

Behavioral Finance – February 11, 2013
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Behavioral Pitfalls I: Scott McNealy & Sun Microsystems

The cover story in the July 26, 2004, issue of *BusinessWeek* was about Scott McNealy, the chief executive officer (CEO) of high-technology firm Sun Microsystems. Sun is known as a leading manufacturer of servers and for having invented the Internet software programming language Java. The *BusinessWeek* article uses the following adjectives to describe Scott McNealy: optimistic, smart, acerbic, cocky, and combative. These are all psychological traits that influenced McNealy's business decisions.

McNealy was one of Sun Microsystem's founders, became its CEO in 1984, and had a history of being willing to take major risks in order to avoid disaster. During the 1980s, against the advice of his executives, he decided to substitute Sun's own microprocessors for those manufactured by Motorola. That decision turned out very well for Sun.

During the 1990s, Sun's competitors produced servers that used Microsoft's Windows operating systems. McNealy instead chose to invest in servers that ran Sun's own software Solaris. That decision also turned out well, as Solaris came to be highly praised for its speed, reliability, and security. Sun's sales, profits, and cash holdings soared, and it dramatically increased its spending on a great many research and developments projects.

Sun's fortunes changed with the onset of an economic recession in 2001. Wall Street analysts called for Sun to cut costs. However, McNealy was optimistic that the recession would be short-lived. In 2001, during a conference call with analysts, he said about business cycles: "*We don't have rolling waves. We seem to have real edges.*" Instead of cutting costs during the recession, Sun invested heavily in new projects. In justifying that decision, McNealy stated: "*The Internet is still wildly underhyped, underutilized, and underimplemented. I think we are looking at the largest equipment business in the history of anything. The growth opportunities are stunning.*"

Cisco Systems is the leading producer of router products used on the Internet. On March 8, 2001, Cisco announced that because the economic downturn looked like it would last much longer than expected it was going to lay-off 18 percent of its workforce. Some of Sun's executives wanted to follow suit. One stated: "*When times are hard, you've got to shoot activities that aren't making money.*" However, McNealy refused to do so.

In an effort to cut costs, Sun's customers sought low-end servers. McNealy initially dismissed

their concerns. Later, Sun spend \$2 billion to acquire Cobalt, a manufacturer of low-cost servers. However, after the acquisition, Sun chose to limit Cobalt's budget, and McNealy later admitted that the acquisition was a mistake.

The economic downturn was much longer than McNealy had forecast. In the following three years, Sun lost a third of its market share, its sales figures fell by 48 percent, and its stock price fell from \$64 in 2000 to about \$4 in 2004.

In order to illustrate some of the psychological phenomena (biases and heuristics) that we discussed in today's lecture and that underlie the study of behavioral corporate finance, consider the example above of Sun Microsystems. Your goal is to identify the psychological attributes of Sun's CEO Scott McNealy and the financial decisions made by Sun's management. Please keep the financial market developments during these days such as the burst of the Internet bubble in mind.