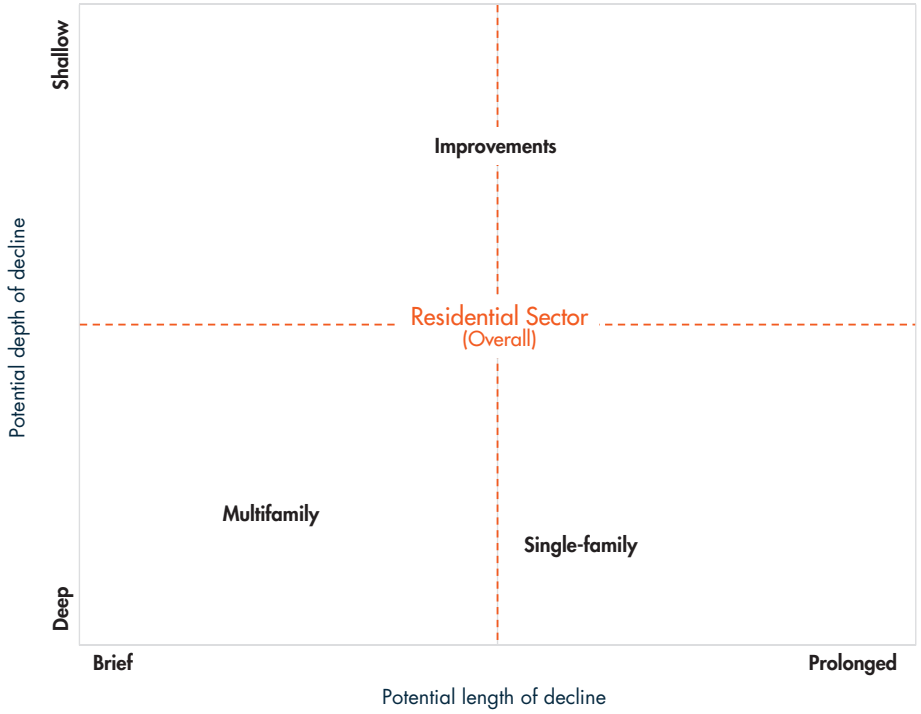
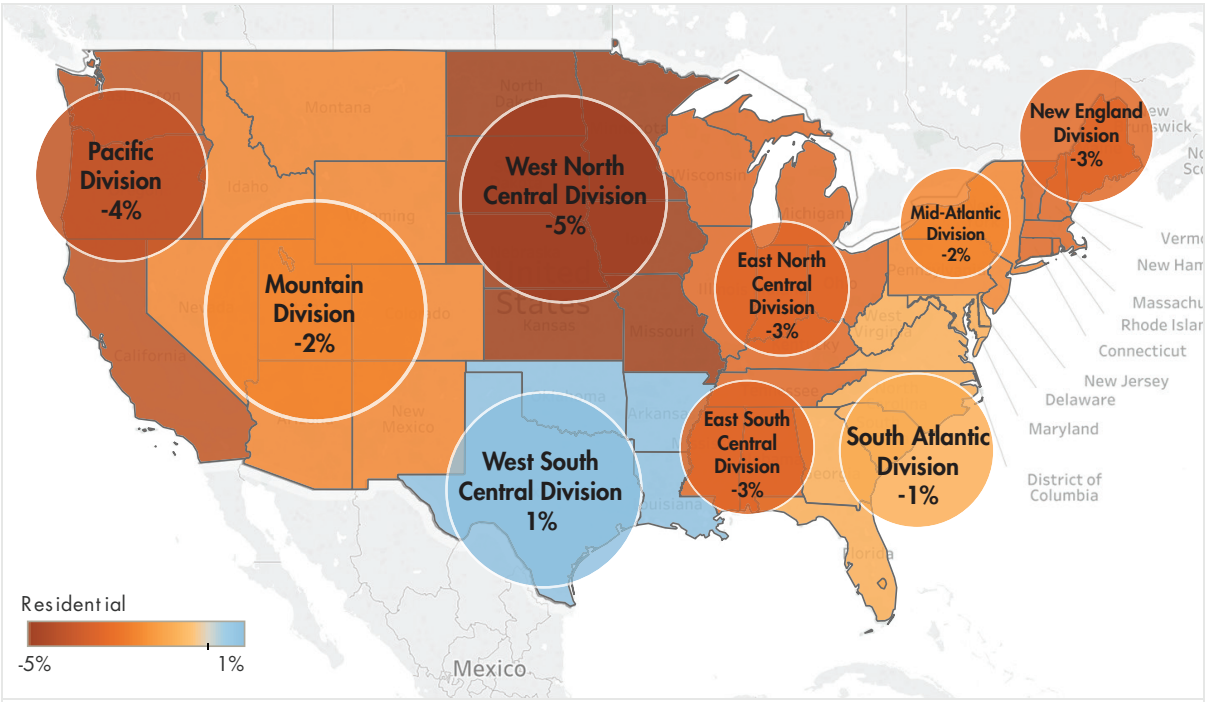


Exhibit 3. Residential buildings construction segment recession risk/potential depth and length of decline



Source: FMI, March 20, 2020

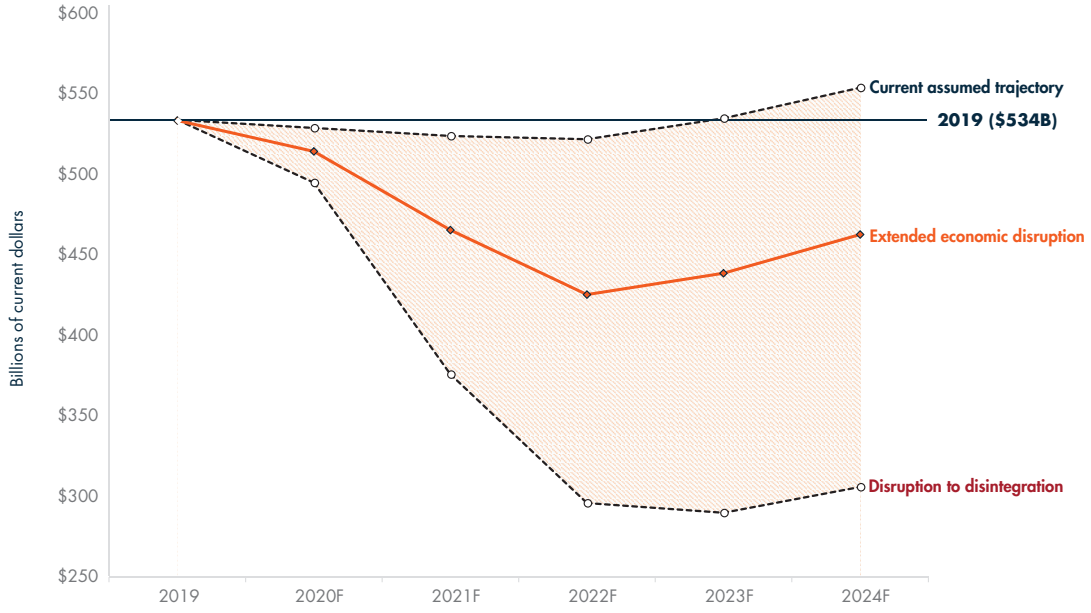
Exhibit 4. Forecast 2020 growth in residential buildings construction put in place by Census Division



Source: FMI, March 20, 2020

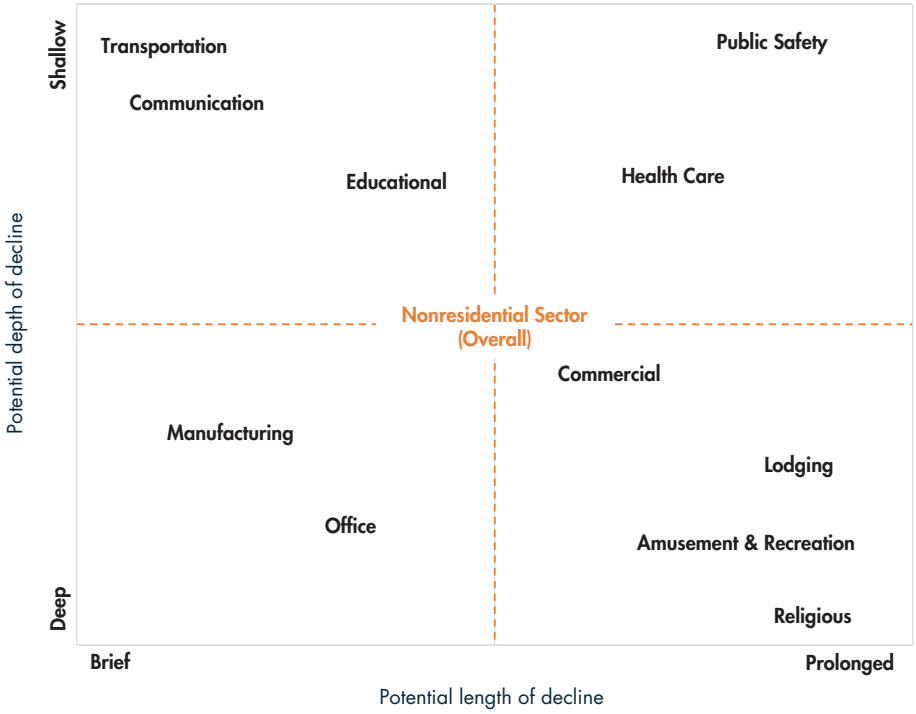
5. **Nonresidential construction is currently at risk of falling below Great Recession levels over the next five years.**

Exhibit 5. U.S. Total Nonresidential Buildings Construction Put In Place



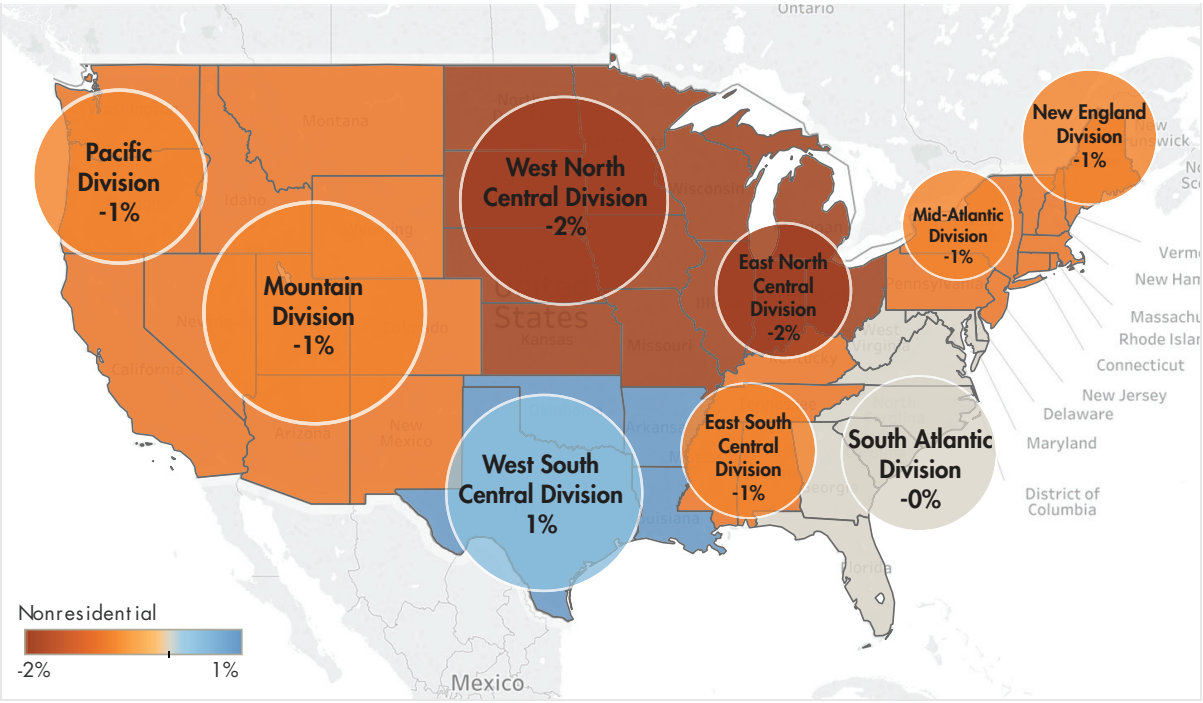
Source: FMI, March 20, 2020

Exhibit 6. Nonresidential buildings construction segment recession risk/potential depth and length of decline



Source: FMI, March 20, 2020

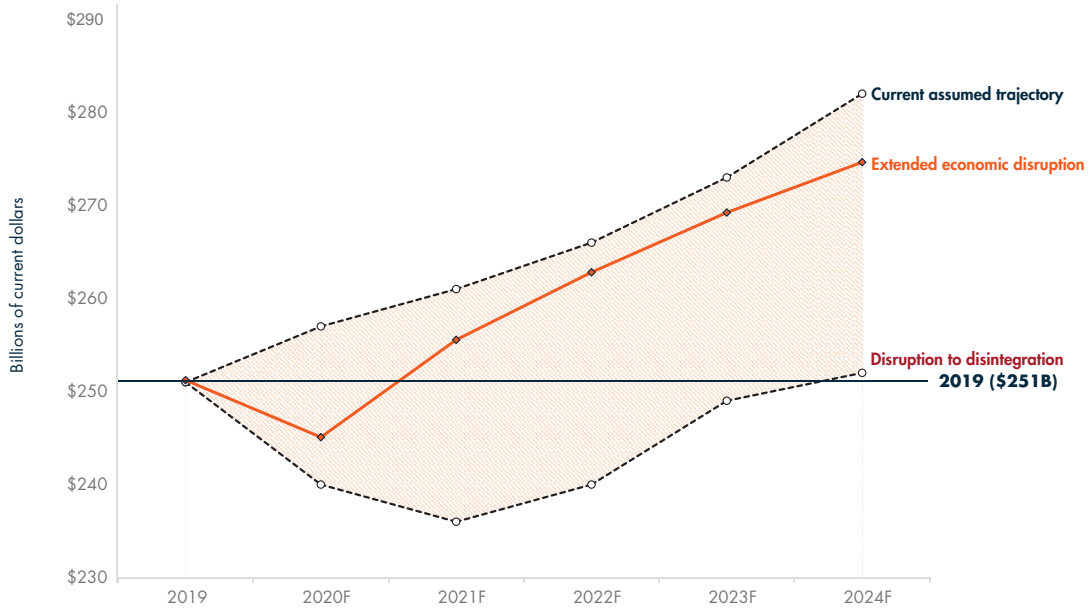
Exhibit 7. Forecast 2020 growth in nonresidential buildings construction put in place by Census Division



Source: FMI, March 20, 2020

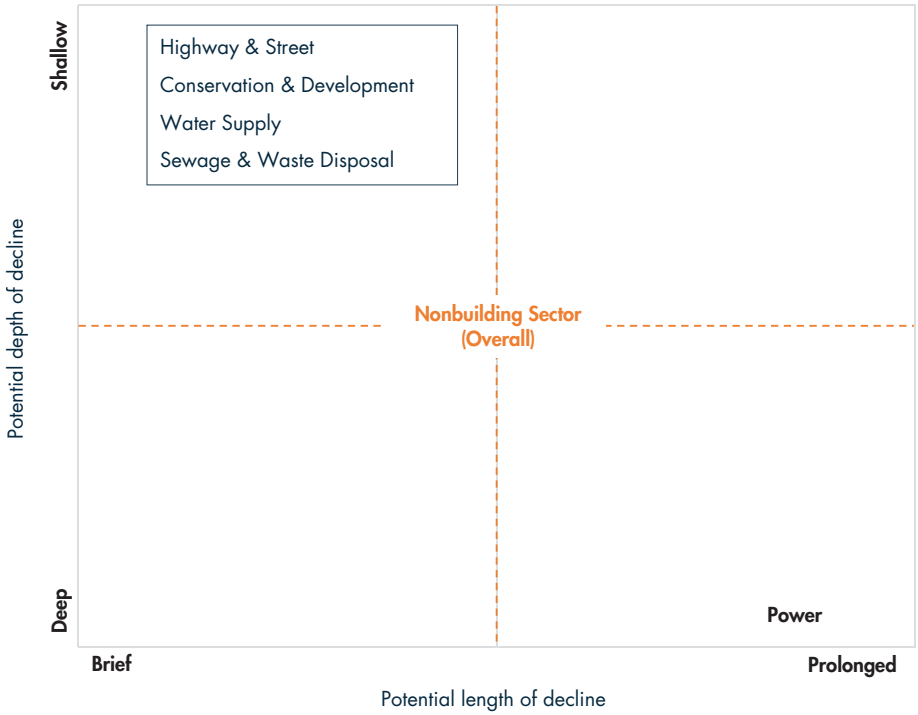
6. **Nonbuilding construction is likely to moderate over the next five years.**

Exhibit 8. U.S. Total Nonbuilding Structures Construction Put In Place



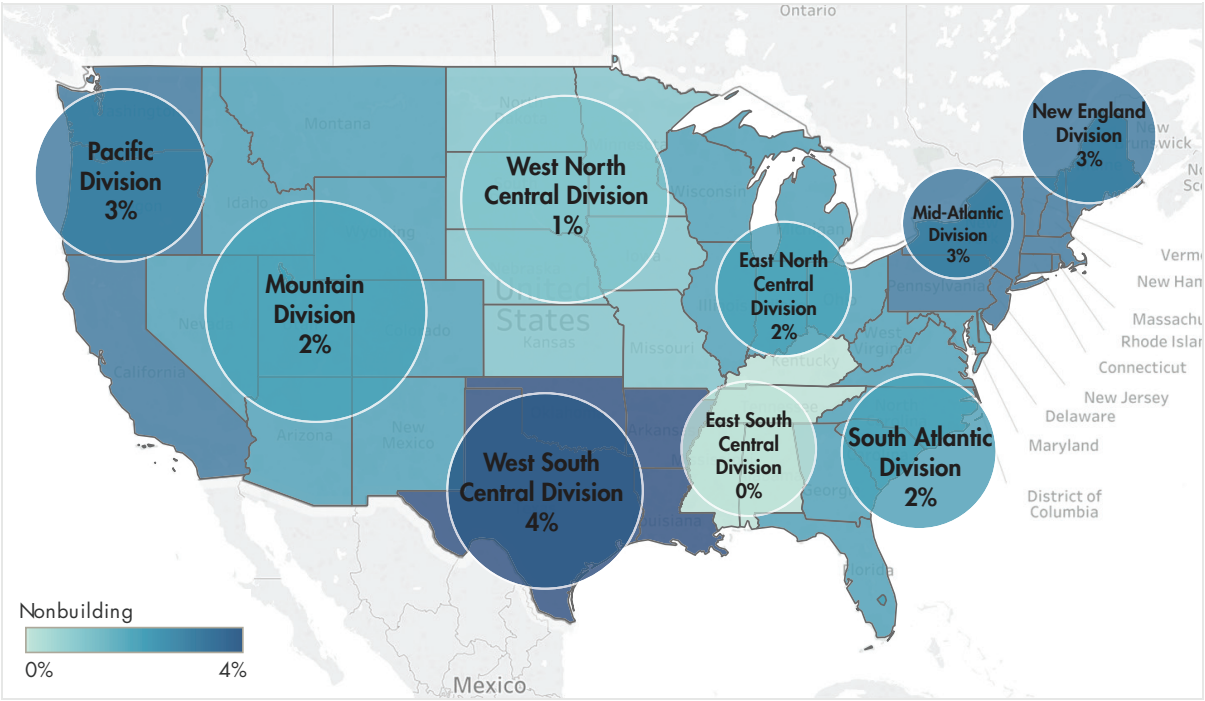
Source: FMI, March 20, 2020

Exhibit 9. Nonbuilding structures construction segment recession risk/Potential depth and length of decline



Source: FMI, March 20, 2020

Exhibit 10. Forecast 2020 growth in nonbuilding structures construction put in place by Census Division



Source: FMI, March 20, 2020

7. **Few have the luxury of taking a "wait-and-see" approach.**

Now is the time for managers to consider the options available to them and adapt to the changing market. Through the set of scenarios, options and resulting courses of actions should be developed. With these, managers may then monitor the key variables to determine which scenario is likely to emerge. This requires the ability and resources to be adaptable. Few organizations can afford to "wait and see" where the market ends up. Those that can are characterized as having a unique solution, low-cost structure or exclusive relationships with multiple clients/customers.

Food for Thought

- It's important to separate the news into three categories: 1) Facts, 2) Informed extrapolations from analogies to other viruses, and 3) Opinion or speculation.
- The questions many people are asking are how deep the economic halt is, how long it will last, and what impact it will ultimately have, as the damage has already been done.
- It is worth noting that we have had 10 epidemics/pandemics since 2000, and most of those saw double-digit growth in the stock market six months after the initial contagion. This does not mean we will experience the same this time, but it is worth noting.
- Strategy is as much about what you say no to as what you say yes to. Be careful to avoid potentially damaging decisions because they seemed expedient in the moment.
- Research demonstrates that the quality of decision-making goes up appreciably when more than one alternative was considered, yet few even weigh the pros/cons of more than one alternative.
- Broaden your data collection in making decisions. Don't rely on a single or limited source. This can lead to confirmation bias.
- Don't be afraid to make plans without 100% of the data and information. Don't be afraid to change plans when new data and information are revealed.
- People are scared. Jim Collins' research found that enduring organizations had an uncanny ability to confront the brutal facts while being unswervingly optimistic. To overcome this, our leaders need to lead powerfully. In a crisis, the cadence of communication must accelerate.

We will make it through this one. No boom lasts forever, and no bust does either. However, it is easy to be caught in the moment. As Howard Marks remarked, "In the real world, things generally fluctuate between 'pretty good' and 'not so hot.' But in the world of investing, perception often swings from 'flawless' to 'hopeless.'"

About the Authors

Jay Bowman is a principal with FMI. Jay assists a broad range of stakeholders in the construction industry, from program managers and general contractors to specialty trades and materials producers, with the identification and assessment of the risks influencing the strategic and tactical decisions they face. In this role, Jay's primary responsibilities include research design and interpretation, based on developing an understanding of the context within which these organizations operate. Jay can be reached at *jbowman@fminet.com*.

Brian Strawberry is a senior economist with FMI. Brian's expertise is in economic and statistical modeling. He leads FMI's efforts in market sizing, forecasting, and building product/construction material pricing and consumption trends. Brian's combination of analytical skills and creative problem-solving abilities has proven valuable for many contractors, owners and private equity groups as well as industry associations and internal research initiatives. Brian can be reached at *bstrawberry@fminet.com*.

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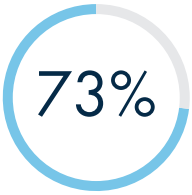

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