An Introduction to Scenario Thinking

"We cannot predict the future, but we must act!"

By Eric Best

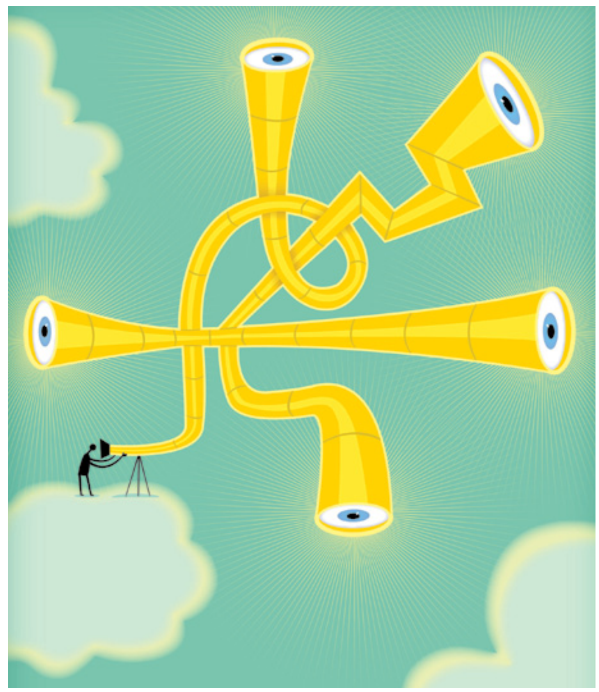
In early 1997, a group of senior executives from a prominent US investment bank, including the local CEO, met for two and a half days in a Tokyo hotel to develop their first "strategic scenarios" for Japan's future.

The investment bank had begun to apply the scenario technique, which originated in ancient military practice, to business challenges around the world, including:

• Impacts of the Internet on financial services. A scenario called "T+0" suggested in 1995 that a much more transparent, instantaneous and competitively challenging information environment was dawning, with radical implications for value-creation, client demands and financial service end-users;

• The future of the New Europe. The single currency would mean accelerating demands for services and changes in foreign exchange that would require rapid adjustment by the bank's various businesses;

• Information technology in the latter 1990s. The increasingly internet-driven workforce and associated restructuring would require new hiring approaches and competitive strategies.



In Tokyo the executives quickly determined that the two most important uncertainties – the macro-economic environment and Japan's reform-adjustment efforts – were unlikely to produce a positive business environment. Their scenario framework was built around a strategic acquisition question and informed by analysis about Japan's financial services from inside and outside the firm. Thinking through the possible but divergent paths for Japan was crucial to the bank's investment approach.

In the middle of the second day, one of the youngest participants spoke up in a tone that mixed finality with frustration. "There simply is no plausible upside scenario for Japan for the next three to five years," he said.

An uncomfortable silence followed.

"Then why would we buy anything?" demanded the most senior investment banker. He was not alone in his skepticism about the major Japanese retail brokerage acquisition being contemplated by Morgan Stanley's top management in New York.

"We cannot predict the future, but we must act!"

Scenarios – or the development of "alternate futures" to gain strategic insight – came into the corporate mainstream at Royal Dutch/Shell in the late 1960s after scenarios had been broadly applied to business questions by Herman Kahn at the Hudson Institute.

The idea was simple enough (although the process of applying it inside a corporation was intellectually and politically challenging). The future is not predictable but people must act with clear intention and conviction. Moreover, the tendency to believe too deeply in an "official future" can be dangerous if an enterprise is entrenched in its strategy to the point of being unprepared for the unexpected. Scenarios provided the means to think the unthinkable and broaden the context of expectation, to identify a wider range of options for investment and contingency planning.

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Thierry Porte, the Morgan Stanley CEO for Japan, would later say this moment in the scenario offsite delivered a crucial strategic insight. And the shift in Morgan Stanley's approach would make millions for the firm. Japan would be mired in its problems for more than another half-decade, during which the bank would focus on merchant banking, trading and deal-financing, avoid acquisitions, deepen local skills and wait for the market to turn. This produced exceptional profits for Morgan Stanley and dodged the costly error of a close competitor, who proceeded with its retail acquisition and recorded a $1.2 billion loss when the deal had to be unwound.

The Shell scenario group within corporate planning, which included Pierre Wack, Ted Newland, Arie de Geus, Peter Schwartz, Napier Collyns and others, conceived of a low oil price scenario at a time when the world expected prices to rise indefinitely under virtual domination by OPEC. The scenario included the fall of the Soviet Union, a weakening of OPEC and other changes in the geopolitical and economic environment. These scenarios profoundly challenged the future on which Shell had based its five and ten-year budgets. They would be credited with helping the global exploration and production company prepare for the low price environment and establish trading capabilities to move it from the No. 6 to No. 1 oil company in the world at that time.

so that it could be undertaken in eight steps to generate different and challenging futures. These alternative views had to be taken equally seriously in order to challenge conventional thinking and entrenched assumptions within an enterprise. Scenario thinking was often difficult for executives or strategy practitioners who believed they had to provide "answers" about the future rather than illuminate a range of possibility. Executives and strategists in the "certainty camp" tended to argue that probabilities about alternative futures could and should be calculated. Ogilvy stressed that scenario probabilities were incalculable. The scenario process required a suspension of belief in certainty and faith in the thinking process. It would naturally inform individual and collective intuition about the business environment. Executives would then have to act on their more informed judgments about the options to pursue and contingencies to prepare for.

The unexpected, by definition, cannot be adequately anticipated. So how does one plan for it?

"Only the prepared mind can respond in time"

The Shell scenario approach was taken outside the company in the late 1980s by the founders of Global Business Network (GBN) in Emeryville, California, who included Collyns, Peter Schwartz and Jay Ogilvy. Drawing on an expansive business network, GBN practitioners began to apply scenario-thinking techniques for clients around the world. Schwartz's book "The Art of the Long View," written with Art Kleiner, became a de facto bible for nascent corporate scenario practitioners.

Ogilvy, a former Yale philosophy professor and consultant at SRI, was credited with "deconstructing" the Shell method

Scenario thinking becomes "conventional wisdom?"

A recent Bain study has shown that more and more major corporations in the last two decades have applied and internalized scenario thinking as part of strategy development, partly in response to increased volatility in financial markets and shifting geopolitical risks in the post Cold-War period. One of these was Morgan Stanley, which I joined in 1996 after our 1995 Internet scenario project. This began a 10-year process that would internalize scenario thinking across a wide range of financial businesses and expose it to many corporate clients around the world.

As a formal process, scenario thinking addresses a conundrum in business strategy. The unexpected, by definition, cannot be adequately anticipated. So how does one plan for it? Moreover, most companies tend to invest in assumptions about the future upon which current behavior is based. Denial is also a factor, where uncertainties or dangers seem too complex or "unknowable" to face, and so are better ignored. Some senior executives dictate their own views about the future without contemplating or planning for reasonable alternatives. These attitudes may be promulgated by subordinates without being effectively examined or challenged. And yet, some of the most important changes in the business environment and among competitors, old and new, will develop outside the range of expectation or current belief. How is one to deal with this?

In his popular 2007 book, "The Black Swan," Nassim Nicholas Taleb described a term for the thing that was thought not to exist but which appears unexpectedly. If we accept that all swans must be white, we do not anticipate the black swan. Taleb makes the case that it is better to prepare for events that are highly improbable, but which have a huge impact, than to participate in the conventional wisdom that will either lead to modest returns, or take the herd over a cliff. Taleb argues that asymmetric events provide optimal competitive opportunities for anyone who can imagine them coming, and who buys appropriate options in the event that they do.

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We are left with questions about how to anticipate and prepare for what we do not know. A Black Swan is elusive because it means something that cannot be known or named in advance. A "grey swan," however, is something unlikely that you might consider, and would prepare for if you had only made the effort to think about it.

Scenario thinking in the business environment has proven that the contemplation of grey swans can prepare for the black. Morgan Stanley developed Y2K scenarios to contemplate the range of potential market disruption. Two scenarios implied that if the

Bank of New York were suddenly unable to settle electronic transactions, this could disrupt Morgan Stanley trading to the point of illiquidity and enterprise risk. Considerable effort went into advance discussions with the Bank of New York to assure that such a breakdown would not occur.

As history showed, Y2K came and went without disruptions of the kind imagined. But the 9/11 Twin Towers attack did bring down the Bank of New York's trade settlement system through the destruction of a Verizon substation. The Y2K preparations at Morgan Stanley kept the firm out of harm's way. The actual future had not been predicted, but scenario thinking had stimulated the right contingency preparation. Grey swans had effectively foretold a black.

In the months following 9/11, Morgan Stanley used its scenario approach to describe four different dimensions of geopolitical uncertainty. In extensive internal sessions, the firm uncovered what its chief equity analyst called "a high likelihood in three out of four scenarios of a financial crisis not currently priced into markets." On the basis of this insight, given its source, the enterprise risk committee reduced market exposures that saved millions in ensuing market turmoil. Relatedly, one of the firm's largest fixed income clients in Asia, exploring the same scenario framework, discovered "much more volatility in the near future than we had expected." The chief investment officer consequently adjusted their trading positions to be longer volatility "to a degree that saved our portfolio for the year," he later explained.

The Power of the Story

Scenarios are powerful "stories," built around the most critical uncertainties, and these stories are sometimes able to enter an organization's thought process – or that of its leaders – in ways not otherwise possible. These "hypotheticals" can re-order perceptions about alternative environments in which business decisions will play out. Scenarios that are built to be relevant and plausible, but challenging, help people to think more openly and deeply about the forces - known and unknown - that will create the future. Scenarios are not predictions. They are powerful narratives about the future, and not theories, and not required to comply with theoretical models. They must be focused and customized to the specific business culture, corporate context and competitive environment - but not in ways that are limited by current practice or normative thinking. This process can be very powerful on behalf of executives who are trying to explore strategic questions or test hypotheses about market trends. The process has proven very helpful to new CEOs or division/business unit heads who want to explore the competitive environment and organizational issues with their leadership groups, and expand the thinking of those who report to them.

In initiating a new project, a scenario strategy team will typically identify key factors and driving trends around an important strategic issue. This may involve interviewing the client stakeholders and outside "experts" in a field or marketplace. During workshops, which may require artful facilitation to navigate around entrenched assumptions and practices, the client team must determine the most fundamental uncertainties that might lead to plausible but sharply different worlds. These may be defined by social, political or competitive logics relevant to the strategic questions at hand.

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By raising possibilities and surfacing assumptions not previously acknowledged, the scenario process as we approach it will generate a range of implications and actions that sharpen an organization's understanding of the present. It enables the leadership and the organization to clarify its operating strategy and to build a more common understanding of necessary actions.

Scenario development is a highly interactive effort that can draw on a range of people inside an organization, as well as on perceptive outsiders. Depending on its long-term objective, a scenario project may take up to 12 months, but its general application is an ongoing tool for organizational learning and strategic insight.

The Application of the Process

Scenario thinking and the process of engagement enable management to think constructively about present and future uncertainty, and then to act. Part of the challenge is not only to "think outside of the box" but to identify actionable options, and act on some of them. Corporate, business unit, portfolio and IT management are among those who can benefit from the discipline. Scenarios are typically developed to address:

- Geographic uncertainties (Future of China)
- Industry sector development (Asset management)
- Product planning (Autos, food, bio-pharmacy)
- Portfolio / risk management (Hedge fund industry practices)
- Business / market development (Renewable energy)
- Political and regulatory questions (Japan's regulatory framework)
- Global market uncertainty (Rise of developing country economies)
- How various strategic options may play out (International airline strategies)

Action Plan & Results

Ultimately, scenario planning is only as effective as the executive action that follows. However, developing a strategy is often not obvious or easy. Scenarios, by definition, provide divergent perspectives of what the future may hold. Management will need to take a view, prioritize action steps and press for follow-through. This requires skilled facilitation and ownership at a high level.

Scenarios can also be very effective at portraying complex issues in a digestible format, creating a common language to describe a constantly evolving business environment. One important benefit of scenarios is that they prepare the mind for a multitude of events that may unfold.

The process of engagement can provide an organizational bonus. Workshops can engage disparate stakeholders in a common dialogue about the future and therefore be a strong team-building tool. The "people side" of the scenario process should not be underestimated. Scenario discussions can often overcome the tendency for individuals and organizations to withdraw or invoke denial when faced with adversity.

A scenario project requires:

- A project plan (scoping, interviews, workshops, follow-up)
- Project managers / facilitation
- An executive action and communications plan and owner for follow-through, typically in the context of planning initiatives already in motion.

The time required will vary from one-off executive strategic briefings, based on previously created frameworks, to 6-12 week in-depth engagements, or longer. The scenario approach should be thought of as a strategic conversation that becomes a continuous process of culture change, learning, thought and action. One typically begins by engaging key executives in a conversation about the strategic uncertainties that most trouble their enterprise.

When it comes to uncertainties in the business environment, what keeps you up at night? You cannot predict, but you must act.

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