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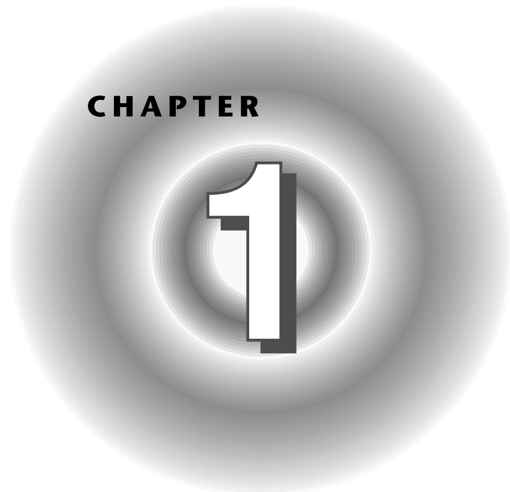

Strategies and Tactics of the Master Cyclist Executive

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"The brightest people in the world didn't see [the recession] coming."

—John Chambers, CEO, Cisco Systems

"We saw this recession coming three years ago. It was obvious the booming economic cycle couldn't continue. We tightened our belts. We focused on cash flow."

—Ralph Larsen, CEO, Johnson & Johnson

Timing is everything. In love and war, most certainly. But certainly also in managing the business cycle.

Consider, for example, a "Master Cyclist" CEO such as Johnson & Johnson's Ralph Larsen, who studiously follows key leading economic indicators, who accurately anticipates an approaching recession, and then implements an appropriately "well-timed

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strategy." His executive team begins to cut production and trim inventories—even as his rivals are upping theirs. His team might also better be able to "right size" the company through more timely layoffs—even as rivals continue to add workers at premium wages. Nor, as Larsen's quotation suggests, will such an executive team embark on an overly aggressive capital expansion program at a time when cash flow is likely soon to begin falling and borrowing costs are at their highest.

In anticipation of the 2001 recession, Larsen's J&J did indeed boldly cut its capital expenditures by more than $100 million at the height of the economic boom in 2000—the first decrease in seven years. As J&J significantly built up its cash reserves, the company saw double-digit growth in both revenues and earnings. These positive indicators coupled with a "sector rotation" by investors into defensive sectors such as health and medical care stocks as the bear market took hold helped give J&J's stock a double-digit boost in both 2000 and 2001—and allowed Larsen to turn over the CEO reins in 2002 with his head held high.

In contrast, consider a brilliant but nonetheless "Reactive Cyclist" CEO such as John Chambers of Cisco. Lacking the appropriate "business cycle literacy," Chambers failed to read numerous signs that the March 2001 recession was on its way—from a doubling of oil prices and a flattening yield curve in 1999 to a collapsing stock market and dramatically rising interest rates in 2000. Chambers also presided over a company that, by its very organizational design, lacked many macroeconomic variables in its business cycle forecasting models. As one Cisco top executive put it, "The economy is too complex to get anything meaningful out of such broad numbers as GDP or interest rates."[1]

Is it any wonder that Cisco got caught flat-footed in the 2001 recession and was eventually forced to write off more than $2 *billion* in excess inventory—even as the company had to lay off more than 8,000 people. While J&J's stock price was soaring, Cisco's came crashing back to earth.

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Using a wealth of real-world examples involving some of the most successful—and hapless!—companies in the world, this book examines the startling contrast between the well-timed strategies and tactics of business cycle-savvy executives like Larsen versus the ill-timed and ill-considered reactions of executives like Chambers.

You will see that while Master Cyclist companies like J&J routinely achieve superior performance using these well-timed strategies and tactics over the course of the business cycle, Reactive Cyclist companies like Cisco often both literally and routinely hemorrhage cash *and* people during recessions—and, in the worst case, go bankrupt.

The Master Cyclist Management Wheel

"The essence of strategy is to achieve a long-term advantage over the firm's competitors."

—Professor Arnoldo Hax, Sloan School of Management

The Master Cyclist management "wheel" illustrated in Figure 1-1 provides an overview of the well-timed strategies and tactics that have been shown to be the most effective by some of the very best strategists running some of the very best companies in the world. These strategies and tactics encompass not just the key functional areas of marketing and pricing, production and inventory control, and human resource management. They also target the all-important areas of risk management, the strategic implementation of capital expenditure programs, and the tactical timing of acquisitions and divestitures.

Accordingly, this management wheel spans virtually every major activity of the modern corporation, and a solid understanding and careful study of the well-timed strategies and tactics arrayed in

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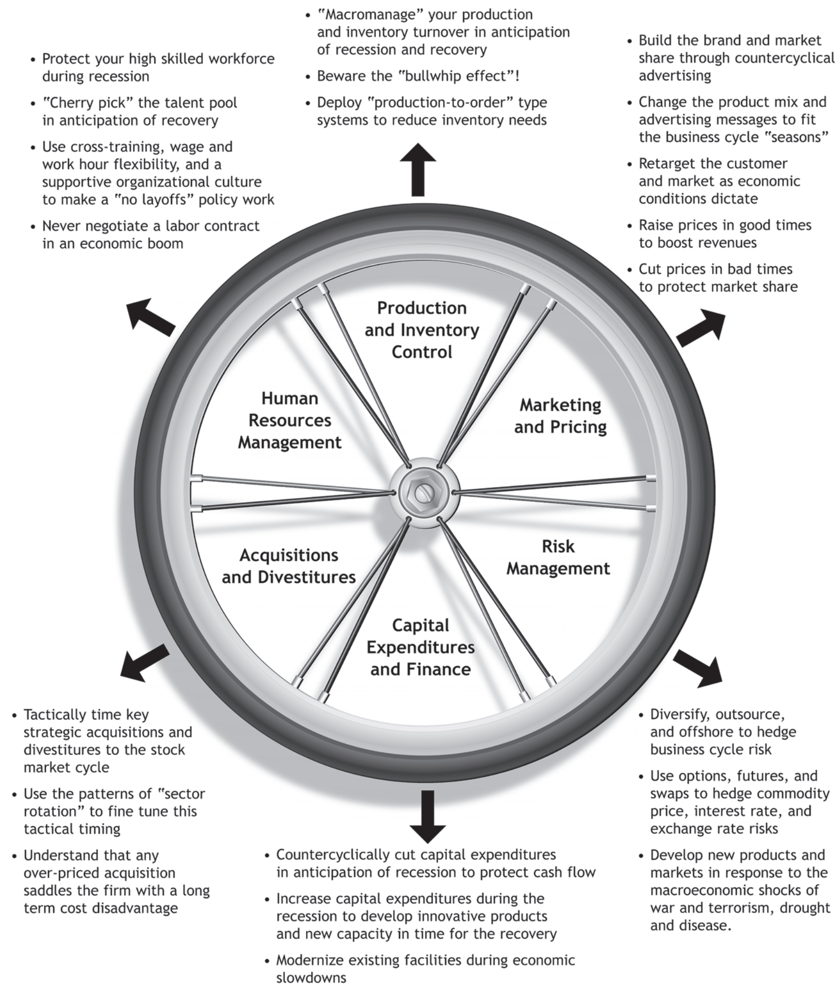
this wheel will help any business executive team dramatically improve company performance.



▲ **FIGURE 1-1** *Well-timed strategies and tactics of the Master Cyclist executive.*

Countercycling Your Capital Expenditures

The J&J example has already briefly highlighted the virtues of countercyclically *cutting* capital expenditures in anticipation of recession. This is a prudent *defensive* strategy that preserves cash flow at a most opportune time.

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However, the most proactive of Master Cyclist executive teams also use the countercycling of capital expenditures as a potent *offensive* weapon. This is done by *increasing* capital expenditures during a recession in anticipation of a recovery and renewed and surging demand.

In this countercyclical way, Master Cyclists can position their companies to take the market high ground when the recovery begins. As examples from the likes of Loews, Intel, and a fascinating real estate company known as SOHO China will teach us, they do this with an abundance of new production capacity, an expanded retail outlet network, new and innovative products, and/or the latest and lowest-cost production and supply chain technologies.

Strategically Timing Your Acquisitions and Divestitures

From a strategic perspective, there are many compelling reasons why one company acquires another. The acquisition might open new markets, or the acquired company might own a complementary new technology. It might be a crucial link in the supply chain or possess a key patent. Most Machiavellian, the acquisition target might simply be a key rival that needs to be eliminated if competition is to be reduced and prices are to be raised.

Still, from a Master Cyclist perspective, it *never* makes any sense to impulsively make an acquisition if the stock price is too high—no matter how compelling the strategic reason. That is why, as you will see with stellar examples from companies such as chipmaker Micron, telecom calling card King IDT, and the credit-scoring maven Fair Isaac, the acquisitive Master Cyclist executive team always uses its highly sophisticated understanding of the business and stock market cycles to tactically time any key acquisition or divestiture to the business cycle.

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The Art of Cherry Picking and Other HRM Tactics

In the deep dark depths of a recession, the last thing many companies want to do is to hire more people. *Not* so for the Master Cyclist.

The Master Cyclist knows that it is precisely at the trough of a recession that the labor pool is at its deepest and highest quality. Moreover, any wage pressures will have totally subsided. That is why to the Master Cyclist, a recession is a great time to “cherry pick” the labor market.

In this way, the Master Cyclist executive team gains a critical competitive advantage precisely because, when the new expansion begins, it is able to deploy a more highly skilled work force with lower labor costs than its rivals. That is a strategy that you will see played to absolute perfection by companies such as Avon, Isis, and Progressive in industry sectors as disparate as cosmetics, biotechnology, and insurance.

Production and Inventory

As you already have seen in the Cisco example, companies that continue to increase their production and build up inventories as a recession approaches inevitably suffer in myriad ways. Most obviously, bloated inventories increase holding costs, leave a company more vulnerable to breakage and pilferage, and, in the worst-case scenario, result in costly inventory write-downs—as Cisco painfully learned.

There is, however, a far more subtle cost to mismanaging one’s inventories as a recession approaches. As the examples of Gateway and Hewlett-Packard will stunningly illustrate, a large inventory overhang can also leave a company with obsolete or out-of-fashion products that then must be dumped at fire-sale prices—even as more nimble competitors swoop in to seize market share.

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Bloating the inventory as a recession approaches is not, however, the only—or perhaps even the worst—sin of the Reactive Cyclist. Indeed, companies that fail to increase production and build inventories in anticipation of an economic recovery are often left at the starting gate by far more aggressive rivals. The result, very often, is a sudden loss of market share to more business cycle-sensitive Master Cyclist competitors able to quickly stock shelves and showrooms with the latest products and styles as the economy kicks once again into high gear.

Indeed, this is a highly dynamic "macromanaging" process that you will see played out in a marathon boxing match between two heavyweight truck manufacturers. In one corner will be the consummate Master Cyclist Paccar, with its incredible accordion-like ability to ramp down or ramp up its production at the first sign of recession or recovery. In the other corner will be the historically pitiful and pathetic Navistar, which has always been caught a day late and a dollar short over the course of the business cycle—and frequently knocked down and out by Paccar in the battle for profitability and market share.

Marketing and Pricing Through the Business Cycle Seasons

The strategic and tactical implications of Master Cyclist marketing and pricing offer some of the richest insights into building competitive advantage in all of management strategy. For example, as a "time capsule" example of what was then a very young and upstart Dell will illustrate, increasing advertising during a recession can be a highly effective way of building the brand and increasing market share. This is because during recessions, ad rates are at their cheapest, and there is far less competition and "noise" in the marketplace.

Paradoxically, despite compelling evidence that countercyclical advertising is a highly effective strategy, you will nonetheless see that many companies do just the opposite in a recession and severely slash advertising. This happens because the Reactive

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Cyclist leaders at these companies inevitably succumb to the pressures of the company "bean counters" who will always find advertising expenditures to be one of the easiest and most inviting cost-cutting targets in the company's beleaguered recessionary budget. However, as Kmart's myopic "Mac the Knife" CEO will grimly illustrate, such a misplaced strategy can be a shortcut straight into Chapter 11 bankruptcy.

It is not just in the realm of countercyclically advertising that the Master Cyclist shines. Far more subtly, the Master Cyclist marketer is also adept at tactically changing both the marketing messages and product mix to fit the customer's changing "moods" across the business cycle seasons.

The simple truth behind such tactical cycling of the product mix and messages is that many consumers respond much more to product value than style in recessionary times. This is a point that will be driven home in high culinary style by the likes of the "Crazy Chicken"—the fast-food, flame-grilled chicken chain El Pollo Loco. The company's highly creative and cost-saving "dark meat gambit" in the darkest days of recession turned out to be one of the most wildly successful marketing promotions in the company's history.

Tactically Hedging Business Cycle Risk

The business cycle can be very risky business indeed. Accordingly, many companies choose to strategically deploy a variety of hedging tools such as futures and options to completely neutralize both general business cycle risk as well as the more specific macroeconomic risks associated with movements in commodity prices, interest rates, and exchange rates.

For example, the Master Cyclists at Royal Caribbean Cruise love to hedge the company's substantial exchange rate risk with currency futures when they buy billion-dollar ships in euros from Europe. So, too, will you see how a company such as Good Humor-Breyers always hedges the costs of its most important

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ingredients—from premium vanilla cultivated in Madagascar to premium-quality New Zealand butterfat for its heart-stopping ice cream brands. In this way, both Royal Caribbean and Good Humor-Breyers are able to focus on their "core competencies"—whether it be providing high-quality cruise experiences or the most tasty pint of Ben & Jerry's Cherry Garcia.

Still, you will see that the true mark of the Master Cyclist involves not just static strategic hedges to neutralize risk but also more proactive "tactical hedging" to opportunistically leverage such risk. This is a lesson to be learned from the likes of the utterly masterful Master Cyclists at Southwest Airlines who, unlike virtually all other airlines, have brilliantly and opportunistically adjusted their oil price hedges in response to forecasts from their own internal and highly sophisticated models.

Strategically Diversifying Business Cycle Risk

Beyond simple hedging instruments such as futures and options, the Master Cyclist deploys two other important risk management tools: *business unit diversification* and *geographical diversification*. Of course, just as with acquisition and divestiture strategies, there are many good strategic and synergistic reasons why a company might want to engage in business unit or geographical diversification that have *nothing* to do with managing business cycle risk and broader macroeconomic risk.

Consider that with *business unit diversification*, an automaker that diversifies into producing SUVs may be able to build larger manufacturing facilities and thereby realize "economies of scale" and lower unit costs. More subtly, if some parts and assemblies can be used in *both* cars and SUVs—shocks, brake drums, or engines—the vehicle maker can also realize "economies of scope" by jointly producing the two kinds of vehicles, each with lower costs.

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That said, there are equally obvious benefits to various forms of business unit diversification that effectively do hedge business cycle risk. You will see, for example, how a highly astute Countrywide Financial executive team has created a “natural business model hedge” by having one business unit that focuses on mortgage loan originations and another that focuses on mortgage loan servicing. Because the revenues from these two businesses move in *opposite* directions with movements in interest rates, Countrywide is able to achieve more stable revenues over the course of the business cycle and related interest rate cycle.

As for *geographical diversification*, there are likewise many excellent reasons to engage in such a strategy that have nothing to do with hedging business cycle risk. For example, by diversifying into new foreign markets, companies can achieve greater economies of scale. They can also deploy their core managerial and production skills across a broader range of opportunities.

Still, these strategic benefits notwithstanding, it is equally true that one of the primary benefits of geographical diversification is to significantly reduce business cycle vulnerability. Such geographical diversification works because, as a matter of statistical truth, the business cycles and political conditions of various countries are not, as they say in academia, “perfectly correlated” statistically. In lay terms, this means that while Europe or Japan might be experiencing a recession, China or the United States might be in the midst of a robust expansion.

This is a point driven home in one of the most sophisticated and entertaining examples in the entire book. This example involves the giant Mexican cement manufacturer CEMEX and its bold, bargain-hunting foray into Indonesia and the Philippines during the chaos and confusion of the 1997 through 1998 Asian currency crisis meltdown.

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From Random Shocks Come Profitable Opportunities

A new kind of dangerous urban combat in Iraq creates a lucrative opportunity for companies such as Ceradyne and Kyocera to hawk their ceramic body armor. Terrorism spawns huge new markets for products as diverse as bomb-detection equipment and biometric identification. Companies such as InVision and Viisage swoop in with new products to grab a lion's share. Bird flu sweeps across Asia and sets off a vaccine-development sweepstakes to the benefit of large companies such as MedImmune and smaller speculative ventures such as China's Sinovac. Is it any wonder that economics has been dubbed the "dismal science"?

Dismal and grim though these thoughts may be, the random shocks that can arise both from the madness of mankind and from the Mad Cow rampages of Mother Nature present both dangers and opportunities. Unfortunately, in the chaos that often ensues after a random shock, many executives are caught flat-footed.

Master Cyclists are, however, immediately able to parse both the tactical implications of such random shocks as well as their longer-term strategic opportunities. You will see these themes played out by a diverse cast of companies that deftly illustrate how to develop new products or retarget old markets in response to the ravages of randomness.

An Old Classic Sets the Stage for Our Master Cyclist Beginning

"Knowing when to act is as important as knowing what to do."

—Lakshman Achuthan, Managing Director, Economic Cycle Research Institute

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To end this chapter, I want to leave you with a highly compelling example from the slim but nonetheless important work of Professor John McCallum—one of the earliest advocates of managing the business cycle for competitive advantage. This story aptly sets the stage for the numerous examples to follow, even as it illustrates why, as Lakshman Achuthan of the Economic Cycle Research Institute asserts in the preceding excerpt, "knowing when to act" is strategically just as important as "knowing what to do":

> *Retailer Montgomery Ward is the classic example of what can happen when an enterprise miscalculates the direction of the macroeconomy for too long and by too much. Believing that depression always followed a major war, chairman Sewell Avery did not open a new store between World War II and the mid-1950s. Sears took the opposite tack, opening new stores relentlessly, particularly in the fast-growing suburbs.*
>
> *Sears was betting on strong, post-war growth driven by pent-up demand. Sears took off; Montgomery Ward never really recovered and eventually filed for bankruptcy. Many factors were involved in the dramatically different post-war paths of these legendary Chicago retailing rivals. The crucial fact remains that one was right about the macroeconomic direction. The other was wrong.*

In the chapters that follow, you will see this same kind of battle played out in myriad intricate ways as we use a treasure trove of real-world examples to systematically work our way through the Master Cyclist management wheel. In the course of what should be for you both a very interesting and highly entertaining journey, one abiding fact will stand out.

In an increasingly global and fiercely competitive economy, the line between corporate success and failure is now being drawn by the ability—or lack thereof—of the modern executive team to first understand the business cycle in all of its strategic and tactical richness and then proactively manage that cycle for competitive advantage.

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