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PREFACE

This Faculty publication is produced in parallel with the Braybrooke Press publication of the same name. Accordingly, references in the text to issues of *Manager Update* prior to April 1997 relate to the Braybrooke edition.

Manager Update helps the general manager keep abreast of the latest articles in specialist management journals. The most useful ideas in the fields of Strategy and Organisation, Marketing, Accounting and Finance and Human Resources Management are carefully selected from a wide range of publications with the busy general manager in mind. Experts in each field explain and discuss the relevance, practicality and usefulness of the key new concepts and ideas, thus enabling the senior executive to keep really up-to-date. The articles represent the personal views of the authors and not necessarily those of their organisations or of the Faculty. The nature of some subjects will preclude the articles from being definitive or mandatory. Being general in nature, the points made in *Manager Update* may or may not be relevant to specific circumstances.

The Faculty committee intends that *Manager Update* will act as an aide-memoire for members, provide new ideas, and encourage good practice, but cannot accept responsibility for their accuracy or completeness. Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on 0171-920 8486. (or by e-mail to CDJackson@icaew.co.uk)

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ARTICLE SUMMARIES

Marketing *Customers, Channels and Supply Chains*

This issue of *Manager Update* concentrates on managing relationships beyond the boundaries of the firm. The articles selected consider different facets of these relationships, both in traditional channels of distribution and in newer 'virtual' channels in electronic markets. Insights are provided into how to use a market orientation in the supply chain to strengthen the ties that lead to the end-customer. But the more dramatic changes are occurring in electronic markets, where 'cybermediaries' are evolving. **Page 2**

Human Resources Management *Developing an Effective HR Strategy*

How involved should top management be in Human Resources Management? And what evidence is there that greater involvement leads to better results? Here, some recent writing on the linking between HRM and corporate strategy is considered, including implications for explicit HR planning objectives and processes. This *Update* also raises the issue of whether the development of corporate strategy should actually begin with a consideration of the capabilities of key employees. **Page 6**

Strategy and Organization *Pacing Strategic Change*

As product life cycles have shortened, so the importance of continual innovation has increased. The companies that will be supreme in this fast moving world are those that systematise their process for innovation and change, so that these become integral to their cultures. One useful way to cope with uncertainty is to view strategy as considering and managing a series of options. Each option needs to be analysed in terms not only of its expected value and inherent risk, but also of its timing. Reviewing options regularly is helpful because as new knowledge becomes available it can throw a different light on the relative attractiveness of the different projects. In this way strategic change can be better monitored and guided by top management. **Page 11**

Accounting and Finance *European Economic and Monetary Union*

What will be the implications of European Economic and Monetary Union (EMU) on international capital markets? One implication for fund managers is that pan-European sector analysis will become much more important. This trend will be reinforced by closer collaboration among Stock Exchanges. It is also likely to accelerate the development of European bond markets. **Page 16**

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MARKETING

Customers, channels and supply chains

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‘As companies focus on their core activities and outsource the rest, their success increasingly depends on their ability to control what happens in the value chain outside their own boundaries’. (Magretta)¹

This issue of *Manager Update* concentrates on managing relationships beyond the boundaries of the firm. The articles selected consider different facets of these relationships in traditional channels of distribution and of the virtual channels in electronic markets. Siguaw, Simpson and Baker² focus on the impact of market orientation of suppliers and distributors, and show how to use the supply chain to strengthen the ties that lead to the end customer. Stank, Dougherty and Ellinger³ concentrate on the realities of customer service and logistics. However, the more dramatic developments are in electronic markets, where the structure and composition of distribution channels are still emerging. Whilst some suggest that there will not be a role for the intermediary in the direct and immediate exchanges in electronic markets, Sarker, Butler and Steinfeld⁴ suggest that there will be a significant role for intermediaries. In discussing the range of channel decisions available in the financial services sector, Morrison and Roberts⁵ consider the relationship between electronic distribution decisions and the characteristics of the service purchased by the customer. Whether virtual or traditional, the relationship between channel management and financial performance is crucial. Tan, Kannan and Handfield⁶ examine the relationships between supply chain management practices, customer satisfaction and financial and market performance.

Partnerships and channel management

The changes and the shifts in the balance of power in channel relationships have been widely discussed, the most well known being the concentrated power of the supermarkets in the retail sector. However, the current trend is a move away from adversarial encounters towards co-operation and partnerships that have been made possible in part through the availability of technology aided developments in information management and cost effective communications. Buzzel and Ortmeyer,⁷ suggest that there are a number of prerequisites for successful channel partnerships. These factors mirror exactly the antecedents of a market-oriented organization. They emphasise the need for:

- Top management commitment, and changes in systems, structures and culture that could support cross company working.
- Management of inter-organizational relationships to support a partnership rather than an adversarial position.
- The availability of technological skills and resources.
- Reward systems based on mutually agreed performance measures rather than sales volumes or gross margins.

Whilst partnerships are not without their difficulties, Buzzel and Ortmeyer suggest that those ‘... that choose not to partner will find it nearly impossible to compete with the more efficient, effective business systems of those who do’. Indeed, they conclude that partnerships may not be the differentiator that provides long term competitive advantage, but rather that it will represent normal business practice.

Market orientation in channel relationships

As managing partnerships becomes an everyday management activity, Siguaw, Simpson and Baker highlight the tensions emerging between channel partners. These are largely the result of competition

in mature markets, the pressures of globalisation, the emergence of alternative channels and the demands presented by knowledgeable and often powerful customers. They suggest that the tensions could be eased if suppliers and distributors adopted a market-orientated approach. Recent research in the area of market orientation has concentrated on business performance, employee behaviour and the orientation of sales staff: here, this work is extended to consider the impact of market orientation on channel relationships.

The authors base their research on the definition of market orientation developed by Kohli and Jaworski (1990), which was also discussed in the Issue 4 of *Manager Update* (ICAEW edn). In this context Siguaw, Simpson and Baker state that: 'Market oriented firms will gather and use information more actively and openly to satisfy customer needs to the betterment of all channel members than will their less market oriented counterparts'. They develop a model which they use to examine the effect of market orientation on the relationship between suppliers and distributors, the impact on trust, co-operation and commitment in the relationship and the effects on satisfaction and performance levels. The model examines the relationship from the supplier's perspective and the distributor's perspective.

The model was tested in research in which 1,127 questionnaires were sent to pairs of suppliers and distributors. They received 833 responses, of which 179 were matching pairs of suppliers and distributors. These pairs formed the basis of their analysis. The results are both interesting and important as they suggest that the supplier's level of market orientation can affect the distributor's commitment to the relationship and levels of market orientation. They found that distributors use the suppliers as their benchmark. This provides suppliers with the opportunity to develop norms in the channel, and by their own example show the distributors how to treat their customers, thus enabling suppliers to strengthen their relationships with the end users.

Thus, in a competitive environment, where partners are constantly assessing the viability of partnerships and comparing them with alternatives, and relationships between suppliers and distributors are more precarious, it seems that market orientation can be used to improve stability and strengthen the bonds in the chain of relationships to the ultimate customer.

Customer satisfaction, service and logistics

On a more practical level, it seems that the pace of change in supply chain and channel management has tended to be incremental and somewhat cautious. However, the demands of the faster paced markets are noted by Stank, Dougherty and Ellinger, who emphasise that the pressures on logistics are to deliver faster, provide a tailored service, deliver individual items not necessarily in volume, hold inventory, and to deliver on demand. Despite these pressures, they suggest that distribution and the management of logistics is often a neglected aspect of marketing, in which decisions are made in response to demand generated rather than being used proactively to create customer satisfaction. Yet they see that: 'Logistics represents the service component of an augmented or value added product that allows firms to focus not only on attracting new customers but on becoming closer to the ones they already have'.

It seems that the pressure for change is providing new impetus for management, to adopt a strategic approach and move away from rigid systems that have evolved often in a piecemeal fashion over a number of years. In this research, based on two case studies in the personal care products and the prepared foods sectors, the investigation concentrates on the link between logistics service performance and customer satisfaction in the consumer goods market. They suggest that successful logistics organizations focus on three key issues; operational effectiveness and customer closeness, logistics capabilities and performance measures.

- Operational effectiveness and customer closeness can be achieved by balancing an understanding of the existing and potential customer – their needs, expectations and behaviours – with efficient operational processes. Operationally, benchmarking, TQM, initiatives in time-based management, operating standards and internal performance measures can help organizations become more efficient. However, to develop a sustainable competitive advantage Stank et al suggest that firms need to focus on the proposition that 'customizing service offerings that already demonstrate operational excellence allows a supplier to become an integral part of the customer's business'.

- The logistics capabilities important in today's competitive environment are positioning, integration, agility and measurement. Logistics has a strategic and a structural position in the organization. Firms need to be responsive and flexible when dealing with the customers' requirements. They need the techniques to manage the internal systems and the external relationships in the supply chain, and firms need to monitor and measure their service levels.
- The key performance measure is seen to be customer satisfaction. Here, firms should use their efficient logistics operations to develop long term customer relationships. Through the repeat business generated through customer loyalty the impact will be seen on market share, profitability and growth.

Stank, Dougherty and Ellinger conclude by stressing that logistics and distribution should not be considered as costs centres but as a means of creating market value. They develop a continuum of logistics capabilities. At one end of the continuum is the least sophisticated level, where firms focus on low cost 'cheap' logistics operations. At their most sophisticated, logistical capabilities are used to create customer value by using alliances and information gained by being close to the customer to differentiate their service. They state that the firms that aspire to develop customer closeness need to base their strategy on partnerships and developing a market orientation.

Virtual channel management

Whilst managers struggle to manage the conventional intermediaries, the growth of the Internet and the importance of electronic commerce and markets provides a different challenge – managing in the marketplace⁸ rather than the marketplace. One view of the electronic marketplace challenges the role of the intermediary and suggests that customers aided by 'software tools including intelligent agents and distributed databases' will deal directly with suppliers, thus prohibiting the development of intermediaries. Sarker, Butler and Steinfeld dispute this and suggest that as electronic commerce develops organizations will emerge to manage the interface between buyers and suppliers. They give these organizations the name cybermediaries. In electronic markets, they suggest that: 'cybermediaries also increase the efficiency of electronic markets, in a role similar to intermediaries, by aggregating transactions to create economies of scale and scope'. They use transaction cost economics to underpin their research and ask a number of questions considering, for example, the structure of electronic marketplaces, the role of cybermediaries and the emergence of virtual channel systems.

Distributors have conventionally been 'full service providers' of inventory, logistics, planning, customisation, and added value activities. In electronic markets, Sarker, Butler and Steinfeld suggest that there will be disintegration – cybermediaries will be more focused in particular areas of distribution and the linear nature of distribution channels may give way in electronic markets to shorter networks of information intermediaries. 'Eg, some firms may locate products, others provide evaluations of related products, others provide training, others provide settlement services, etc.'

As markets evolve, the use of intermediaries tends to change – small entrepreneurial firms tend to use intermediaries initially to provide skills they do not have themselves. As the markets develop, the more integration occurs and the length of channels reduces. In electronic markets, the authors suggest that the length of the channel will not shorten to the same degree, as there will be no cost advantages to internalising the activities of the cybermediary. Their view is that the role of the intermediary will be more complicated in electronic markets, and that cybermediaries will be more numerous and even more diverse than distributors in traditional markets.

Electronic distribution channels

Even though there is much discussion about the electronic delivery of products and services to the customer, Morrison and Roberts suggest that there is little research to show that the customer is prepared to accept or to use these new channels of distribution. They consider consumers' preferences for different channels of

distribution and the fit between the channel and the services being delivered. Their work is based in the financial services sector, where they investigate beliefs about banking services and the appropriateness of electronic distribution channels. The financial sector operates a range of distribution channels, from conventional face-to-face service delivery in the bank to telephone banking and, increasingly, home banking and electronic exchanges via personal computers, the Internet and interactive television.

The authors develop a model to assess the congruence between the service required and the appropriateness of the channel of distribution selected. Their work suggests that there is some reluctance on the part of customers to use electronic methods as they clearly see the advantages of face to face banking and are yet to be convinced of the benefits of electronic methods. Thus, they conclude that: 'managers should seek to build up consumers' perceptions that new shopping methods are appropriate vehicles for delivering their service rather than trying to boost preference for the distribution method itself'.

Financial and market performance in the supply chain

Organizations are under increasing pressure to deliver products and services to internal and external customers along the supply chain in a more 'timely and effective manner', whilst meeting their own financial targets. To satisfy these demands and their performance targets Tan, Kannan and Handfield show that organizations have striven for integration, a theme that is prevalent in different forms in practice and in the literature – it can be:

- Integrated purchasing strategies.
- Supplier integration.
- Buyer-supplier partnerships.
- Supply base management.
- Strategic supplier alliances.
- Supply chain synchronisation.
- Supply chain management.

In this article, they focus on supply chain management as its scope covers all aspects of supply to final production: it emphasises processes, technology, competences and competitive advantage and: 'when all the strategic suppliers in the chain 'integrate' and act as a single entity, performance is enhanced throughout the chain'.

Tan, Kannan and Handfield investigated the relationship between supply chain management practices and supplier performance and company performance with an emphasis on financial and market performance. They distributed 1469 questionnaires which resulted in a 21.3 percent response rate. The research considered a number of customer relations issues: feedback, customer support, standards, customer expectations, relationships, complaints and satisfaction levels. The findings emphasise the importance of 'downstream integration with customers' and they state that the partners saw the value in 'attempts to improve performance, encourage trust, and improve communications to foster long term co-operation and strategic alliances'.

The investigation into the relationship between supply chain management and financial performance revealed that using supplier knowledge, sharing information, and using cross-company teams all correlated positively with return on assets, growth in market share, sales and return on assets, and correlated significantly with customer service, product quality and competitive position. Their discussion of the results emphasises the importance of a long-term supply chain perspective in relationships and maintaining communication and close contact with customers.

In designing and managing channels, whether they are conventional intermediaries or virtual cybermediaries, these articles emphasise the importance of partnerships, customer focus, market orientation, logistics, channel structures and the financial and market performance. Furthermore: 'In

the 1980s the focus was on supplier partnerships to improve cost and quality. In today's faster paced markets, the focus has shifted to innovation, flexibility and speed.' (Magretta, 1998)

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HUMAN RESOURCES MANAGEMENT

Developing an effective human resource strategy

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Few would deny that managing the human resource of an organization is critical for the creation of competitive advantage in a global environment. For proponents of Human Resource Management (HRM), effective strategic planning requires the involvement of HR managers in the process, and even better, the presence of HR directors on the board. This view is very much in the tradition that has argued for a move from personnel management and employment planning, to HRM and HR planning. But what form should this involvement take? What happens in practice and what evidence is there that involvement contributes to greater organizational effectiveness? This issue of *Manager Update* will consider some recent writing on the linkage between HR and corporate strategy, and on the importance of having clear HR planning objectives together with an explicit planning process. It will also raise the issue of the extent to which the development of a corporate and competitive strategy should begin with a consideration of people capabilities, through an examination of barriers to effective human resource management in Russia.

HR strategy and corporate strategy

For Torrington and Hall¹ the 'interest in strategy has taken personnel management by storm'. They identify five potential relationships between organizational strategy and human resource strategy:

1. 'Separation' where there is no relationship at all.
2. 'Fit' where HR strategy meets the requirements of organization strategy.
3. 'Dialogue' where there is debate between the organizational and HR strategies.
4. 'Holistic' or mutual development of the two strategies.
5. 'HR driven' where HR strategy is in prime position.

In an ideal world, they argue, the development of human resource strategy would be fully integrated with the development of organizational strategy. In reality, this relationship is often of a very different nature.

Grundy² considers the links between HR strategy and corporate strategy, and also the role that these links play in determining organizational effectiveness: or the capacity of an organization to adapt rapidly to its environment and to achieve good business performance. HR strategy, which may be 'deliberate' or 'emergent', is concerned with developing the human capability of the organization to meet the future needs of its internal and external environment.

He argues that the notion of linking corporate and HR strategy through 'strategic fit', part of what has become known as the 'matching model', is simplistic and that linking HR strategy to corporate strategy is likely to be very difficult, even in the most favourable environment, for several reasons:

- The complexity of the diverse linkages that need to be managed.
- The degree to which it is possible to have separate identity for an HR strategy.
- The presence of an emergent corporate strategy.
- The more intangible nature of human capability.
- Organizational turbulence.
- The question of ownership of HR strategy.

The dangers of an emergent strategy

Grundy argues that to make effective linkages in practice between Corporate Strategy and Human Resources Strategy requires a shift from a separate HR strategy to a unified 'organization and people' (O&P) strategy, about which more will be said later. Moreover this should not be founded on 'out-of-date, bureaucratic processes'. It requires a simultaneous review of the business an organization wishes to be in, its competitive positioning and prospects, and the distinctive human capabilities which can achieve competitive advantage.

The key conclusions of his small-scale qualitative research on two major UK financial services companies are that:

- An emergent HR strategy may undermine organizational effectiveness.
- Culture may be the basis for designing a competitive strategy rather than vice versa.
- Pursuing differentiation and cost leadership strategies at the same time minimises the contribution of HR strategy to organizational effectiveness.
- HR strategy should not be separated out from business strategy.
- HR strategy may be marginalised if it is seen to be owned by the HR or personnel department.

An emergent HR strategy, which often follows from an emergent corporate strategy, can lead to a number of difficulties: inadequate management of the interdependencies between HR programmes, a lack of attention to HR as a source of competitive advantage, poorly implemented HRM, the simultaneous pursuit of differentiation and cost leadership, the decoupling of brand strategy from plans to develop staff's behaviour values and skills, and a lack of thought on softer issues such as people's implementation capability. A 'robust HR strategy clearly linked with corporate strategy' is necessary to give HRM programmes 'direction, clarity, coherence and critical mass to add real value'. For Grundy 'it

does very much seem to matter whether a deliberate or emergent approach to HR strategy is taken, and how well this links to corporate strategy'.

Towards an 'organization and people' strategy

A number of implications for theory and practice follow from these arguments:

- Given that it is implementation that frequently lets corporate strategy down, companies may be as well to start with some thinking about HR strategy instead of starting off with product/market and competitive positioning.
- Since HR strategy elements are so interdependent with operational initiatives, and the people resource is only one part of the operational mix, it makes less and less sense to extract the pure HR element.
- Fruitless attempts to compile complex frameworks for HR strategy planning processes may be avoided.

Grundy proposes that organizations develop an organization and people strategy, owned and developed by line managers with facilitation by HR, and which is seen as the flip-side to competitive strategy. He argues that this approach will have the following practical benefits:

- Helping to dissolve the Line/HR barrier.
- Dovetailing into both competitive and business plans.
- A greater chance of senior manager sponsorship.
- Easier integration of hard initiatives (such as BPR) with HR initiatives.
- Easier evaluation of business and financial effects of HR programmes because they do not stand alone.

From strategy to planning

Lam and Schaubroeck³ argue that very little empirical research has been undertaken to determine how HR planning is actually being carried out in organizations. In addition, little is known about how the planning process is integrated with organizational strategies.

Many HR planning methodologies have been developed which typically include the setting of formal objectives, identifying appropriate organizational strategies, and searching for innovative HR applications. The appropriateness of the various methods of formal planning is dependent upon the specific planning objectives. Three different types of HR planning objectives are identified:

- 'Operational objectives' which focus on current capabilities and near-term requirements such as HR costs.
- 'HR planning objectives' which focus on the longer term requirements for demand and supply, the number and type of staff required, and cover such issues as career development and succession planning.
- 'Strategic HR planning' objectives which involve line managers in developing and evaluating HR practices which contribute to strategic planning and a process which builds commitment to organizational strategy across different levels and functions of the organization, with HR professionals adopting a facilitative role.

'As organizations move toward a more strategic planning orientation, the identification of means to establish and maintain core competencies and the building of commitment to the strategy is at the forefront of HR planning'. With this orientation, objectives are set in the context of the organization's internal and external environment and reflect the organization's position and values.

Planning processes may vary in terms of their sophistication and formality. Formal approaches rely on clearly defined planning steps, on techniques and models, and on schedules and documentation. Within an informal approach there are few written procedures or guidelines, and objectives are accomplished primarily through informal discussions, without explicitly predefined steps. Research cited by the authors suggests that formal and sophisticated strategic planning processes may not have a significant correlation with financial indicators of firm performance. However, the authors argue that whilst sophistication of planning processes and procedures may not be necessary, a fair degree of formality (or explicitness) in HR planning is needed to fully realise planning objectives – for example, with regard to the collection and interpretation of data critical to creating and maintaining organizational competitiveness, and to evaluate the potential benefits or risks facing an organization when implementing the organizational plan.

Planning orientations, formality and usefulness

Lam and Schaubroeck attempted to identify some contingency factors behind the usefulness of HR planning to an organization. Their study, based on 85 Hong Kong companies representing five different industries with an average size of 841 employees, had three stages: establishing different HR planning orientations; an examination of the perceived usefulness of HR planning to organizational goal attainment; and, finally, examining the joint effects of formality of planning process and HR planning objectives on the perceived usefulness of planning.

Several HR planning orientations were distinguished: ‘strategic impact’ - with a concern for alignment with organizational strategy; ‘control’ - focusing on efficiency and cost effectiveness; ‘co-ordination’ - seeking to integrate HR objectives with each other; and ‘communication’ - focusing on enhancing communication and support amongst employees and top management. Their analysis identified four clusters of planning orientations amongst the companies studied:

1. ‘Strategic impact and communication’.
2. ‘Control’.
3. ‘Co-ordination’.
4. ‘No clear objectives’.

In the second phase of the study, the authors found a clear relationship between the HR planning orientation and planning performance, as measured by the perceived level of usefulness to organizational performance reported by the CEO, Chief Operating Officer or Planning Director of the companies. The ranking of perceived usefulness of each orientation, from greatest to least, was for ‘co-ordination’, ‘control’, ‘strategic impact and communication’ and then ‘no clear objectives’. The presence of HR planning objectives was the most significant source of perceived HR planning usefulness differences, with the presence of objectives positively associated with usefulness.

In the final stage of the study, firms with high to moderate formalisation were found to have significantly higher perceived HR planning performance than firms that were low in HR planning formalisation. When formalisation and objective orientation are considered simultaneously, firms which engaged in high to moderate levels of formalisation in planning and were committed to a single objective orientation, were ranked in the higher usefulness group. Firms with an unclear planning orientation, regardless of level of planning formalisation, were ranked as lowest in usefulness. Firms in the strategic impact and communication cluster differed systematically in their perceived planning usefulness according to the level of planning formalisation: the greater the degree of formalisation, the greater the perceived usefulness.

The principal implications of this research for practice are that:

- HR planning requires a clear and single focussed planning objective.

- An implicit planning process could prevent a properly focussed HR planning approach from benefiting the organization.
- A formal process is more likely systematically to highlight gaps and variances, and to translate data into evaluations of core competencies that are critical to defining a firm's strategic orientation.
- More informal processes do not provide data which is sufficiently clear and understandable to be of use in strategic planning.

Formalisation can also help to enhance organizational learning on strategic planning. However, formalisation only helps when objectives are clearly defined. If there is more than one objective, formalisation can help to enhance integration amongst objectives. Clear objectives in HR planning combined with a formal planning process are more likely to be useful to their organizations' strategic planning and other endeavours. 'Not only must HR planners have good techniques, they must clearly define these objectives in applying these techniques'. They recommend further research into contingencies to identify other factors affecting usefulness, such as environment factors and particular HR practices.

The Russian HR experience

It has already been suggested that in developing corporate strategy, account must be taken of the capability of people to implement that strategy. In addition, when transferring HRM practices from one context to another, it may be necessary to adapt those practices to take account of any differences in the cultural and institutional contexts. Both points are vividly illustrated in the experience of human resource management in Russia.

Following the perestroika (reconstruction) movement fostered by Gorbachov in the late 1980's, and the transformation of Russian management practices to free market standards in the 1990's consequent on the break-up of the Soviet Union in 1991, the reform of HR management systems can be seen as critical to the transformation to a market economy. Russian organizations have been faced with the challenge of creating 'more comprehensive, contemporary HR departments' operating without centralised directives in and 'to be competitive in the new profit-driven global environment'.

How much progress has been made? May, Bormann Young, and Ledgerwood⁴ identify a number of barriers to management effectiveness in Russian human resource management which are seen as residual problems arising from the centralised Soviet era, with restriction of individual initiative. These barriers, which have the potential to impede the success of international ventures, are:

- Underestimating the complexity of the free market, and a tendency to rely on imported formulas/recipes.
- Lack of organizational commitment.
- Lack of personal accountability and responsibility.
- Disregard for health and safety management.
- Confusion surrounding compensation and benefits.
- Strained labour/management relations.

They argue that given '... the instability of the nascent free market in Russia, it is imperative that Western executives be prepared for the unique barriers to management effectiveness they may encounter as they expand into Russia, particularly in the context of human resource management. For companies entering the Russian market, an effective HRM function is paramount to success. Thus, it is important that Western executives understand the idiosyncrasies of Russian HR practices, particularly if host country nationals will play a vital role in establishing and managing the HR functions on location in Russia.'

Amongst their recommendations are the encouragement of a hybrid form of HRM incorporating free market practices and Russian culture; fostering the concept of the organization as a living entity and encouraging personal commitment to the organization; and, tying rewards to efforts to build credible

management practices and encourage risk-taking, creativity and a long-term perspective.

The key lessons of this research are not only that culture and capability are critical for the success of an organization's corporate and human resource strategies, but also that behaviours deeply rooted in history may take considerable time and effort to change. Furthermore, HR professionals must question whether practices which work in one culture may simply be translated to another national context when the cultural prerequisites are not shared.

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STRATEGY AND ORGANIZATION

Pacing strategic change

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In this issue of *Manager Update* we shall be looking at some more contributions to the study of strategy under conditions of uncertainty, which is clearly a topic of prime interest to strategists everywhere. We start with an interesting new contribution by Eisenhardt and Brown.¹ These authors contend that, in order to cope with very fast moving industries and, indeed, to gain and sustain a dominant position in such industries, managers need to move away from 'event pacing' to time pacing.

Event pacing is about making changes to strategy as a result of internal developments, eg the emergence of a new product or technology, or the appearance of a market opportunity. This approach, they argue, is quite suitable for stable market situations but in fast moving industries epitomized by the information technology industry, a different approach is required, one that involves creating new products and services or entering new product markets, not on an opportunistic basis but according to a set pattern or calendar. Perhaps the most famous example of this is 3M's principle that 30 percent of revenues will come from new products every year. By setting such a target Eisenhardt and Brown believe that managers can create a more predictable and fast pace rhythm for change within the company.

At its simplest, Eisenhardt and Brown's prescription boils down to the rather trivial insight that the more times you do something the better you get at it. They rightly point to the problems involved in most companies in managing major transitions, ie acquisitions, structural reorganizations, etc. Their point is that companies that set out to do this on a continual basis by calendar develop the capability to achieve it. They point for example, to Gillette which is famous for introducing a constant flow of new products in order to dominate the market and deter all but the most determined competitors. 'Choreographing transitions' like this requires great attention to organizational structure and processes, and this is clearly a factor for success at companies like Gillette, Intel and Netscape who feature in Eisenhardt and Brown's article.

Arguably, there is nothing new about this either. Indeed, it is not so very long ago that management books regularly decried the practice of automobile manufacturers in the 1950s and 1960s launching a new product every year; but the process that they went through in order to do this is surely not unlike the process which is described in Sony with the rapid updating and relaunching of the Walkman range,

ie, a process of modularity where a few key components – engines, drive chains, gear boxes – are kept current over a relatively longer period of time but styling changes occur more frequently in response to consumer needs. It is strange that at Sony this is called ‘time-pacing’, whereas at Ford and General Motors it became denigrated as cynical styling changes.

Nevertheless, there is enough in Eisenhardt and Brown’s approach for us to reflect on. It is clearly true that, as product life cycles have shortened, so the importance of the transition from one project or product to another has become much more critical. As they put it: ‘It’s like competing in the 4x 100 metre relay – the laps are so short that the execution of the baton pass often determines the outcome of the race’.²

And it is also true that companies that are supreme in this new fast moving world have systematized their processes and honed them to a high level of effectiveness. This makes the difference, for example, between a company like Bombardier whose strategy has been based on a series of well planned and integrated acquisitions and other companies for whom acquisitions occur more sporadically and opportunistically.

Using the rhythm method

Eisenhardt and Brown are big on rhythms. The point here is that you have to align the time pacing with the natural rhythms of the marketplace. So, for example, if there are seasonal peaks or troughs in your industry, then your time pacing activities have to coincide with this. For example, a manufacturer of personal computers became aware that consumers were turning more and more to computer magazines, and one in particular, to make their decisions about new computer purchases. As a result, they timed the introduction of their new products to coincide with product reviews in the magazine. Eisenhardt and Brown are not arguing for change for change sake or even extolling permanent revolution. They believe that managers should choose a manageable pace for innovations and match the rhythm of their time pacing to the company’s capabilities. It is clear, however, that in the time paced companies that she cites, time pressure is pretty relentless. ‘When forced to make a decision about whether to stay, for example, on schedule, or meet a product’s future specifications, companies at Time Pace, by definition, choose to stick with the schedule’.³

Winning the Pools

According to a new article by Gadeish and Gilbert,⁴ managers in today’s corporations are labouring under the misapprehension that growth is the Holy Grail. Mr Gadeish must know something because he is chairman of Bain & Company, but most recent strategy articles have berated companies for focusing too closely on short-term profits and cost reduction exercises. No company, we are told, ever shrunk its way to greatness. Certainly, in a survey published recently by Mr Gadeish’s rival AT Kearney, it emerged that as far as UK companies were concerned, they had hardly grown at all in real terms over the last ten years so the timing of Gadeish and Gilbert’s article is a little puzzling. Their basic contention is that companies should look not at market share or turnover but at profitability and, when looking at the profitability of their industry, they should focus not on the industry as a whole, so much as the individual stages of the value chain. An industry they say, is a profit pool, a nice analogy because, as they say, the pool will be deeper in some segments or stages of the value chain than others. This must be pretty obvious stuff. Most people who work, for example, in aero engines, know that most of the money is made not in the sale of the engines per se but in the supply of after sales parts and support. Likewise, retailers of petrol know that the profit is made not in the petrol per se but in the additional services provided through petrol stations. Equally, it is well known that if you dissect the automobile industry, the process of manufacturing is far less profitable than the financial services such as leasing and finance associated with car purchase, one of the reasons of course why large companies like Ford and Volkswagen made huge investments in these areas over the last few years.

So what relevance does all this have to turbulent or uncertain business? The answer is that rapid changes in industry structure can lead to decisive shifts in the profitability of individual stages in the value chain. In many industries there are so called ‘choke points’, where a dominant player has attained a monopolistic or quasi-monopolistic position which enables them to influence the distribution of profits in the

industries; for example, Microsoft's control of the computer operating system. So, new technology or another sort of major shift, eg deregulation, can have a fundamental effect on industry profitability.

In this context, the authors mention the move by pharmaceutical companies into acquiring distributors of health maintenance organizations which control the dispensing or prescribing of drugs, particularly in the United States. This type of forward integration is now generally viewed with suspicion and, indeed, many of the pharmaceutical companies which engaged in such acquisitions have now divested themselves of them, having lost money in the process. Gadeish and Gilbert recognise these criticisms but claim that even though these acquisitions may have been loss making, in terms of the profit pool as a whole, they probably created a net benefit by deterring new entrants and protecting existing sources of profits.

This argument is less than totally convincing. A pharmaceutical company, to protect its profitability on the manufacturing side from buyer pressure exerted by more co-ordinated purchasing, would need to purchase much greater control of that part of the value chain than the acquisition of a single organization would supply. The experience of this type of forward integration, in pharmaceuticals as also in entertainment (eg Matsushita and Universal, Sony and CBS), has generally been unsatisfactory for both elements of the industry value chain. Retailers, for example, generally prefer to have access to the greatest level of choice at the best price for their customers rather than being tied to any one particular manufacturer, and this can only be achieved by dispensing with exclusive distribution deals with the parent company.

Concentrating on the parts of the business which yield the greatest profit may seem to be a pretty obvious technique. Nevertheless, the authors are probably correct to state that many organizations eschew this simple principle: 'a company may for example, hold off from pursuing obvious growth opportunities in favour of concentrating at first on seemingly less exciting business segments with a richer profit pool. It may shed traditional customer groups, product lines and even entire businesses in order to focus on best profit sources. It may deliberately reduce its profits in one area of its business to maximise them in another. It may, for example, decide to co-operate with its rivals in order to block or take advantage of value-chain shifts that threaten an existing profit pool'.⁵

Keeping our options option

If the current glut of articles on options theory is to be believed, shareholder value analysis is out and options theory is in. We have already referred in an earlier *Manager Update* to some of the insights which options theory is starting to generate for strategic analysis in conditions of uncertainty.⁶ Options theory, of course, is derived from corporate finance. The basic concept is that many strategies and strategic investments should be viewed not in terms of their overall returns (or net present value) but rather as an option to exercise a right sometime in the future. As Copeland and Keenan of McKinsey point out,⁷ options are rights without obligations. The value of an option depends on a number of factors:

- The value of the underlying variable, eg the total market share for the reserves of a particular oil well.
- The level of uncertainty. The greater the level of uncertainty the greater the value of an option, as opposed to a complete investment, becomes.
- The exercise price. The higher the price at which the option can be realised, the lower its value becomes.
- The time to maturity of the option. The greater the time to maturity the higher the value of the option becomes, because uncertainty increases with time.
- The time value of the money. This depends on the risk free rate of interest and as the interest rates rise, so the present value of the exercise cost falls.

Copeland and Keenan argue convincingly that options theory makes more sense in evaluating options under conditions of uncertainty than traditional SVA type methods employing net present value calculations. SVA type calculations assume that there is no managerial intervention between the time that the investment decision is made and the return is realised. They typically cope with risk and

uncertainty by taking an average between two extreme scenarios, the worst and the best. This generally produces conservative investment decisions, whereas real options can reveal a more realistic and less over-cautious analysis. SVA type analysis turns out to be most suitable where outcomes are predictable and industries are relatively stable.

'In effect they assume that management makes an irrevocable decision based on its view of the future and then does not deviate from its plan no matter how things actually shape up. The life of the project is assumed to be fixed and the possibility of abandoning it in the face of adverse circumstances or, conversely, expanding it in response to unanticipated demand is not even considered'.⁸

Options theory on the other hand, as the name suggests, allows managers to keep their options open. This is also more practical since entry and exit costs in any industry are often quite high and may in some cases weigh more heavily than discounted cash flow calculations.

Classifying options

Copeland and Keenan come up with a new framework for strategic options based around three main options:

- Invest and grow, which in turn can involve:
 - scaling-up incrementally as the market grows;
 - switching-up to the next generation of product or technology;
 - scoping-up by diversifying into other industries.
- Deferring/learning:
 - by studying or starting;
 - delaying fuller investment until more information is obtained.
- Disinvest/shrinking through:
 - scaling down a project part-way through;
 - switching down to more cost effective or flexible assets;
 - scoping down by abandoning operations and limiting the scope of the business.

Compound options

In their second article on this subject⁹ Copeland and Keenan deal with compound or staged options. Take, for example, a nuclear waste company that is investigating the possibility of excavating a repository for low level waste. The process would involve a number of distinct stages starting with geological surveys leading on to test drilling of potentially suitable sites, underground laboratories to test for geological stability and finally, if all went well, to the excavation of an underground facility. Calculating at the outset the probability of a successful site choice and deciding whether or not to commit to the full cost of constructing the facility would be an extremely difficult calculation, and one where the calculated probability of success would probably deter any further investment. But this single point decision ignores the capability of management to walk away from the next stage of investment if investigations reveal the option not to be advisable. Copeland and Keenan refer to this sequential process as a 'growth staircase', where each successive stage is dependent upon the completion of its predecessor and this principal can be applied to all types of business strategy, not just capital investment decisions.

Often, the value of proceeding incrementally in this fashion is that it can resolve two different sources of uncertainty. To take the example cited above, one level of uncertainty is caused by lack of knowledge about the precise geology of the area and this can be resolved through investing in learning. Another area of uncertainty, however, may lie in the potential demand or market size when this could not be resolved through investigation or market research and, as time passes, is likely to become more accurate.

Clearly, these options have a cost as well as a benefit. The process of discovering information about the drill site will incur further expenditure, and the time taken to investigate demand may delay completion or allow

a competitor to enter the market more quickly. The real option approach offers a more realistic and accurate way of valuing options at each stage in this sequential process. For example, instead of using a single discount rate at the outset, the rate can be varied at different stages in the process to take account of the relative level of risk that different cash flows involve, and this can have a substantial difference on the outcome.

Strategy as a portfolio of options

Timothy Luehrman takes this options approach one stage further by applying it to portfolio strategy.¹⁰ Luehrman has developed a grid which enables companies to make decisions about when and if they should invest in a particular strategy. To illustrate the meaning of the grid, Luehrman uses the metaphor of tomatoes. No gardener worth their salt, Luehrman claims, plants tomatoes at the start of the season and then turns up at the end to harvest them. This essentially is the SVA approach. Where the gardener periodically checks up on the progress of his tomatoes, on any given occasion there will be some tomatoes which can be discarded and some which are ripe and ready to eat. These are the easy decisions to make in strategy: you are either going to do them now or you are never going to do them. But there are many tomatoes which are picked and could be eaten but could probably bear further ripening, that is if they were to survive depredations of insects, moles or squirrels. On the other hand, there are some which look less promising and may require an unusual degree of sunshine and water for them to ripen before the end of the season. Hectic gardeners of course are not just making repeated option choices, they are also looking for ways to influence and control the underlying variables to their advantage.

The grid which Luehrman develops is based very much on this approach. It uses two metrics on the one axis, a measure of value cost which is the value of the assets which the strategy is intended to acquire divided by the present value of the cost required to build or buy them. Projects or strategies either have a valued cost metric between 0 and 1 which means it is worth less than the cost of creating it or higher than 1 in which case it is worth more than the present value of what it costs to create. On the other axis the principal metric is volatility. This measures the level of uncertainty or, risk in the future value of the assets to be invested, which in turn is also a function of the length of time as well as the inherent uncertainty.

This grid, in turn, can be divided into six areas. The top left and right of the grid respectively are the easiest to manage because the conclusion here is clearly never to invest or to invest now. Further down on the right hand side, options in region 2 may be exercised now; whilst further down in region 3, projects should probably be implemented later. Moving round the grid clockwise to bottom left are the options which could be implemented later in region 4, and they in turn lead to the options in region 5 which will probably never be implemented because their volatility is too high and their value to cost too low.

As time passes, most options tend to move upwards and to the left. This is because volatility declines as time runs out whilst the present value calculation which makes up the value to cost element, will decrease over time. On the other hand, as Luehrman points out, managers can actively work to push options into more favourable positions, either by reducing volatility or perhaps more easily by increasing the value to cost.

By deploying options theory as the basis for the analysis, Luehrman's grid enables us to think not just of market shares or growth rates but also of the inherent risk and timing of investments.

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ACCOUNTING AND FINANCE

European economic and monetary union (EMU)^{1,2}

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Economic and Monetary Union (EMU), representing the movement towards European economic and monetary union, has the ultimate goal of introducing a single currency called the Euro on 1 January 1999. To this end, European Union (EU) leaders formally approved on Saturday, 2 May 1998, in Brussels, the launch of a single currency on 1 January 1999. The following 11 countries became founding members, creating the world's second largest economy after the United States – Germany, France, Italy, Spain, Portugal, Belgium, Luxembourg, Netherlands, Finland, Austria and Ireland. Of the four remaining EU members, Greece failed to meet the economic conditions for joining and Britain, Sweden and Denmark opted out for the moment.

The euro – a competitor to the dollar?

The creation of a single European currency will be the most important development in the evolution of the international monetary system since the widespread adoption of flexible exchange rates in the early 1970s. A successful Euro will be the first real competitor to the dollar since the dollar surpassed sterling as the world's dominant currency during the inter-war period. It is reckoned that as much as \$1 trillion of international investment may shift from dollars into Euros and a bipolar currency regime dominated by Europe and the United States will emerge, with Japan as a junior partner.

The global economic roles of the European Union and United States are very similar. The EU accounts for about 31 percent of world output and 20 percent of world trade (excluding intra-EU transactions). The United States provides about 27 percent of global production and 18 percent of world trade. The dollar, however, maintains a share of world finance that far exceeds the economic weight of the United States: 40 to 60 percent, depending on the category of transactions and whether intra-EU holdings are excluded (as they will be with the creation of the Euro). This total far exceeds the global role of 10 to 40 percent of the combined European national currencies. The dollar's market share is three to five times that of the Deutschmark, the only individual European currency that is now used globally.

There is little doubt that the Euro will be a dominant player as a world currency. Its potential importance can be assessed with reference to the following five factors, identified by Bergsten:³

1. The size of its underlying economy and global trade.
2. The economy's independence from external constraints.
3. Openness and the avoidance of exchange controls.
4. The breadth, depth and liquidity of its capital markets.
5. The strength and stability of the economy and its external position.

According to Bergsten, in terms of the first of these criteria, the gross domestic product of the European Union was \$8.4 trillion in 1996 compared with \$7.2 trillion for the United States. The European Union also has a modestly larger volume of global trade flows. Excluding intra-EU trade, EU trade (exports plus imports) totalled \$1.9 trillion in 1996. The comparable number for the United States was \$1.7 trillion.

As regards the second criterion, both regions are fairly independent of external constraints and can be expected to manage their policies without being thrown off course by any but the most severe exogenous shocks. In terms of the openness criterion, it is virtually inconceivable that either the EU or US would unilaterally resort to exchange or capital controls. As regards the breadth, depth and liquidity of its capital markets, it is less clear when Europe will reach full parity with the United States. The American market for domestic securities is about twice as large as the combined equivalent European markets. The European financial markets are highly decentralised. There will be no central governmental borrower like the US Treasury to provide a fulcrum for the market. It may take some time to align the relevant standards and practices across the EU. On the other hand, the total value of government bond markets in the EU is 2.1 trillion Ecu, as compared with 1.6 trillion Ecu in the United States. The issuance of international bonds and equities is considerably higher in the current European markets, taken together, than in the United States. Futures trading in German and French government bonds, taken together, exceeded that in US notes and bonds in 1995. Expectations of the launch of EMU have already produced a substantial convergence in the yields of government bonds throughout Europe. There are clear signs of the development of an integrated European capital market for private bonds. So, European parity on this key criterion is likely to occur eventually, though it could take a while to achieve.

The final criterion is the strength and stability of the European economy. There is no obvious risk of hyperinflation or any of the other extreme instabilities that could disqualify the Euro from international status. In addition, America's external economic position may pose doubts about the future stability and value of the dollar. The United States has run current account deficits for the last fifteen years, whereas the EU has a roughly balanced international asset position and has run modest surpluses in its international accounts in recent years. On this important criterion, the EU is superior to the United States.

What will be the likely impact of EMU?

A number of journals have devoted substantial coverage to the impact of the EMU. For example, a recent edition of *Euromoney* devoted a number of articles to the subject in a section entitled 'The onslaught of the mighty Euro'.⁴ The Treasurer, the journal of The Association of Corporate Treasurers, also devoted a section to a number of articles headed 'Spotlight – European Stock Markets', to reflect the fact that over the past two years Europe has experienced massive increases in fundraising coupled with huge growth in investments.⁵

There is little doubt that EMU will have profound financial and political implications because it removes the existence of different currencies, monetary policies, and to some degree, fiscal policies from Europe's financial markets. It effectively brings about a merger of the capital markets of the countries that join the EMU. A key part of the merging capital markets will be achieved via the European Central Bank (ECB) and this, together with the national central banks, will form the European System of Central Banks (ESCB). The ECB will control and oversee a common European monetary policy.

What is not often appreciated is that the Euro is not just another currency that can automatically be supported by organizations that have installed multi-currency capabilities. EMU is a replacement of multiple existing currencies, which do not use the same market conventions such as market holidays, day count basis, coupon frequency and reset dates. The implementation of these changes will require broad revisions to operational procedures, documentation and technology.

EMU implies significant changes for all of banking and commerce:

- National and international payment and settlement systems will require major modifications.

- Cross-border payments will be accepted in Euro only.
- Equities will be priced and settled in Euro only.
- Government debt will be re-denominated over the conversion weekend.
- All static references on deals need to be in Euro.
- Banking institutions will be legally required to make and accept payments in Euros to both consumers and trading partners.
- Goods and services will be priced in Euros.
- Financial contracts will be converted to Euros.
- Some organizations are also seeking to use the transition to Euro accounting as an opportunity to change accounting conventions.
- Financial institutions that are subject to government regulations will be required to report information in Euros (regulatory reporting, client reporting, etc).

What will be the specific impact of EMU?⁶ The Euro should eliminate foreign exchange risk in long-term contracts between entities in EMU countries, and the relative importance of other types of risk will probably increase. Credit risk is likely to become the most important determinant of securities prices, but other factors (eg, liquidity, settlement, legal, and event risks) will also influence pricing. However, one area where EMU will have a significant impact is fund management.

EMU – asset allocation, fund management and equity portfolios

For the fund management world, EMU will involve:⁷

- Asset allocation shifts away from the traditional safety of domestic markets.
- The broadening of capital markets because of increased country access and the resulting marketplace liquidity.
- Changes in the investment process from being country focused to sector focused.
- Increased use of external management, essential in managing more complex less national portfolios, and a greater focus on investment performance.

A very real implication of EMU for the fund manager will be the emphasis upon sector analysis. By all accounts, research undertaken by Goldman Sachs and reported by Lee suggests that many sectors may have more potential from an asset allocation perspective than the traditional reliance upon countries.⁸ An analysis of average bilateral quarterly price correlation with asset classes (highly correlated groups of assets) in Europe revealed that the highest average correlation was Norway with a score of 0.866, followed by seven sector groups with the next highest correlations (scores from 0.744 to 0.636). These sectors were real estate, financial services, autos, aerospace, household durables, precious metals and mining stocks.

Of real importance in the analysis is that sectors showed strong negative correlations with each other, unlike countries. Whereas the relationship between returns from country asset classes (Italy versus Belgium) appeared to be random, some success was achieved in projecting from certain economic assumptions on exchange rates, interest rates and economic growth, the different effect on sectors. For example, in strong economic conditions cyclical sectors, like chemicals, might be expected to outperform others, such as utilities and insurance. This outperformance in terms of returns may have a cost in terms of higher potential risk, which could potentially be assessed by historical statistical analysis. The implication of such sector analysis is that, in principle, the basis for choice can be made between investments in terms of the risk-return relationship across national boundaries.

This all sounds very straightforward and indeed common sense. Some analysts and fund managers already use such considerations in making their investment choices, but it is important to appreciate that

traditionally investment selection criteria have been very nationalistic in approach and parochial in operation. The move to assessing pan European sector portfolios does represent a major change.

Much emphasis is placed within the world of finance in understanding the risk-return relationship. A good deal of financial training is devoted to the underpinnings of modern portfolio theory in the form of the Capital Asset Pricing Model (CAPM), beta analysis, and the like. In a converging Europe and with the turbulence associated with monetary unification, many of the traditional tools of modern portfolio management will feel the strain. The potential for understanding the risk-return relationship by sector analysis may present a real opportunity, but there are some limitations. Such analysis does depend upon being able to assess the economic environment – everything has its cost!

Stock market developments

EMU is likely to accelerate the growth of competition, the consolidation, and the technological innovation that have characterised equity markets in recent years. In the late 1980s, the London Stock Exchange, Europe's largest equity market, stimulated turnover in continental equities by creating a screen-based dealer market for non-UK stocks (SEAQ-1) that was separate from the London dealer market. Since the early 1990s, continental exchanges have recouped a substantial share of trading with new electronic continuous auction markets, particularly CAC in Paris and IBIS in Frankfurt.

In recognition of the implications of EMU, stock exchanges are adopting a number of strategies.⁹ Collaboration between exchanges has been a major development in recent times, culminating in a strategic alliance between the London Stock Exchange and the Deutsche Borse of Frankfurt. The driver has been the need to provide a broader service level by centralising liquidity, harmonising regulation and reducing the heavy fixed-cost investment required to renew technology. This alliance is intended to form the basis of a pan-European stock exchange for Europe's 300 or so major blue chip companies. In keeping with the trend identified earlier, it will allow institutions to invest across Europe by sector rather than by country, via low-cost access and involving a single point of liquidity.

Corporate bond markets

Although EU financial market legislation and the fund-management industry have begun to chip away at regulatory and tax impediments to the development of European corporate debt markets, these markets have remained small until recently. Of the total outstanding volume of debt securities issued by EU private entities (approximately \$4 trillion, or roughly 87 percent of the US corporate debt market), only about 25 percent was issued in international markets. The volume of domestic issues in 1995 was low compared with other developed markets: \$0.1 billion in Germany and \$6.4 billion in France, compared with \$20.7 billion in the United Kingdom, \$77.2 billion in Japan, and \$154.3 billion in the United States. However, the advent of EMU looks likely to accelerate the development of European corporate bond markets, as indicated recently in an article by Glenn Drexhage.¹⁰ By all accounts, deals for Europe's bond market in the first six months of 1998 have taken off and the deals keep coming.

It appears to be the case that oversupply has been an issue in the US, but there is plenty of scope for corporate paper in Europe. This is also taking the form of a certain amount of innovation for Europe in the form of corporate preference share offerings, Euro-convertible bonds, corporate Euro floating-rate notes and zero-coupon bonds in new markets.

Conclusion

The structural changes that will take place in Europe's financial markets as a result of EMU and other developments will have a significant impact on international portfolio adjustments and capital flows. To the extent the Euro is perceived as a stable store of value, it will assume an important role as a reserve currency. Indeed, its role could be greater than the combined roles of the former currencies of EMU

members. This would make the Euro the world's second most important reserve currency, after the US dollar. Whether the Euro will also play a prominent role in international financial transactions and trade invoicing is less certain, but this is clearly possible.

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