Financial Models and Good Judgment

Harry Strachan, circa 2006

In the early 1970s in my preparation of finance cases, I began to try to build a financial model of the business I was studying. I was intrigued by how the best businessmen seemed to have an intuitive feel for their industries, a feel that permitted them to quickly see the implications of any event in the environment likely to impact their company. I develop the hypothesis that as a result of their considerable experience, they had developed, perhaps unconsciously, a mental model of their industry which permitted them to translate these changes into the implications which would show up on the financial statements. While financial statements tended to look alike, each industry had a different set of key variables. I began to try to identify these few variables and through simple algebra translate them into financial statements.

At that time HP had come out with a calculator which permitted me to put my models onto a magnetic strip so long as my key variables were fewer than nine. The calculator allowed me to write a 100 step program drawing on up to nine data memories. I began to use my models to help me prepare for class and in my consulting. One case involved a Nicaragua feedlot for fattening cattle. The key variables I identified were the spread in price per pound between what was paid for the calf and what was sold to the slaughter house, the cost/day of feed and medicines, the lbs/day gained and so forth. I had the opportunity to interview the 80 year-old owner of a feed lot, a businessman famous for his shrewdness. I presented him with a number of situations which I had already figured out on my calculator. "Suppose, don Manuel, that the average price/lb has dropped by 10% over the 18 months during which you were fattening the cattle … what would it do to your business"? Don Manuel sitting behind his desk squinted his eyes and quickly gave me an estimate of the lost profit on each head in his lot. His answer was almost identical to that of my calculator but, when I asked him how he figured it out, he could not tell me. He said he did no math in his head just that the number he'd given felt about right.

In the past forty years large spreadsheets on personal computers have permitted much more complex models than my simple algebraic ones. However, I still make my case teams get up to speed in an industry by trying to identify the key variables in the intuitive models of the best practitioners and then fit them into an algebraic model of structural profitability. Independently I continue to build my own simple models, which have occasionally helped me recognize errors that have crept into the more complex models of my case teams.

I've also occasionally found in consulting that the intuitive model developed by an experienced CEO has been rendered incorrect as a result of subtle changes in the industry. Because his model is intuitive, he may not be fully aware of why his judgment isn't leading to the correct actions. Helping him make his original model explicit and then update it for the new circumstances almost always clears up the problem.