Disciplined Decisions: Aligning strategy with the financial markets

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The goal of strategy is to make investment decisions that create shareholder value. The markets are the final judge of an investment's value. By applying the discipline of markets, managers can use more objective criteria and avoid making important decisions using subjective considerations.

A disciplined decision has three components:

- The decision is framed in terms of the options it creates.
- The relevant information on value and risk available in financial markets is taken into account.
- Financial market transactions are used to acquire options or otherwise mitigate risk whenever required.

When a company takes an options-based approach, the question is less about what it will gain by moving from Point A to Point B. it is more about the options that will be created as the company moves down the path.

Some decisions seem very close to the market. There is a clear link between the real options involved and financial securities. But other decisions may be distant from the market with the real options looking quite different from financial options. But as more and more risks are securitized, the real options frontier will expand.

For a soy processing company, building a new processing plant would create various options. One would be to shut down the plant during times of low supply. The difference between the spot price of the soybeans and that of oil tells a lot about the market value of processing capacity. When the crush spread is large, less efficient plants enter the market but when the spread narrows, these plants have to shut down. The spread essentially reflects the efficiency of the least efficient processor. By looking at the spread futures, the company can see if it can process the beans efficiently at the time of the harvest. Looking at futures prices on different delivery dates, the company will be able to make out what level of plant efficiency will be needed to remain profitable in the future. If the spread is volatile, the company may postpone the decision to shut down, even if the plant becomes unprofitable. This is because the spread might widen again, making the plant profitable. The spread futures prices can also help the company make decisions about reserving capacity with another crusher-firm or flexible commitment, how much capacity and so on.

Consider a mortgage company which wants to upgrade its information system. The decision, at first sight, appears to be internal and has little to do with financial markets. But this decision can also be evaluated by using the real options approach. The enhancement provides a platform for future upgrades and extensions. Using the upgraded information system, the company may be able to customize its mortgage offerings for individual customers. This may expand the market. The upgraded system may also help the company to reduce the cost of delivering the service.

The project can be run as a series of staged investments. The initial stage can be a pilot to test whether the technology can be implemented and used successfully by the company. This resolves many of the private risks. At this point, the focus shifts to market risk. The company must track interest rates which will have a big influence on the demand for mortgages.

If the pilot is successful, the company can move to the next stage and maybe roll out the technology on the retail side of the business. And if this is successful, the technology can be rolled out to the rest of the company. If this stage is successful, a further investment can be made to customize the offerings for individual customers.

Companies can take a disciplined approach to decision making by looking at the options created at each stage of the prospective investment. No company's investment decisions are completely isolated from the financial markets. But achieving discipline is not easy. Real options are complex and involve private as well as market priced risks. So, their value cannot be measured as precisely as in the case of financial options. However, as more risks are securitized, private risks are turning into market priced risks.

The real value of real options does not lie in mathematical formulas such as the Black Scholes model. It lies in reshaping executives' thinking about strategic investments. By providing objective insight into the uncertainty present in the markets, the real options approach enables executives to think more clearly and realistically about complex and risky decisions.