Manager Update

September 2004 Issue 30

A quarterly summary of topical management ideas, focusing on four key issues.

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

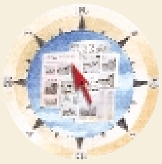
Faculty of Finance and Management

in association with

HENLEY MANAGEMENT COLLEGE

Tel: 020 7920 8486 Fax: 020 7920 8784

ISSN 1467-5765



Manager Update

... is produced in parallel with the Braybrooke Press publication of the same name.

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 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.

Manager Update is compiled and edited by Kevin Money, director of the Centre for Organisational Reputation and Relationships at Henley Management College.

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Cover illustration by Lincoln Seligman (© L Seligman 2004)

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CONTENTS

We would like to congratulate Susan Foreman on her appointment as professor of marketing at Henley Management College. We would also like to congratulate Richard McBain for the recent completion of his doctorate. Their new positions establish them even further as leaders in their field and we are proud to have them as contributors to *Manager Update*.

Behavioural finance

What can economists learn from psychology? Are all investment decisions rational? Certainly not, yet economists have traditionally left the science of human decision making out of their models. **Roger Mills**, professor of accounting and finance at Henley Management College, argues that by applying some simple psychological theories, economists can improve their understanding of investor behaviour and share prices.

Many see finance theory as primarily concerned with market efficiency and predictive models and, relatively devoid of human behaviour. Indeed, since the 1950s, finance theory has focused on market efficiency and neglected almost any potential impact of human behaviour in the investment process.

The efficient market hypothesis (EMH), introduced by Markowitz in 1952 and subsequently named by Eugene Fama in 1970 assumes that financial markets incorporate all public information and asserts that share prices reflect all relevant information. Three forms of market efficiency were originally proposed by Fama[1]:

- *weak-form efficiency* – share prices contain all past information and no investor can earn excess returns by developing trading rules based on historical price or return information;
- *semi-strong-form efficiency* – share prices contain all information in the public domain and no investor can earn excess returns from trading rules based on publicly available information; and
- *strong-form efficiency* – share prices contain all currently available information and no investor can earn excess returns using any information, whether publicly or privately available.

The debate about market efficiency has continued throughout recent decades and has prompted a significant body of research. Results, it seems, have often provided some support for both the weak-form and semi-strong-form of market efficiency. According to William Megginson, "While empirical tests of capital market efficiency do not provide completely unqualified support for the most extreme versions of efficiency, there remains little doubt that modern capital markets are immensely fast, accurate, and impartial processors of information".[2]

Aswath Damodaran, a well renowned authority on valuation issues, provides a useful interpretation on the thorny issue of what is an efficient market. For him, it is: "one in which the market price is an unbiased estimate of the true value of the investment".[3]

For him, three key issues concerning market efficiency are that:

- the market price of a share is not necessarily right at any point in time, only unbiased (randomly higher or lower than the true value);
- deviations from true value are not correlated with any other variable (price earnings ratio, etc); and
- no group of investors can consistently beat the market.

To date, there is no evidence that any individual investor or group can consistently outperform the market and, the generally accepted view seems to have been that there is no evidence that information can be utilised in an economically profitable trading strategy. However, despite the emphasis on the EMH in finance, there seems to be increasing evidence of substantial anomalies in financial markets.

These suggest that the underlying principles of rational behaviour underpinning the EMH may, in fact, be flawed. Some, therefore, have begun to look at other elements present in financial markets, including idiosyncratic human behaviour. Indeed, significant bear market conditions in recent times have supported the shift away from market perfor-

The efficient market hypothesis (EHM) assumes that financial markets incorporate all public information

The underlying principles of rational behaviour underpinning the EHM may, be flawed mance theories based purely on mathematical or logical bases because of their apparent inadequacy in explaining actual outcomes. This has prompted the development of what is now known as behavioural finance.

What is behavioural finance?

Behavioural finance integrates psychology and economics into finance theory

Behavioural finance integrates psychology and economics into finance theory and has its roots in the pioneering work of psychologists Daniel Kahneman and Amos Tversky.[4] James Montier provides a useful review of the background to behavioural finance[5] and draws upon work by Hirschleifer that traces the mistakes humans make in decision-making to four common causes:

- self-deception (limits of learning), characterised by such effects as over-optimism and over confidence;
- heuristic simplification (information processing errors), characterised by such effects as 'loss aversion' where investors treat gains and losses differently, with losses feared disproportionately compared with gains;
- emotion effects, manifested in such effects as investor mood; and
- socially manifested, characterised by imitation and herding.

Support for behavioural finance is increasing and seems to have one clear message, we can all make mistakes when it comes to decisions

These support the case for focusing upon behavioural finance because it is contended that they underpin market inefficiencies, which can be explained with reference to:

- *prospect theory* – which is a mathematically-formulated alternative to expected utility theory and deals with decision-making under uncertainty. It argues that it is changes in wealth rather than absolute levels which are important;
- *loss aversion* – where investors treat gains and losses differently, with losses being feared disproportionately to gains;
- *mental accounting* – whereby individuals tend to compartmentalise their decisions based on superficial attributes. Instead of looking at the broader picture, as would be implied by expected utility theory, they look at individual, smaller, decisions separately;
- *regret* – whereby investors may avoid certain options simply because of regret rather than a rational assessment of the investment. There is a human tendency to feel regret at having made errors: if you wish to avoid regret, it is sometimes necessary to alter your behaviour to select an option that may perhaps be irrational; and
- *overconfidence* – whereby investors are overconfident and overestimate the reliability of their knowledge and their abilities.

Behavioural finance thus challenges the efficient markets perspective and focuses upon how investors interpret and act upon information freely available to them. Support for behavioural finance is increasing and seems to have one clear underlying message, we can all make mistakes when it comes to decisions. The key issue, though, seems to be whether this message represents a major challenge to market efficiency in terms of providing the potential for individuals to exploit benefits.

Facilitating investment decisions

Montier reviews some of the key problems we face as people in making investment decisions.[6] He focuses upon confidence and over optimism, the tendency to deliberately look for information that agrees with you, the problem of judging events by how they appear rather than how likely they are, and human limitations in recalling information.

Montier's explanation of investment behaviour and his identification of what one should be aware of is one thing; using it to facilitate investment decisions quite another. One of the best-known finance gurus, Richard Roll, gives a good illustration of the distinction between understanding behaviour and using the principles of behavioural finance as a tool for prospective decisions:

"Over the past decade, I have attempted to exploit many of the seemingly most prominent 'inefficiencies' by actually trading significant amounts of money according to trading rules suggested by the 'inefficiencies'… Many of these effects are surprisingly strong in the reported empirical work, but I have never yet found one in practice, in the sense that it returned more after cost than a buy-and-hold strategy."[7]

Roll's quote preceded the recent emergence of behavioural finance and is relatively dated, so, one can ask, has the world changed? Garrett has to a certain extent addressed the issue, reviewing two of the issues associated with mood, one of the four categories (emotion effect) attributed to Hirschleifer by Montier. Garrett asks whether seasonally adjusted disorder (SAD) and the weather (sunshine) effects are exploitable in terms of whether the returns to trading strategies on which they are based offer greater returns than a buy-and-hold strategy.[8]

According to the psychology research, mood can determine how individuals evaluate things and interpret information. This means, in a financial context therefore, that mood should influence individuals' assessments of future prospects and their assessment of risk. As Garrett puts it:

"If the decisions of the marginal trader (ie the trader who sets prices) are influenced by mood then it is not unreasonable to suspect that mood will influence stock returns."[9]

Garrett acknowledges that mood affects stock returns, but concludes that there is no evidence of market inefficiency. Whilst the weather and the SAD effects may be apparent in stock returns, for example, they don't seem exploitable. Both influence the attitudes of market-makers towards risk, rather than that of individual investors to trading equities, ie in the case of the weather effect, it is reflected in liquidity as measured by the bid-ask spread, rather than the behaviour of individual investors.

Garrett's review focused on mood, which is just one issue of interest to behavioural finance advocates, and did not, for example, study over-optimism or over-confidence which have both attracted a good deal of research interest. In an empirical study entitled: 'Trading is hazardous to your wealth: the common stock investment performance of individual investors',[10] Brad Barber and Terrance Odean concluded that individual investors who hold common stocks directly pay a tremendous penalty for active trading.

Of almost 70,000 households with accounts at a large discount broker during 1991 to 1996, those that traded most earned an annualised geometric return of 11.4% net, while the market returned 17.9%. According to Barber and Odean, the poor performance is a result of the high level of trading which can be explained by the behavioural bias of over-confidence; individual investors are over-confident and this over-confidence leads to excessive trading.

The study also yielded interesting findings about individuals' investment style. Individual investors can buy stock directly using a broker without taking advice; they can take the advice of a broker to help them in their sales and purchases; or, alternatively, they can invest in mutual funds run either by broking houses or professional fund managers, where they have no influence over the stocks purchased.

Recent research at Henley has focused on whether investors transacting on retail broker advice receive a superior performance to that of the individual investor with no information and, also, whether these investors engage in excessive trading resulting from the recommendations they receive, which affects the overall level of their returns.[11] The research was based on the Barber and Odean (2000) tests, involving an analysis of trading behaviour supplemented with other tests. The design used quantitative methods to build up a picture of the trading behaviour of individual investors and their under- or out-performance relative to specified benchmarks.

Mood can determine how individuals evaluate and interpret information

The major finding of the research was that returns achieved by investors receiving advice were found to be superior to those trading without advice. Those acting without advice were found to trade excessively due to over-confidence, in a similar fashion to the clients in the Barber and Odean study.

Applications of behavioural finance

While the Henley research acknowledged limitations and the need for more work in the area, the results still have serious implications for the investment community. That there may be substantial opportunities for those offering advice using the principles of behavioural finance has, indeed, been recognised. Levy provides a useful review of the work of the behavioural finance investing community in the US.[12] He integrates a review of the history and principles of behavioural finance with an overview of how organisations, like Prudential Investments, make use of it.

Research shows those investors acting without advice were found to trade excessively due to overconfidence

By all accounts, the researchers at Prudential spent several years building a computer programme that downloads 150 different bits of information on 2,000 US and 1,000 international companies every evening. For slower growth companies, those falling at the bottom of the list based on their five-year sales and earnings forecasts, the programme places extra importance on traditional valuations like price earnings (P/E) and price-to-book ratios, not unlike the criteria that a traditional value investor focuses on.

Much focus of organisations like the Prudential is on patterns rather than fundamental analysis

By contrast, for fast growers the programme gives more weight to issues that other investors overlook, discount or ignore: earnings-estimate revisions, stock movements at about the time of earnings announcements, the history of estimate revisions and the differential between estimated and actual earnings. The programme also tracks dividend increases, stock buybacks and insider trading. Within the insider trading category, the programme adjusts for which executive is selling and a chief executive officer or a chief financial officer bailing out is treated as particularly bad news, whereas the purchase by the head of product development is treated as very good news. The programme also accounts for the relative size of stock sale; one million shares could be an entire holding or a fraction of an executive's stake.

What is interesting about the work of organisations like the Prudential is that much of their focus seems to be on patterns rather than fundamental analysis and in very simple terms, their focus is upon signals. Buy signals are represented by:

- improvements in earnings;
- insider buying; and
- repurchases that result in share reductions.

By comparison, sell signals are:

- selling by investors;
- high valuation relative to the industry; and
- insider information is reflected in the stock price.

Behaviour-based analysis has also been gaining momentum in Europe

Behaviour-based analysis has also been gaining momentum in Europe, and Brodie provides a useful illustration of its application in the German stock market.[13] He illustrates how behavioural finance was probably used by his company to implement a successful strategy in the German stock market. In particular, he argues that three principles of behavioural finance are most significant and robust:

- *prospect theory* (reviewed earlier);
- *hyperbolic discounting* – Brodie compares this with the exponential discounting principle of discounted utility theory. He argues that some sort of discounting is essential when evaluating the relative value of two outcomes that are separated by a time difference, such as a reward now and a larger reward later. Whereas the exponential discounting model predicts that the amount of discounting should depend only on the amount of delay that separates the two outcomes and the discount rate is constant, the hyperbolic model predicts that the discount rate itself will decline the further away the reward in the future. Put simply, investors are impatient and the initial delay from now attracts the greatest discounting. Furthermore, when two rewards are compared from a distance with a small nearer gain and a large more distant gain, a relative evaluation may favour the larger reward. However, as the nearer reward comes closer to the present time, its discounted value rises hyperbolically, while the still distant reward continues to incur a heavy discount. In such cases, the investor's preference might suddenly reverse to favour the smaller gain, such that despite a well conceived rational plan, investors may take profits early; and
- *cognitive dissonance* – this theory, drawn from psychology proposes that human beings employ a self-defence mechanism when faced with information that conflicts with their beliefs, in order to shield them from the simple fact of being wrong. This mechanism involves systematically avoiding information that contradicts our beliefs dissonant information. When this is not possible, human beings will try to downplay the importance of this news or try to discredit the source. At the same time, they will actively seek a source of information that is in harmony with their own convictions and only once information is in line with beliefs in the form of consonant information will the need to seek information diminish.

Conclusions

So what conclusions can we draw from the above review? Clearly, behavioural finance provides a useful explanation of investment behaviour and the key issues to be aware of, but its merits in facilitating investment decisions remain unclear.

There is, for example, a significant divide within the financial community about the relative merits of using behavioural finance as a proactive investment-making tool. Perhaps the most appropriate concluding note is to highlight Montier's[14] advice on avoiding some of the most perilous errors connected with investment decisions:

- you know less than you think you do;
- be less certain in your views, aim for timid forecasts and bold choices;
- don't get hung up on one technique, tool, approach or view – flexibility and pragmatism are the order of the day;
- listen to those who don't agree with you;
- you didn't know it all along, you just think you did;
- forget relative valuation, forget market price, work out what the stock is worth (use reverse DCFs);
- don't take information at face value, think carefully about how it was presented to you;
- don't confuse good firms with good investments, or good earnings growth with good returns;
- vivid, easy-to-recall events are less likely than you think they are; subtle causes are underestimated; and
- sell your losers and ride your winners. **MU**

Behavioural finance povides a useful explanation of investment behaviour... but its merits in facilitating investment decisions remain unclear

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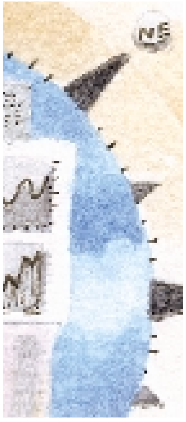

Retaining, maintaining and regaining customers

Relationship marketing is now an established approach aimed at enhancing the value of customers to an organisation over their lifetime. But, how can managers improve their relationship market strategies to enhance their value? **Susan Foreman**, professor of marketing at Henley Management College, argues that providing different offerings at different stages in a relationship life-cycle, as well as a focus on both defensive and customer acquisition strategies, are key. An area often neglected is regaining lost customers. Important do's and don'ts in this process are highlighted here.

In 1992, Frederick Webster[1] wrote that "New organisational forms, including strategic partnerships and networks are replacing simple market-based transactions and traditional bureaucratic hierarchical organisations". His article argued for a new conceptualisation, to ensure marketing remains relevant and continues to deliver superior value to customers. His paper placed relationships at the centre, and they, of course, remain a key management issue today. This article will focus on relationship management, the value of relationships, collaboration and the need for a co-ordinated approach to managing 'portfolios' of customers.

A 'new dominant logic' in marketing may be evolving

However, before looking at current research, it is important to note that Stephen Vargo and Robert Lusch have recently published what many see as a seminal article on the state of marketing theory today. Their work, which goes beyond Webster, claims that a 'new dominant logic' in marketing, which has significant implications for marketing theory researchers and marketing managers, is evolving. Some have even suggested that this article provides a new foundation for marketing theory.

The fundamentals of marketing

Like Webster before them, Vargo and Lusch[2] chart the development of marketing from the turn of the last century to the present. They show that marketing has evolved from a rational economic view of exchange with a product focus to accommodate the exchanges in the business-to-business environment in the service and voluntary sectors. For them, marketing theory has changed from a focus on classical and neo-classical economic theory to an institutional economics approach: whereas the focus was on marketing management and the marketing mix, more recently it has been on social and economic marketing that is more customer-based and relational.

After this brief contextual history, they argue that the product-based marketing mix approach was appropriate in the last century, and that the balance of power has now changed from the producer to the consumer. Therefore, organisations need to re-orient their operations and adopt a service-oriented perspective. This is fundamental to modern day economic exchanges with customers.

They define services broadly as, 'the application of specialised competences (knowledge and skills) through deeds, processes and performances, for the benefit of another entity or the entity itself.' Here, processes and relationships are essential for all organisations. The service-oriented perspective they recommend for all organisations is based on:

- involving the customer as a 'co-producer' to help the organisation customise its offerings. In fact, they say, customer involvement must be maximised;
- identifying core competences, or what they call 'operant resources', so that they are shaped and co-ordinated to meet customer requirements. Indeed, they say, marketing should be a core competence rather than simply a function or department. They state that, "If firms focus on their core competences, they must establish resource networks... This means that they must

learn to be simultaneously competitive and collaborative."; and

- the notion that the successful organisations of the future will have marketing as a core competence. Products become 'appliances' in the delivery of the service. Manufacturing will therefore change and organisations will not make or sell but will be providers of a customised service. In this approach, "interactivity, connectivity and ongoing relationships" are crucial to the organisation.

Customer relationship portfolios

Relationship management is, clearly, an important part of everyday business life. Some organisations are engaged in simple exchanges or transactions where the 'market' is used to regulate and manage the transfer of goods. Others, though, are managing a number of closer relationships that might be at different stages of development and which can be a mix of immature and new relationships and more established partners. Some organisations are involved in complex networks of intermediaries, suppliers, customers and customers' customers; all directly or indirectly involved in exchanges, interactions and relationships of some form.

Michael Johnson and Fred Selnes[3] draw on work in transaction cost economics to show where the value lies in differing relationships. For example, we often assume longer-term relationships are more valuable, but we should also know what value young, developing relationships bring to the organisation.

When organisations co-operate and share information, resources and processes, they can create value though integrating elements of production, consumption and support services. In this mêlée, relationship managers must keep their customers' needs at the forefront, understanding that needs change over time and that creating value for customers requires investment, so that services or products can evolve and change as the customers change.

Many in the business-to-business sector are experienced in managing networks, yet many struggle with the efficient management of profitable relationships. Johnson and Selnes emphasise the need to think of customer relationships as a portfolio, rather than merely individual relationships. Their work focuses on the economic worth of relationships (rather than the behavioural aspects) and the need to understand the value of the portfolio of relationships held in the organisations.

Nevertheless, the portfolio remains a combination of separate relationships and, before the value of the portfolio can be determined, it is necessary to understand the nature, role and value of individual relationships. They do this by using the following classification:

1. *strangers to acquaintances* – *s*trangers are either 'new' to the market or currently working with competitors. When contact develops, mutual value (when compared with the competition) can be created. Johnson and Selnes say this is when parity value is developed. By repeating transactions there are a number of advantages for the customer: the perceived risk is lower and they trust that the product will be satisfactory. For the supplier, the repeat business will bring 'repetition effects' in production efficiencies, cost benefits and economies of scale;
2. *acquaintances to friends* – as customers become 'friends' they value a modified approach, more adaptations and, indeed, some customisation. Suppliers can distinguish themselves from the competition by meeting these needs, as they are providing a product that has superior value for the customer. Here, the supplier has moved beyond providing parity with competitors to providing differential value to customers in a trusting relationship. It is important to share, communicate and focus on mutual needs to create this value; and
3. *friends to partners* – trust is established when the supplier and the customers become friends; commitment and co-operation come to the forefront when the two become 'partners.' Ultimately, suppliers must have the ability and competences to deliver not just customised but also personalised service and manage customer knowledge to meet their commitments. For the customer, the benefits are customised value and tailor-made solutions. Naturally, though, they must be prepared to pay for the premium service they trust the suppliers to provide.

Relationship management is, clearly, an important part of everyday business life

Many in the business-to-business sector are expeienced in managing networks, yet many struggle with the efficient management of profitable relationships

Customer portfolio lifetime value

Yet, two key questions emerge from such theories. First, how do we calculate the value of these relationships and, second, how do we calculate the value of portfolios?

The existing work on the lifetime value of relationships emphasises the positive impact on revenue of customer retention and the use of 'defensive' marketing strategies to maintain the relationship. Johnson and Selnes' work, though, doesn't just compare the values of new and existing customers. Instead, they have developed a more holistic approach, which calculates the value of all relationships at their different stages. They examine, therefore, the value of acquaintances, friends and partners, and the costs involved in developing these relationships over time as relationships move between the stages.

How do we calculate the value of these relationships and of the portfolios

Ultimately, the value of the portfolio is a combination of parity value provided by the acquaintances, the differential value provided by friends of the organisations, and customised value created by partners. Customer portfolio management is seen as problematic because, as Hunt states, "there is significant ambiguity surrounding portfolio decisions". Johnson and Selnes' work tries to explain some of the complexity in portfolios.

For example, they emphasise the interest in acquaintances, which may appear at first glance to be of lower value. In fact, due to 'repetition' effects, they are a good source of economies of scale and while they may be less profitable their role is important, the authors say. The benefits of scale economies are often discounted in relationship management strategies. Friends are also important as they provide a balance of 'risk and return trade-offs', whereas the partners provide the structural benefits that include profitability.

Friends are important as they provide a balance of 'risk and return trade-offs'

Ultimately, Johnson and Selnes advocate a blend of defensive and offensive marketing. This ensures that relationship managers work with friends and partners, who often form a profitable part of the portfolio, whilst developing new partnerships with acquaintances that may be less profitable but provide other benefits to the portfolio. Thus, they say, even though it is difficult to plan a portfolio with precision, it is possible to manage the evolution profitably.

Co-operating with the competition

While partnering with customers is a long-established and desirable strategy for many organisations, traditional management theory (and practice) suggests co-operation between competitors has undesirable effects for customers. In fact, there are two perspectives: the first says collaboration is harmful to customers when competitors act opportunistically with their own interests in mind, a view which is at the heart of US anti-trust laws, for example.

Alternatively, supporters of competitive alliances suggest these can lead to benefits like cost reductions or reduced risk and uncertainty.

Aric Rindfleisch and Christine Moorman[4] have adopted a customer-oriented, rather than a traditional legal or economic approach, to investigating competitor alliances. They found that the nature of the competitor alliances did have an impact on the relationship with customers. Where closeness and trust were not apparent between the collaborators, when they held similar knowledge and where collusion could be identified, customer focus was difficult to maintain. Here, organisations spent more time watching each other than the customer!

The authors also found that in competitive alliances, customer orientation tended to be highest where the alliance partners invested in the relationship and had developed close relationships with each other. The alliance partners were then able to focus on understanding the needs of the customers, to create customer value and mutual benefits. Trust, it seems, is key, and organisations able to devote resources to relationship-building activities, sharing information and encouraging co-operation within the collaborative alliance were more likely to be able to build customer orientation.

However, Rindfleisch and Moorman found that firms involved in competitive alliances tended to be less customer-focused if they did not have a mediator to intervene to manage conflict or to mitigate collusion. More importantly, the customer orientation diminished over time if the alliance partners failed to create the appropriate relational bonds to support their customer-facing activities.

Recapturing customers

Business relationships have varying life spans; some end after long and fruitful partnerships and others after a shorter period of successful or unsuccessful exchanges. A lot of attention is devoted to managing these relationships, and in calculating the lifetime value of customers, developing retention strategies and in assessing customer defections. Very little though, it seems, is devoted to what Jacquelyn Thomas, Robert Blattberg and Edward Fox[5] call 'customer winback'. As the name suggests, these are the strategies intended to re-ignite or restart fading customer relationships. Furthermore, where these strategies do exist, they tend to focus on simple discount pricing strategies.

The telecommunications sector in the US and the UK, where customer 'churn' is a concern, provide good examples of such strategies. Price reduction and discounts seem a first resort, a simple strategy intended to attract customers who have either defected or simply lapsed. Thomas, Blattberg and Fox warn, though, that this approach may not be sufficient. Pricing strategies, they say, should certainly be coupled with other relational strategies.

They suggest that there are two key issues to consider. The first is to be selective and only target profitable customers who have lapsed. Second, managers need to understand what to 'offer' before pricing decisions are made. It is necessary to consider how 'restart' customers will respond to prices in the short and the long term and what the impact on the length of the relationship may be. Indeed, they state "the firm may not want to price so as to reacquire all lapsed customers and instead may want to focus on customers with attractive profiles".

Too many approaches, the authors say, have been indiscriminate in their targeting, while the marketing strategies employed have lacked sophistication. Thus, it is important when targeting the profitable groups of lapsed customers to re-calculate a new lifetime value by looking at the pricing strategy at the start of their first relationship with the company, the restart pricing levels and, then, the potential lifetime value of the relationship second time around. The authors' research in the service sector found that customers who had defected and then restarted tended to have shorter relationships the second time.

Thomas, Blattberg and Fox have conducted a number of second lifetime value calculations (SLVC). These looked at many factors, including reacquisition prices, last prices in prior relationship, lapse duration, and probability of reacquisition, costs and margins. On the retention side, they examined the average retention price, retention costs, margins and value. They found that in the attractive target group lowering prices did enable organisations to reacquire customers but, to maximise profits, firms needed to increase prices once the relationship had been developed.

Business relationships have varying life spans

They noted, intuitively, that 'new' relationships needed to be treated carefully, as customers responded differently to prices at different times. For example, at the 'restart' of their relationship, customers often compare prices at the time of their first relationship with the company. Once the relationship has developed, though, they "respond in a way which reinforces their decision to re-enter the relationship". It therefore seems that it is possible to increase prices above the acquisition prices without an impact on the longevity of the relationship.

However, it is worth noting that if the overall price in the second relationship is lower than the one in the first relationship this tends to lead to longer relationships second time around!

In practice, relationship marketing and management tasks should not stop with customer defections and should always consider the potential of a win back strategy. It is a strategy worth pursuing when the possibility of closing a sale on a new customer has a 5% to 20% chance of success and the possibility of repeat selling to a lapsed customer is 20% to 40%. For a customer in a current relationship, unsurprisingly, there is a 60% to 70% chance of closing the sale. **MU**

Relationship marketing and management tasks should always consider the potential of a win back strategy

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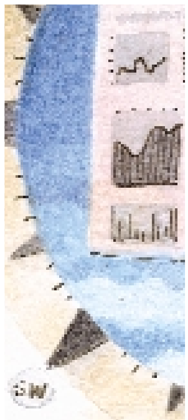
Emotional intelligence – an emerging construct



Emotional intelligence (EI) is now a widely accepted concept, yet many questions still remain contested. How can it best be conceptualised? Can it predict leadership capability and performance? Can it be developed and can it be measured? **Richard McBain**, director of distance learning programmes at Henley Management College, answers these questions and argues that different definitions of EI may provide answers to different management questions. Despite these difficulties, there is growing evidence of the link between EI and leadership, and EI and performance. There is consensus, however, that EI should be measured by more than self-report and needs to take account of the views of colleagues.

There has long been interest in other intelligences than the 'traditional' IQ, but the term 'emotional intelligence' (EI), first coined by Peter Salovey and John Mayer[1] and subsequently popularised by Daniel Goleman,[2] has particularly captured the imagination of many researchers and practitioners. This probably reflects increased interest in the role of emotions within organisations, and the widespread view that personality and IQ alone are not sufficient to explain variations in employees' performance.

Yet, simultaneously, the construct of EI also generates an equal measure of disdain from some researchers. This article will consider recent research into the emerging construct of EI and will address key issues including whether there is a need for the construct, whether it can be measured adequately, whether it is useful for understanding or predicting performance and leadership effectiveness and, finally, can it be developed?

What is EI?

Emotions enable individuals to respond to changes in themselves, their relationships and in their environments. While there is broad agreement that the domain of EI is the perception, integration, understanding and utilisation of emotions by individuals, a number of different models lie beneath this consensus. Three models may be identified.

1. The ability model

This approach is exemplified by Mayer and Salovey[3] for whom EI enables an individual to "perceive emotions, to access and generate emotions so as to assist thought, to understand emotions and emotional knowledge, and to regulate emotions reflectively so as to promote emotional and intellectual growth." It is a type of intelligence, like IQ, that is concerned with problem-solving, with information derived from across the emotional and cognitive (or thinking) domains. As such, EI should be assessed by tests of performance, for which there are right and wrong answers, and measures of EI should correlate more highly with other measures of intelligence than with personality measures.

EI enables an individual to "... regulate emotions reflectively so as to promote emotional and intellectual growth."

2. The personal factors model

The personal factor model has a different challenge, that of distinguishing between EI and personality, since the factors are a combination of dispositional and learned traits. In this sense EI isn't really an 'intelligence'. For Victor Dulewicz and Malcolm Higgs,[4] EI relates to those factors that underpin emotionally and socially competent behaviour in the world of work. They identify seven factors or elements of EI: self-awareness, emotional resilience, motivation, inter-personal sensitivity, influence, intuitiveness and conscientiousness. Another example of this approach, although not confined to the work context, is Dr Reuven Bar-On's[5] model of emotional and social intelligence.

There are three models of EI – the 'ability', 'personal factors' and 'emotional competency' models

3. The emotional competency model

This model focuses upon emotional competence, or the translation of underpinning abilities into on-the-job capabilities. The term

Research found that levels of EI predicted levels of morale and stress

competence is a broad one and may refer to traits, abilities or, indeed, any underlying characteristic of a person that relates to performance. The dominant model of this type, and one that has been very influential among practitioners, is that developed by Daniel Goleman and colleagues[6] which identifies 20 specific competences in four clusters:

- *self-awareness cluster* – emotional self-awareness, accurate self-assessment, self-confidence;
- *self-management cluster* – self-control, trustworthiness, conscientiousness, adaptability, achievement orientation, initiative;
- *social awareness cluster* – empathy, organisational awareness, service orientation; and
- *social skills* – leadership, communication, influence, change catalyst, conflict management, building bonds, teamwork and collaboration, developing others.

Can EI be measured?

The three models of EI will require different types of measurement approaches. An ability model uses a performance test, while the most common approach used by both personal factor and competency approaches is that of self-report tests. The measurement of EI has generated much debate, focusing on questions of reliability and validity. A measure that is reliable has internal consistency between its components and consistency over time. A measure is valid when it measures what it is intended to measure. Content and construct validity refer to whether the test items and the test itself capture what they are designed to measure.

The elements of EI most related to performance are self-awareness, emotional resilience and motivation

Convergent and divergent validity is also required: the former involves producing similar results to other measures to which it is conceptually related, and the latter requires that it produces results that are not correlated with measures from which it is not conceptually related. Finally, predictive or criterion-related validity identifies whether the measure predicts the outcomes it is supposed to predict. Two, recent articles address the reliability and validity of measures of EI.

Dulewicz, Higgs and Mark Slaski[7] make the case for the reliability and validity of their EIQ-M measure of EI, based upon a personal factors model. Their study of 59 middle managers in a large retail organisation examined the relationship between EI, stress, well-being and performance. They found that levels of EI predicted levels of morale and stress. Furthermore, the elements of interpersonal sensitivity, influence and conscientiousness are significantly related to morale, while self-awareness, emotional resilience and motivation were significantly correlated with perceived levels of stress, distress and morale.

Levels of overall EI accounted for 30% of the variance in management performance, as measured by line managers' appraisal against the organisation's competency framework. Once again, the key elements of EI that were most significantly related to performance were self-awareness, emotional resilience and motivation. Results from the EIQ-M were compared with the results of other measures used to assess the constructs in the study, such as stress. In broad terms, the results from this study provide support for the content, construct and criterion-related validity of one measure of EI.

However, Carolyn MacCann et al[8] offer a different approach and conclusions based upon a review of published studies employing several different measures of EI. These include Mayer, Salovey and David Caruso's[9] MSCEIT (a performance-based ability measure), Bar-On's EQ-I[10] (a self-report personal factor measure) and the ECI (360-degree self/other report competency-based measure) based upon Boyatzis, Goleman and Rhee's[11] emotional competence framework. Their main conclusions are that:

- self-report tests appear to measure personality traits rather than abilities and, while they may have some predictive validity, much of the variance in these scales may be explained by established personality constructs, such as extraversion and emotional stability/neuroticism. Accordingly, they argue that further work is required to identify emotional dispositions that go beyond existing personality models and thereby show incremental validity;
- while ability scales appear more promising, difficult issues remain. One, key concern is the provision of an accurate scoring system. It is also not clear what ability scales actually measure: a basic aptitude, acquired skills or conformity to cultural norms? Furthermore, evidence for the criterion validity of ability scales is not yet compelling; and
- further research is required before tests of EI are suitable for making real-life decisions about individuals in organisational settings.

EI and performance?

Alongside the development of instruments to measure EI has been the exploration of the relationship between EI and performance. Given the relatively brief existence of the construct, researchers have sought to examine the relationship between EI and established constructs, such as those of self-efficacy, personality and culture. There is, though, a high level of assertion and model-building which will hopefully be followed up by testing with increasingly reliable measures.

Gundlach et al,[12] provide an example of model-building relating to the link between EI and self-efficacy, which refers to a person's cognitive beliefs in their capabilities to organise and execute the courses of action required to produce specific outcomes (Bandura 1997). The relationship between self-efficacy and individual and organisational performance is well attested, and an individual's emotional states are a potential source of self-efficacy beliefs. The authors make a cogent argument that EI, involving awareness and control of emotions, may have an impact upon self-efficacy.

The process by which this occurs involves judgements (attributions) regarding the cause of an event as being either internal or external to the individual and either controllable or uncontrollable. These attributions can lead to differing emotions, which may be negative in the case of anger and frustration, or positive in terms of motivation, and in turn these may influence self-efficacy judgements. The model suggests that the higher the level of an individual's EI, the more s/he will be able to understand how their attributions have influenced their emotional responses and control the impact on their self-efficacy beliefs. The model, as yet, remains untested.

The link between EI and personality is a key issue and research has identified five main dimensions of personality: conscientiousness, agreeableness, extraversion, openness to experiences and emotional stability. Of these, conscientiousness, which is demonstrated by individuals who are dependable, disciplined, attentive to detail and driven to complete a task, has been shown to be the most important predictor of job performance. It is, therefore, interesting to consider the relationship between EI and conscientiousness. Douglas, Frink and Ferris,[13] for example, examined whether the relationship between conscientiousness and performance is stronger for individuals who are high on EI. Two hundred and five students took part in the study and their performance was measured in terms of exam performance and peer ratings for contribution.

EI was measured using a shorter version of the EQ-i questionnaire. Both conscientiousness and EI were highly significant predictors of performance in themselves. However, levels of conscientiousness and EI interacted, so that conscientiousness predicted increased performance for individuals scoring high on EI, but predicted lower performance for those with low EQ-i scores. These results suggest that social skills are required for personality to realise its potential and that "conscientiousness, without the more proximal EI savvy and skill needed to bring it to life, and regulate and channel it in appropriate ways in order to realise its potential, is not sufficient for a high level of performance" (p10). EI may, indeed, add something over and above a consideration of personality dispositions.

Alongside the development of instruments to measure EI has been the exploration of the link between EI and performance

Another approach to the role of EI and performance, and one which incorporates considerations of culture as well as effectiveness, is provided by Frank Shipper et al[14] in a study of 3,785 managers in a multinational firm based primarily in the US but also in the UK and Malaysia. The measurement of EI here was different to other studies considered so far and involved a measure of self/other agreement in relation to data gathered in a 360-degree assessment of managerial skills. In all three cultures there was a positive relationship between the level of self/other agreement and perceived managerial effectiveness.

However, in low power distance cultures, characterised by a lower acceptance of inequalities of power such as in the US and UK, self-awareness of interactive skills seems crucial to effectiveness, whereas in high power distance cultures self-awareness of controlling skills may be more important.

The link between EI and personality is a key issue

EI and leadership

Perhaps the main area for consideration and debate regarding the value of EI is that of leadership, and interest in the construct has coincided with the development of transactional-transformational models of leadership. While transactional leadership involves the exchange of contingent reward for performance between leader and follower, transformational leadership is based on deeply-held personal value systems which tap into emotional domains.

EI plays a critical role in both leadership and the promotion of effective team productivity

L Melita Prati et al[15] provide an example of hypothesis development in this area and argue that EI plays a critical role in both leadership and the promotion of effective team interaction and productivity. Propositions are derived from the literature regarding the positive impact of the emotionally intelligent leader on team motivation, on the use of charismatic and transformational influence, and awareness of the leadership role. In addition, the level of EI within the team is likely to impact upon levels of trust, collaboration, cohesion, creativity and decision-making, and reduce social loafing, all of which may improve team performance. These are significant claims worthy of further testing, but they are not without challenge.

A response by John Antonakis[16] to their article indicates that debate on the value of the EI construct is very much alive: "Evidence that EI is a viable construct independent of IQ or personality factors is sparse, and various measures of EI suffer from low reliability and validity… These problems would imply that speculating about the practical utility of the EI construct might be premature. Despite such warnings, EI is being viewed as a panacea for many organisational malaises with recent suggestions that EI is essential for leadership effectiveness…" Only further empirical research will provide evidence that EI provides a unique contribution to leadership effectiveness.

One EI claim is that the higher one advances the more important EI becomes

In this context, research by John Humphreys et al[17] is noteworthy. They examine the relationship between leader behaviour, follower commitment and the EI of each. Commitment, which concerns the strength of identification with an organisation, has been shown to be important for organisational effectiveness, and transformational leadership has been associated with organisational commitment.

The study involved 23 department heads and 190 of their direct reports in a regional medical centre. Surprisingly, the researchers found no relationship between leadership behaviour or leader EI, and the levels of follower commitment. Nor was there any evidence for a positive relationship between EI and transformational leadership behaviour. The small number of leaders should be borne in mind.

However, an individual follower's emotional and practical intelligence was found to be positively correlated with levels of organisational commitment. In other words, individuals with higher levels of EI and also with higher levels of commitment rated their leaders as more transformational. This research suggests that a follower's perspective should be included in studies that examine the leader/follower relationship, and that the relationship between leader attributes and follower outcomes may not be uni-directional. Individual dispositions may have an impact on the appraisal of managerial effectiveness, a consideration that needs to be borne in mind in assessing the conclusions of 360-degree appraisals.

A claim from the EI literature has been that the higher one advances in an organisation the more important EI becomes. A recent contribution from Dulewicz and Higgs[18] considers this question and they report the results of three separate studies of board level leadership:

- the first study of 339 board members suggests that 9 of the 10 board level competencies linked to the elements of EI were considered vital or highly relevant to either chairman or chief executive officer (CEO) leadership positions, and less important for executive or non-executive director roles;
- in the second study, data on 40 personal competencies for 90 company directors was collected by a self-assessment questionnaire. The competencies of the 24 CEOs and chairmen were compared with those of the 66 other directors (executive and non-executive). Significant differences were found in the competences considered to reflect emotional (EQ) and intellectual intelligence (IQ), but not those relating to managerial competencies (MQ); and
- in the third study, data from an earlier study that collected competence data from 100 managers and directors concerning 40 job competencies found that company directors were found to have higher overall EQ, sensitivity and emotional resilience competencies than managers, but no difference was found between the two groups in terms of IQ or MQ competencies.

Possible explanations for the differences between CEOs and chairman and the other directors could include the different audiences and responsibilities between the different roles. These studies suggest that the assessment of leadership competence and leadership selection should consider elements of EI.

Can EI be developed?

The last issue considered in this review is to what extent EI may be developed. Both the ability and personal factor models may suggest somewhat limited possibilities for development given the heritability of abilities and dispositional traits.

A competency view may, on the face of it, allow for a greater level of development, given its focus on the application of EI. Another recent study by Dulewicz and Higgs[19] considers the possibility of developing EI from a personal factor perspective and they report the results of three separate studies:

- 59 middle managers in a retail company participated in a four-day EI training programme and EI was tested (using the EIQ-M) prior to training and six months afterwards. Overall EI improved, as had all elements of EI, except for intuitiveness and conscientiousness;
- an experimental group of 14 team leaders in a pharmaceutical company took part in continuous improvement development, not specifically designed to increase EI, and their performance was compared to 13 team leaders in a control group. All participants re-took the EIQ-M 12 months after the initial assessment and no differences were found either in overall EI or any of its elements; and
- research into 12 boat crews that took part in the BT Global Challenge (2000) found that the levels of intuitiveness of boat skippers increased, as did levels of intuitiveness for the top four boat crews. Conversely, levels of sensitivity, intuitiveness and influence decreased for the bottom four boats.

Dulewicz and Higgs argue that there is evidence that some elements of EI may be developed. In particular, they argue that the elements of EI may be classified as follows:

- *drivers* (energisers) – motivation;
- *constrainers* (controls) – conscientiousness; and
- *enablers* (facilitate performance)
  - intra-personal enablers – self-awareness, emotional resilience, intuitiveness;
  - inter-personal enablers (especially important for working with, and achieving results through, others) – inter-personal sensitivity, influence.

It would seem, on the basis of this research, albeit using relatively small samples, that the enabling elements, and particularly those of self-awareness, interpersonal sensitivity and influence, may be capable of some development.

Conclusion

The construct of EI is one that despite its promise, particularly for HR practitioners and managers, remains in the relatively early stages of development and testing. Many issues need to be explored further before the construct may take its place alongside others that have contributed to the understanding and prediction of performance in organisations. However, the gradually accumulating evidence suggests that, in time, this may be achieved, but the level of credibility for measures of EI remains a particularly critical, ongoing issue. **MU**

The level of credibility for measures of EI remains a particularly critical, ongoing issue

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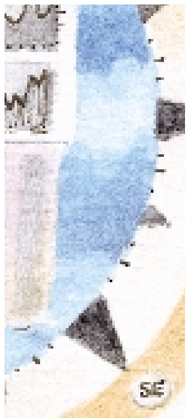
Outsourcing, offshoring and the internet



Offshore outsourcing of services and manufacturing and the use of the internet in business are now common practice. But what is their real impact on how managers should develop strategies? **Ian Turner**, professor of management studies and director of graduate business studies at Henley Management College, argues that managers will have to become more aware of the networks that they operate in, and the value of relationships. Networks may no longer be geographically based, but dependent on technological and knowledge standards. It is these standards that will be more and more critical to the development of strategy.

This article will explore recent writings on strategies for networks and communities. In recent years, we have seen the disaggregation of the value creating process in many industries. Many companies, under pressure to compete and survive in increasingly contested markets, have focused on core business operations and outsourced other activities. The application of digital technology and the globalisation of markets has accelerated this process, and many companies now routinely offshore manufacturing and service activities which are linked seamlessly through to satisfy end-consumer needs, wherever they may be.

Strategy in this networked environment is, clearly, likely to be more complex. It requires a deeper understanding of how markets and communities evolve and what the roles and interests of the respective players in each industry are. Implementing strategies which create incentives for partner organisations to collaborate and comply is, therefore, a key task.

Strategy as ecology

Marco Yan Siantsi and Roy Levien use a biology analogy to help explain this phenomenon. They see complex industries as 'business eco-systems'.[1] For example, a prominent company like Microsoft manages an extensive network of relationships with thousands of different independent organisations: the authors identify, for example, over 30 categories of partners with whom Microsoft operates, including software developers, retailers, internet service providers (ISPs) and hardware firms. Clearly, the success of such companies depends heavily on the health of their network partners.

Many companies, under pressure to compete, have focused on core business operations

Yan Siantsi and Levien say three critical measures can help assess the health of the eco-system. They term the first 'productivity', or the ability of the network to produce products and services that are either novel, innovative and/or associated with lower delivery costs. This can typically be measured through gauging the return on investment in each sector. The second is 'robustness', the ability of the network to respond to shocks and adapt to change, and can partly be measured by the survival rate of members of the network. The third measure is the system's ability to sustain viable niches and promote variety. This ability to create and embrace new niches also implies acceptance that some niches may not last forever.

Different organisations play very different roles in a business eco-system. Companies like Microsoft and eBay, for example, play central roles, having what the authors describe as the 'keystone' advantage by providing a common platform for the other members of the community. Such 'keystone' players may not necessarily be dominant in absolute size, but they will play a key role in providing the stability and consistency around which other players can build and develop their offerings.

Application of digital technology and globalisation of markets has accelerated outsourcing

While these companies can, of course, create enormous value, the key insight is that this value is only sustainable in the long term if the keystone players are prepared to share some of the value created. The keystone player's long-term health depends on that of the other members of the eco-system, who must be capable of generating value to survive as well.

eBay provides an excellent example. The company provides the platform for its on-line auctions and is constantly looking for new ways to improve the system and increase the confidence of users to allow them to transact more efficiently. Clearly, given its dominance of the sector, eBay could extract more value for itself by, for example, increasing commission charges. So why doesn't it? Probably because it wishes to continue to develop and expand its own eco-system, encouraging more and more buyers and sellers to use the system.

eBay provides an example

Interestingly, the success of eBay's strategy is not necessarily based upon a correct assessment of which markets or products are likely to be in demand. For example, the success of eBay's on-line car auctions, a significant part of the overall business, surprised the company. It seems in this case that the innovations introduced by eBay have enabled buyers and sellers to develop reputations for honesty and straight talking and build trust in a market where traditionally there wasn't much.

Niche companies are critically dependent on their ability to differentiate and innovate

Obviously, not everyone can have a keystone position in the eco-system. Most players will occupy niches and, as we saw earlier, it is an indication of the health of the overall system that such niches exist and can sustain different companies. Niche companies are critically dependent upon their ability to differentiate and innovate to be able to survive and grow. Eco-systems are not always benign for niche players as keystone holders can seek to absorb, exploit or terminate relations with niche players to manoeuvre themselves into attractive niches.

Niche players, though, are not helpless. One defence against such behaviour, for example, is for niche players to innovate continually. Furthermore, as the authors point out, niche players too are increasingly mobile. Innovations in the IT industry, like XML for instance, now make it possible for niche software developers to join other business eco-systems if they perceive that the keystone player is trying to extract too much value from their efforts.

Innovation in networked markets

In the modern world products are rarely stand-alone, since their true value lies in their compatibility with other products or services. Thus, for example, the value of a piece of software increases if it is compatible with other software products, and hardware increasingly needs to be integrated with other devices for its benefit to be maximised. However, Bhaskar Chakravorti points out an important and paradoxical consequence of networked markets: because so many different factors are brought together to deliver a product or service, once the market has converged upon a particular solution and has achieved equilibrium, then it is very difficult for the system to switch to new products or solutions:

"Network markets allow for rapid diffusion of news, ideas and, in theory, innovations. But they also erect formidable barriers to the adoption of innovations, primarily because of the inter-dependencies between the players".[2] So, if a market is in equilibrium and consumers and producers believe that the offering is 'best choice' then it is unlikely that there will be a radical change unless a new player can upset the existing status quo and gain consensus on the adoption of a new 'best choice'.

This sounds like a formidable task. As Chakravorti points out, it requires careful planning and forethought to think through what the desirable end-state is from the innovator's point of view, to find out the best way to get there and to anticipate what the actions and reactions of the various players are likely to be.

Critical to the process is enlisting the help of what they call the 'power players', which seems to be close to Yan Siantsi and Levien's concept of keystone players. Since these power players are in an advantageous position to be able to influence the behaviour of other network actors, it is important for innovators to enlist their support.

This is most likely to occur if the innovations are complementary to the power players' existing products and services rather than competing directly with them. However, to be successful, the momentum for change must not stop there because the innovator needs to persuade not only the major players, like the network hubs/keystone players, but also the players that act as channels and the end users themselves.

Adobe is a good example of how a relatively small company can innovate in such an environment. It has developed the portable document format software (PDF) that has now become a worldwide standard for the creation and reading of documents on different systems. Adobe's product offering, it seems, appears to challenge the position of Microsoft, but to achieve its adoption as the industry standard the company made two critical choices. The first was to make it virtually impossible for readers to alter documents published in PDF format; reassuring content creators that in the process of exchanging and publishing in PDF format the original documents would be kept intact.

This also differentiated Acrobat significantly from the standard authoring packages which Microsoft was offering, making the product complementary rather than a competitor. Second, the company offered end users free use of the Adobe Acrobat reader in downloadable form. This, and subsequent agreements to include the software in the Microsoft operating system and as part of the AOL service, established a huge user-base and gave Adobe network externalities and first-mover advantages. Other players in the network rapidly converged upon Adobe Acrobat as the standard product because they knew that so many consumers had it on their machines. This then created a self-sustaining virtuous circle and, by making its software code available to third parties, Adobe encouraged other companies to develop new attractive features which, in turn, attracted more content creators and end-users to adopt the standard.

Knowledge clusters and competitive advantage

Economists and geographers have long wondered why firms in the same industry are often located close to one another. In retail, where intuitively one might expect firms to seek out locations which are not already well served by competitors, shirt makers, book sellers or jewellers for example, often congregate in a particular district or street. The reasoning here is that such concentration stimulates consumer demand since customers find it convenient to shop in one location and assume that the presence of so many competitors will mean they get the best possible deal. Firms, too, find it useful to be located close to rivals, since it allows them to respond quickly to competition.

Such clustering goes beyond the retail sector. The City of London in banking, Silicon Valley in information technology and Northern Italy for industries as diverse as sports cars and spectacle frames are all obvious other examples. Industries cluster in particular regions for any one of a number of reasons. The clusters may be based on geographical and natural features, eg, water or coal, which attracted companies there in the first place; there may be historical reasons, such as patterns of government regulation or taxation, which encouraged companies to migrate from one location to another; and, there may be trade and craft skills built up over centuries which lend themselves readily to a particular industry.

Industries cluster in regions for a number of reasons

Michael Porter, amongst others, has pointed to the presence of economic clusters as being a powerful source of national competitive advantage.[3] Now Tallman et al have given us an interpretation of this phenomenon based on knowledge transfer.[4]

The strategy literature on clusters claims that competitive advantage can reside both at the level of the firm and at the level of the cluster of firms. Tallman et al point out, however, that even within the same regional cluster there may be significant differences in firm performance. One explanation, they say, may be the difference in the way that knowledge is held and disseminated throughout the cluster.

These authors accept that there may be good economic explanations for the success of regional clusters to do with, for example, the availability of skilled labour and flexibility of sub-contracting. However, they focus on interdependencies between companies in a cluster, based on shared knowledge which is not traded in any formal sense but nevertheless disseminated through social networks. This knowledge transfer, they believe, lies at the heart of a cluster's competitive advantage.

Their explanation for the success of regional clusters depends on a distinction which they draw between 'component' and 'architectural' knowledge. Component knowledge is usually specific to an industry, technological in nature and can usually be codified and transferred. Such knowledge is only likely to provide temporary competitive advantage and, in an economic cluster, component knowledge will flow relatively easily from one company to another.

Knowledge disseminated through social networks may help regional clusters

Architectural knowledge, however, is more complex as it relates to the organisation as a whole and issues of structure, co-ordination and management. This knowledge is often intangible and tacit, difficult to explain and reproduce and usually a legacy of past decisions in companies (path dependency). Differences in architectural knowledge between companies probably account for variations in the way businesses disseminate and absorb component knowledge within the cluster. Beyond that there is also a cluster level of architectural knowledge which is specific to firms located in a particular area – which include reciprocal understandings, reputation, exchange of employees, social and family connections. This facilitates the transfer of knowledge within the cluster and makes it difficult for such knowledge to flow across cluster boundaries.

Companies competing in industries with regional clusters should join the cluster

What, then, are the implications? According to Tallman et al, companies that are competing in industries which are characterised by such regional clusters should seek entry to the cluster at almost any cost, as non membership will put them at a structural disadvantage. Companies within the clusters aspiring to above-average performance must not rely on private component knowledge as this will leak out to other members of the cluster very rapidly. Instead, they must develop distinctive, firm-level architectural sources of advantage, usually involving the assembly of different types of component level advantage to generate superior performance.

Clusters and the internet

Tallman et al speculate that the internet and the digital age may pose a challenge to the concept of regional clusters. The internet, famously, was supposed to spell the 'death of distance', and, in the future, 'closeness' may be less a function of geographic proximity than of some kind of shared identity. The success of on-line communities such as that spawned by e-Bay would suggest this is plausible.

Teck-Yong Eng has investigated the implications of the internet for clusters of high tech companies.[5] The impact of open systems via the internet has clearly facilitated the links between companies on a global basis. Indeed, there is evidence that high tech companies being part of a global network of partners, as described earlier in this article, is likely to be a key success factor in their growth. The paradox, though, is that regional clustering can improve these global network connections, since the concentration of many important economic actors in a single geographical area provides the economies of scale necessary for investment in advanced IT infrastructure.

Paradoxically, it is the same IT infrastructure which reinforces the strength of the cluster, since it makes communication and dissemination of knowledge between actors in the cluster that much easier. Eng is not arguing that the internet is a substitute for personal relationships, indeed he maintains that interpersonal contact in companies is more likely to be effective in developing trust, an essential ingredient for collaboration. The internet, though, is a complementary way of maintaining routine contact.

The digital economy also offers opportunities for economic actors to collaborate in the delivery of on-line services in a flexible and responsive way. Here again, the impact of new technology may reinforce the value of the local cluster since geographical proximity and interpersonal relationships are likely to be critical to companies responding in a rapid and effective manner. **MU**

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