

iProCon Insight

HR Strategy and the Black Swan

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HR-Strategy and the Black Swan:

How the Right Management of Human Capital Creates Value in Times of Uncertainty

iProCon HCM ...

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In his book "The Black Swan" Nassim Nicholas Taleb has shown that the world is driven primarily by the big unexpected changes rather than the small ones you find considered in your business forecast scenarios. Some people may disagree with some statements and the aggressive stance Taleb is taking against many established ideas, professions and institutions such as the (wrongly) so-called Nobel Prize for Economics¹. However, few can really argue against the core messages and the fact that in all matters involving human behaviour forecasts tend to fail big, when they are most needed.

This paper shows how changes in people management can drive business transformation to become Black Swan ready.

¹ Alfred Nobel actually never created a prize for economics. The Swedish Central Bank created it later as the "Prize in Economic Sciences in Memory of Alfred Nobel" not without some opposition from the Nobel family. Taleb argues that this prize usually goes to people who apply elegant scientific methods to the economy, which do not actually predict the real world, but create a false sense of security and make people believe we can predict much better than we are actually able to.



From the Financial Times, 3rd June 2009:

A BP official explaining why BP is scrapping their final salary pension scheme: "adding that BP is most concerned about the sharp and **unexpected** rise in life expectancy at older ages which has dramatically increased costs."

This is certainly not talking about a Black Swan, but it shows that there are strong mindsets at work that prevent many people from accepting even the blindingly obvious, and make them believe that the realities around them apply only to others.

The Black Swan* in a Nutshell

Readers familiar with the Black Swan concept may skip this section.

While the core messages are quickly told, it is difficult to get the point across without all the examples. So, I'll try my very best, but I highly recommend reading Taleb's book (see our book recommendations on www.iproconhcm.co.uk/books).

Here are the key elements of Taleb's message:

- The business world is driven by the big unexpected exceptions – not by business as usual, as it is considered in forecasts and budgets.
- He calls these big unexpected events "Black Swans". They are characterised by 3 features:
 - They are not predicted.
 - They have huge impact.
 - After the events there are always many experts who can explain why it had to occur.
- Black Swans can have negative or positive impact. So, not being prepared to deal with them can mean incurring huge losses or missing huge opportunities.
- Black Swans live in a world he calls "Extremistan". This is the world where the extremes rule. Most forecasters, among them the majority of economists and corporate planners, pretend to live in "Mediocristan", where the extremes can be ignored as outliers which do not affect the overall outcome and where random changes cancel each other out. However, Taleb emphasises that the business world as well as most aspects of human society belong to Extremistan, where forecasts based on Gaussian statistics (the bell curve) are not reliable.
- A myriad of examples shows that almost everybody grossly underestimates the impact of unexpected outliers. Most people just behave as if they didn't exist.
- Because people don't like uncertainty, they are in denial and keep doing plans and forecasts based on rigorous mathematics, but usually false assumptions. They invest a lot of energy in avoiding small, manageable risks, but miss out on the big ones. If a Black Swan hits them, its 3rd feature comes into play: as it looks predictable in hindsight, the event is put aside as a one-off "mistake", but it doesn't shake the mindset that we are in control.
- So, what does Taleb recommend to deal with all this? Firstly, he says there are many Black Swans that are actually grey: so you can see

Be rather broadly
right than
precisely wrong!

*Nassim Nicholas Taleb:
"The Black Swan", The Random House
Publishing Group, 2007

Strategic Alignment is a focus of
the iProCon HCM People
Strategy Practice



“What did people learn from the 9/11 episode? Did they learn that some events – owing to their dynamics – stand largely outside the realm of the predictable? No. Did they learn the built-in defect of conventional wisdom? No. What did they figure out? They learned the precise rules for avoiding Islamic prototerrorists and tall buildings.”

Nassim Nicholas Taleb

them coming if you apply the right methods and do not rely on traditional statistics and on the assumption that rules from the past generally apply in the future, but replace Gaussian statistics with fractal (Mandelbrotian) methods, where the law of large numbers does *not* make extreme values negligible. Secondly he gives a set of rough guidelines, which we will translate into elements of Human Capital Strategy in this article:

- Understand in which environments you have to expect positive Black Swans and where negative ones are likely.
 - Understand the nature of asymmetry, where the big outliers are dominating the course of events and are not cancelling each other out.
 - Expose yourself to opportunities (positive Black Swans), by losing small to win big. Minimise exposure to negative Black Swans.
 - Be broad-minded: invest in generic preparedness, not in predicting the next big event.
 - Don't trust long-term predictions, normal distributions, and anything based on equilibrium in business and social science.
- Note that the idea of the Black Swan is not about predicting what the next Black Swan is going to be, because, by definition, you can't². It is about building the necessary resilience and agility to deal with and exploit them as they come as surprises.

- Maybe this was Taleb in a Swan's eggshell. To really put it into a nutshell, we could say: “*Expect the Unexpected, which is almost always Underestimated in its Impact!*”

Why is all this relevant for Human Capital Management?

“So what?”, I hear most HR Directors and Change Managers say. Isn't this what we have our risk management team for?

Well, apart from the fact that risk management teams often operate in the way criticised by Taleb, one single team cannot transform an organisation into one that has the best chances to excel under uncertainty. Getting your business Black-Swan-Ready constitutes a fully-grown business transformation requiring different skills, different people, new ways to manage and reward people, different KPIs, ... you name it. Above all, it requires a cultural transformation, because, as we have seen above, there are mindsets that need to be changed. This all sounds to me as if a change in Human Capital Management definitely needs to be a strong driver here, whether led by an HR department or not.

² Although some people are faster than others at recognising Black Swans for what they are, when they approach. Again, it's very much a matter of mindsets. If you are just not prepared to expect the unexpected, you can look into Galileo Galilei's telescope and still not see Jupiter's moons, let alone accept the consequences of this observation.



Focus on the unread books in your library, because what you don't know will probably be more important than what you know"

Nassim Nicholas Taleb

Leadership	Aligning Business Strategy and Human Capital			
	Managing Change			
	Employee Communication			
Managing People	Recruiting	Performance Management	Total Reward	Workforce Planning
	Outplacement	Talent Management	Individual Learning	People Metrics
Enablers	HR Services			
	HR Policies			
	Information Systems			
Corporate Processes	Managing Knowledge / Organisational Learning			
	Managing Innovation			
	Strategic Sourcing			
	Managing Human Capital Risk			

Figure 1: The Human Capital Capability and Excellence Model: Top Layer

At iProCon HCM we use a framework, the HCCEM³, to align Human Capital Management with business strategy. This framework looks at all fields of HCM (see figure 1) and defines 5 levels of excellence for each field along the following 6 dimensions (see figure 2):

- Strategic alignment
- Cultural alignment
- Systems
- Process & adherence
- Roles & capacity
- Metrics

	Poor	...	Best in Class
Strategic alignment	Compensation based on "one size fits all people and situations" or on arbitrary decisions of managers. No line of sight between comp. and contribution to strategic goals and no mechanism to adjust comp. level to profit and labour market.		Makes use of all elements of total reward as fit best to strategic requirements and maximise return on reward cost for individuals. Transparency and clear connection between reward and contribution to strategic goals. Spend can be adjusted to econ. Situation within existing framework without losing transparency. Well understood by managers and employees.
Process & adherence	No defined processor process taken from textbook or competitor without adjusting to organisation and therefore not adhered to by managers. Often fixed yearly cycle.		Transparent and well documented process understood by managers and employees. Flexibility to respond to individual needs, requirements of business units and departments, and economic situation. Process stays in background supporting dialogue between employee and manager. Yearly cycle is guideline only and adjustments can be made whenever required.
Roles & Capacity	Managers have no training or time to perform reward process properly. Employees have no transparency and see themselves as victims who have to shout loud to get their share. HR either not involved at all or owns whole process w/ o managers' involvement.		Line managers own the process and employees feel informed and involved. HR designs framework together with board and representatives from line management. HR acts as advisor and in rare cases mediator during the process.
Metrics	Only rudimentary, accounting-based metrics such as compensation cost. Even these metrics are not well understood and therefore no good basis for decisions (e.g. not clear what's included in compensation cost)		Metrics help to adapt framework to changing strategic goals and environment and help managers to make individual decisions. Not only isolated numbers but showing relationships between comp. and performance. Metrics well understood. Allow benchmarks internally as well as externally.
Systems	Systems only used for payroll purposes and even their often poorly integrated so that outcome of reward process is not always clearly documented.		Whole framework provides dedicated elements across the armory of total reward. Systems help managers to own the process as they guide them based on agreed framework and provide helpful metrics. Provide transparency for employees. Allow HR and board to monitor the process and improve and adjust comp. framework.
Cultural alignment	No consideration for culture. Weak or no cultural awareness. Reward usually focused on money only. Total reward design very often clashes with culture and is therefore very ineffective and can also damage culture, but this causal relationship isn't usually recognised. Employees respond cynically to reward changes in more than 50% of the cases.		Reward systems are based on deep and systematic understanding of culture which is a set element of reward design. Elements of total reward and comp. mix do fit the culture and therefore have strongest positive effect (e.g. team bonus for team culture; non-monetary rewards in low cost competitive culture). Virtually no cynical response to reward design. Rewards are also used consciously to influence culture (e.g. reward margin instead of volume to move from sales to profit as core value; celebrate successes; ...) supporting cultural change or reinforcement initiatives

Figure 2: Total Rewards as an example of the HCCEM's 2nd layer

³ HCCEM stands for Human Capital Capability and Excellence Model and is easiest described as an HR-maturity model. It is generally used for HCM-business alignment in projects of HR-transformation or the Human Capital Element of major business transformation initiatives. It is designed to define, monitor and drive change.

While the framework comes as a template defining cross-industry best practice, each organisation needs to define “how does great look like for us?” and determine their current state. Then the framework becomes a tool to monitor and drive transformation.

When driving strategic transformation, this framework helps to identify every aspect of people management that needs to change to support the new strategy. To implement a strategy to deal with the Black Swan, every aspect of people management will be affected. In the next section of this article we'll just briefly look at a few examples to show the importance of HCM in this context.

Managers from every business function always argue that their function is the most important one and I don't want to argue about this here. But changing the way people are managed (note, that we are not confining this to a HR department) definitely needs to build the foundation for changes in every other business function to be executable.

A few examples: HCM preparing for uncertainty

So, what are we trying to achieve here? Agility and resilience seem to be on top of the agenda. Broad-mindedness, realistic planning approaches, flexible workforce, diversity, creativity, innovation, quick decision making, etc. are other ideas that come to mind.

Let's touch upon a few elements of the HCCEM to see how Black Swan Readiness would affect them:

Recruitment

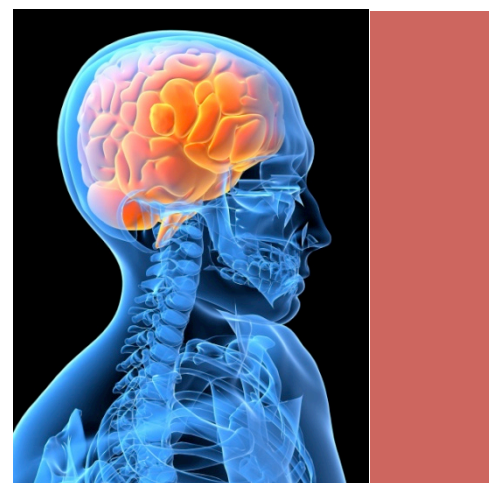
Apart from the need to be quick (i.e. a low “time to fill” KPI) to drive agility as discussed further down in “Strategic Sourcing”, there are a few more points to consider.

For example strong and narrow employer branding and standardised tests lead to improved results in attracting and selecting employees, who are thinking alike. All efforts to increase diversity (in ethnicity, gender, age, etc.) are worthless, if they do not lead to a diversity of thinking. This kind of recruitment process is a typical example of avoiding small risks, which might pay off very well, but increasing the exposure to big ones.

Why is that? Well, hiring people with different values and ways of thinking creates the risk of the occasional person not fitting in and therefore not performing or leaving early with some cost incurred. However, having a more diverse set of minds makes it much more likely to come up with a really big innovation. On the other hand, having a workforce of intelligent, but likeminded people, makes it much more likely that your organisation is sidetracked, because the business world isn't going the way everybody in your organisation is thinking, or that big obvious risks are ignored due to group think.

Performance Management and Total Reward

Here is an obvious point: the objective and incentive schemes of executives, traders and portfolio managers in the financial industry were rewarding exactly the behaviour that contributed to the financial crisis. They discouraged small short-term risks, because the relatively small losses would eradicate their bonuses year on year, while big pay offs would often be cut or not materialise at all during their time of service in the role. Incurring the huge long-term risk of riding on a bubble guaranteed them big bonuses year on year. And when the bubble bursts, there would be one or two years with zero bonuses, while the firm or the taxpayer take on the rest. This went wrong for some, because they lost their jobs – confirming the fact that the scale and impact of extreme outliers is usually underestimated.





"A fascinating study of how we are regularly taken for suckers by the unexpected"

The Guardian on "The Black Swan"

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Another important point in performance management is that traditional systems inhibit agility. Objectives are set for a whole year ahead and sometimes for longer. Quite often, the only thing you need to do in order to explain allegedly irrational behaviour in changing circumstances is having a look at the objectives of the C-level executive responsible for the decisions. While, in theory, most performance management processes have some flexibility built in, in practise these objectives are usually made to last.

Strategic Sourcing

To achieve highest possible agility you need to adopt the quantity of available resources to big changes in the business environment. To do so the full sourcing continuum needs to be used in an intelligent way. The sourcing model has to assign resource requirements along the continuum from core staff to temps, agency staff, contractors, and outsourcing. Decisions need to be made fast with the whole picture in mind, so the traditional way of scattering them between HR, IT, procurement, and other departments with their isolated views doesn't work. This is closely related to the fields of Recruitment, Outplacement and Workforce Planning.

Individual and Organisational Learning

The obvious point here is training employees in accepting the real world uncertainty not tamed by traditional statistic models and in recognising Black Swans for what they are. In the long run this together with many other initiatives needs to create the right culture in the organisation as a whole. This involves unlearning some very basic assumptions about what we can know and predict – and what we can't. Prepare for a big challenge!

On top of this, learning also needs to contribute to agility. This involves teaching more generic methods rather than bespoke facts, multi skilling, and shifting from individual learning to knowledge management. The last point means to provide individuals' knowledge for easy access by others, thus making it easier for a large number of people to move into a task hitherto only done by a few.

These are just a few examples, but I think you have got an idea by now, how the right way of managing Human Capital is the foundation for your organisation to thrive in "Extremistan".

Is your Organisation Black Swan Ready?

It lies in the nature of Black Swans that you can never be certain to be prepared for what's ahead, because you just can't know it. However, we have seen that this is not an excuse for doing nothing for two reasons:

Firstly, you can reduce uncertainty by applying more common sense and less blinkered thinking.

Secondly, there are ways to get your organisation ready to deal with uncertainty thus increasing the chances of

- Dealing with negative surprises without devastating losses (in fact, you can actually win by leaving your competitors behind and gaining market share)
- Making the most of positive surprises