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Manager Update

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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.

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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.

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Stock returns and the cost of equity

The continuing turbulence in equity markets questions the assumption that shares provide better long-term returns than bonds. Many pension funds and insurance companies in the last decade or two have clearly relied on this assumption, and may be now proved wrong. Recent research suggests that the equity risk premium is much lower than was previously thought. The implications may affect investment decisions in companies, depending on the appraisal method used. Here, **Roger Mills** suggests that greater care is now necessary in the choice of method and assumptions about the cost of capital, the relevant discount rate and the 'beta' – the relationship between the return that investors expect from a particular company and the return they expect from the market as a whole.

It is commonly believed that, in the long term, equities perform better than bonds. Indeed, according to analysts, an investment in shares just before the stock market crashes of 1929 or 1973 would have brought far higher returns than a safe bond portfolio.

Shares are commonly thought to out-perform bonds

This very fact, moreover, formed the core of a best-selling 1994 book by Jeremy Siegel of Wharton Business School[1]. Thus, by the end of the 20th century, every dip in share prices has often been presented as simply a good opportunity to buy. Others, such as James Glassman and Kevin Hassett[2], have demonstrated an even greater enthusiasm for the growth potential of shares, predicting in 1999 that the Dow Jones industrial average would nearly quadruple in three or four years time (in fact, it is now around the same place it was then). Yet, whilst these authors have obviously been forced to revise the target date, their core thesis has not changed shares, they argue, whether they are cheap or dear at current prices, are the safest way to guarantee long-term wealth.

Every dip in share prices has been seen as a good opportunity to buy

Of course, such optimism might look odd following the recent precipitous falls in equity markets and the apparently bleak future prospects. And, whilst the current low levels in the equity markets may indeed represent a good investment opportunity, the recent run of corporate scandals and concerns over the integrity of published profits for even the most well-known companies (see *Manager Update*, Issue 22) inevitably cast a pall over such assumptions. However, as the next section will argue, the concern over published profits is not the only explanation for current equity market behaviour.

Triumph of the optimists

Much of the recent enthusiasm for investing in equities has been driven by the recent bull market in the US. This, however, raises two obvious questions. First, what is the longer-term evidence of equity performance and, second, what is the situation outside the US? As reported in an earlier *Manager Update*, Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School have studied the performance of UK equities back to the early 1900s[3] in 'A Century of Investment Returns'.

In addition, they have undertaken a further study, sponsored by Dutch bank ABN Amro[4], that reviews the indices of total returns for 16 countries, using newly gathered data that also goes back to 1900 a full quarter-century earlier than most other studies. They conclude that, overall, shares do in fact beat bonds and that, moreover, in every country in their study real (that is, inflation-adjusted) returns from equities are also better than those from bonds. How, though, do they measure this? The relative performance of equities compared to bonds lies in the equity premium (also known as the equity-risk premium, a subject covered in a previous *Manager Update*), which is a measure of the average annual return over and above riskless debt, such as government bonds, that shareholders expect to receive as compensation for holding risky shares. And this risk is real shareholders are always the last to be paid, after all other creditors, when a company enters bankruptcy proceedings.

There have been long periods where shares have performed worse than bonds

A key issue to emerge from the Dimson et al research is the trend in the equity premium over time. Whereas overall equities beat bonds, the study found that this did not necessarily occur over long periods of, say, 20 years. Indeed, in the 75 years since 1926, it seems possible to measure only three distinct 20-year periods where this trend was found to hold.

And, earlier, there were also periods when shares lost out to bonds. In addition, this 20-year rule was also not applicable to other countries. Dimson et al found four other stock markets – the Netherlands, Germany, Sweden and Switzerland – where, at times, 40 years of market exposure were needed to ensure that shares outperformed bonds.

Overall, the conclusion by Dimson et al should give shareholders confidence in the long-term performance of shares over bonds. More worryingly, perhaps, is that we may currently be in one of those periods where it will take a long time for the better performance of equity to happen.

Why the change in views about the size of the equity risk premium?

As indicated in an earlier *Manager Update*, previous studies may have overestimated absolute equity returns, partly because they may have relied upon inadequate or incomplete data. During the First World War, for example, a period for which data is hard to find returns were generally lower. Earlier studies have also concentrated on the historical share-price performance of quoted companies today, rather than examining the performance of shares that are no longer traded but which would have formed part of a past investors portfolio.

If the equity premium is wrongly calculated, managers may be misjudging investments

Dimson et al, however, corrected for these factors, as well as giving a more comprehensive view of equity-risk premiums through the use of a full century's worth of data. Their approach places Denmark at the bottom of the equity market league and Germany at the top. The authors also provide a global historical average equity premium, over bonds, of 4.6 percentage points.

Interestingly, this is nearly half the widely received forward-looking estimate of 8.8 percentage points from Ibbotson Associates, a consulting firm, and the 8.5 percentage points frequently taught on business school finance courses. The authors, furthermore, believe this estimate may be too generous. Some stock markets, such as those of China, Russia and Poland, are not included in the study, since they were closed down under communist rule. If these markets were taken into account, the authors say, the historical equity premium would be even lower.

The true level of the equity premium, however, is not just a question of fanciful academic debate it has very real consequences for many individuals' everyday lives and for business decisions. Pension funds, for example, must take the issue very seriously. At present, many of their fixed liabilities in the form of the money owed to pensioners are held in the form of shares, which means being over-optimistic about expected equity returns could have painful financial consequences.

Participants in pension schemes with defined contributions, rather than defined benefits, would face substantial difficulties if lower returns than expected left them with a deficit at retirement. In addition, having a good understanding of the equity risk premium will soon be even greater as the number of retired people surges in the developed world.

The implications of the equity risk premium to business decisions are also clear. Considerable damage could result if returns from equities are incorrectly estimated, simply because investment, and hence growth, in the world economy may be misallocated. At business schools, course participants are taught to appraise a new project by comparing its expected returns to expected stock market returns. If the equity premium is incorrectly estimated, managers may be misjudging investments according to sound economic investment criteria.

A new technique for estimating the cost of equity capital

Thus, there are significant differences of opinion over the equity risk premium, one of the key parts of the cost of equity capital. The use of a better method for calculating the cost of equity capital could put capital project appraisal and, therefore, valuation decisions, on more solid ground. Charles Lee et al argue that many common methods for calculating the cost of equity, including the venerable capital-asset-pricing model (CAPM), all share a major flaw[5] – they focus on expected returns that may well be imprecise. CAPM is often quoted because it predicts the cost of equity as a function of 'beta' – the relationship between the return that investors expect from a particular company, and the return they expect from the market as a whole.

To gauge expected returns, companies typically rely on historical or realised returns as captured by the equity risk premium. In principle, this approach should not matter because if markets are efficient, realised returns over a sufficiently long period should approximate expected returns. However, as indicated in the last section, realised returns may, of course, be a very poor indicator of future performance. Consequently, Lee et al suggest that managers should look to the future, not the past, for guidance by using the implied cost of equity to make investment decisions.

The implied cost of equity is the internal rate of return that sets a company's market capitalisation equal to the present value of all future cash flows to common shareholders. In other words, it is the discount rate that investors are implicitly using to value the business and it is, by no means, a new concept.

Lee et al calculated the implied cost of equity for more than 1,000 companies between 1979 and 1995. Their analysis reveals that average discount rates vary significantly by industry a pattern, they argue, which is obscured by studies that use realised returns. The authors also argue that the industry sector within which a company operates also plays an important part in predicting its implied cost of equity. This, along with three other variables a company's book-to-market ratio, its long-term growth expectations and the amount of dispersion in analysts forecasts of future earnings accounted, say the researchers, for 60% of the variation in implied-risk premiums among businesses.

Interestingly, however, the authors caution against attaching too much importance to the precise magnitudes the paper reports for each of the effects. Better, they say, for financial managers to use the results heuristically, starting with the average excess return that investors expect in an industry. The authors, furthermore, recommend capping that figure so as to be no higher than plus 3% or lower than minus 3%, adding it to the market-risk premium, and adjusting it up or down, depending on how a company compares with its industry peers. A high book-to-market ratio, for example, might add as much as 1.5% to a company's implied cost of equity, whereas below-average growth expectations and dispersion in forecasts could lower it by up to 0.5%.

Companies' historic returns may not be a guide to future performance

Clearly, and in common with any valuation method, the procedure developed by Lee et al has potential weaknesses. The initial estimates of the implied cost of equity, for instance, leave room for error. While the authors themselves acknowledge the limitations of their work they also argue that traditional CAPM-based methods have failed to develop reliable cost-of-capital estimates. Managers will make better decisions, they say, if they learn to estimate the cost of capital without relying on current market prices or realised returns.

What is in a beta?

As noted above, the validity of betas has been questioned. However, calculated beta values are widely available to investors in printed publications and on internet web sites. While the discussion of the many controversies surrounding betas is beyond the scope of this section, there is a review of an article by Reinhold Lamb and Katheryn Northington[6] that offers a guide to the methods of beta calculation used in these popular web sites and investor resources. Knowing how beta is calculated, the authors argue, can help investors better understand the variations.

Knowing how beta is calculated can help investors understand the variations

Lamb and Northington illustrate the root of reported betas with reference to 22 values obtained from different sources for GE on 20 June 2000. They identify seven different sources for calculating US beta values and trace the respective calculation methods. They illustrate that the variation in the GE beta value, ranging from 1.13 to 1.25, can be explained in terms of four key inputs that impact on the value of the beta calculation. These four key inputs are:

1) the market indicator used to regress the stock price against;
2) the data to be regressed;
3) the time horizon; and
4) selected time interval.

On the first of these, most providers used the S&P 500, although others also used the NYSE Composite Index. The impact of selecting one index rather than another should, however, be minimal. In the context of the second input, there were differences according to whether the stock price was regressed with or without an adjustment for dividends.

Market volatility undermines the value of beta analysis

The time horizon, however, has a greater impact on beta values. A survey by Lamb and Northington indicates most market information providers, including Value Line, Media General, Market Guide, Standard & Poors and Argus, offer betas with five years of data. Whilst the traditional approach involves using five years of monthly data on returns to measure the firms exposure, Robert Davies et al[7] found that small deviations in the approach to estimating the beta cause wide and inexplicable fluctuations in the result. In fact, about eight years of monthly data were required for a respectable degree of stability in beta estimates, and the authors thus advocate this time period, rather than the standard five-year span, for more reliable beta estimates.

The fourth factor, the selected interval, is also significant. Lamb and Northington illustrate that the seven beta sources differ over the time interval used. Thus, Media General, Market Guide, and Standard & Poors select monthly intervals, Value Line and Bloomberg use weekly data, while Bridge and Argus provide betas that use daily data. Some researchers have suggested that for securities whose true beta is greater than 1.0 (like many current technology stocks), longer return intervals provide betas that are biased upwards, while for defensive stocks the opposite is true.

In global markets, the importance of industry sector is growing

There is also an interval issue brought about by non-synchronous trading, or stocks not trading at consistent intervals. As beta calculations require market closing prices, a stock trading less frequently may show a closing price that reflects market information published several days prior to the resulting trading activity. Equities trading more frequently may absorb market news within the trading day, and thus produce a closing price more accurately reflecting market conditions.

The use of betas is, then, a controversial issue. Some believe that past actions are not a strong enough indicator of future market activity to warrant the heavy use of beta. Current information flows, for example, make today's market significantly more volatile than that of five years ago. In addition, market data for five years past may also offer little insight into the movements of securities today. However, those who do find beta useful need to be aware of the differences in the inputs and the resulting impact on its value.

Global equities – do countries still matter?

Country risk is a key issue in estimating the cost of equity to apply in a cross-border valuation. Various methods have been developed for estimating country risk, but has, for example, the introduction of a single currency in Europe eliminated this risk? This issue is significant, because in the absence of country risk, the influence of national effects upon a company cease to be important.

Mark Barnes et al[8] have studied this issue, conducting a study with a data set covering the period March 1992 until March 2000. It consisted of 3,709 securities, covering 23 developed countries and 10 industry sectors, as classified by MSCI/S&P global industry classification. The authors found that:

- while the importance of the industry sectors is growing, country specific effects remain significant in both euro zone and non-euro zone regions;
- technology/telecommunications stocks had, however, a significant impact on the results of the study. If removed, the influence of the industry sectors would, in fact, be far less;
- the relative contribution of countries and sectors varied according to company size. While the industry sector seemed to matter far more in the case of large companies, country-specific factors had a greater influence on small companies; and
- the opportunity to add value within countries and sectors has increased since the middle of 1998. The chance to generate excess returns is similar for selecting both countries and sectors, while in the non-euro zone focusing upon good country selection is likely to be most profitable.

Barnes et al provide a number of logical arguments to support focusing upon both industry sector and country. Industry sectors are, they argue, likely to gain in importance because:

- cross-border mergers and acquisitions will continue to diminish corporate identification within a single country;
- within the euro zone, European Monetary Union should eliminate significant national differences;
- the removal of legal institutional restrictions and the proliferation of pan-European and euro-zone benchmarks have prompted European investors to purchase international equities; and
- the consolidation of stock exchanges will further diminish the impediments of global investing and harmonise sector performance across markets.

Why, though, do Barnes et al consider that countries will also remain important in determining stock returns? Structural reasons such as language, cultural and political differences will, they think, continue to have an impact on individual security returns. Furthermore, the authors identify several obstacles that will make full economic convergence very difficult, such as high unemployment in many countries caused by rigid labour markets and low labour mobility.

These findings confirm the observations and practices of many equity analysts who, within the euro zone, have become far more sector conscious. Those concerned with assessing stocks further afield, however, continue to pay considerable attention to the variables of the country in question, unless they are dealing with very large companies. **MU**

Outside the euro zone, country factors are also important to analysts

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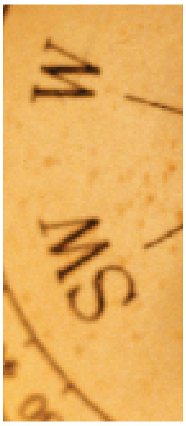

Corporate identity, theatre and pricing

Can a single business have several different identities? Apparently so: but what if they conflict with each other? Should they be aligned or is it better to fuse them into one identity? Reinforcing the brand can support such efforts, and, in retailing, the use of 'flagship' stores has emerged to achieve this. Traditional retail environments are being transformed into 'theatre, drama and enjoyment' based on a variety of themes, which take experiential marketing into new dimensions. **Susan Foreman** argues that a dose of reality does not come amiss, however, and a reconsideration of pricing should help focus the mind. Unfortunately, it seems to be one of the most misunderstood and mismanaged elements in marketing.

Marketing spans the strategic and the tactical

A successful marketing strategy must, of course, bring together many different elements if it is to ensure mutually beneficial and satisfying transactions and relationships for both the organisation and the customer. The scope of marketing spans the strategic and reaches down to the tactical level. This Update, therefore, will begin with a look at the big picture. How is an organisation seen in the market place? What identity is being projected and how is this perceived?

Naturally, some aspects of an organisation's identity can be controlled while others cannot. Two researchers, John Balmer and Stephen Greysner[1], have highlighted the different aspects of corporate identity and provide a framework that managers can use to analyse and assess their identities and, if necessary, effect change.

Yet others, such as Robert Kozinets et al[2], lead us into the developing world of new retail experiences, where the traditional retail environment is being transformed into theatre, drama and enjoyment. Here, brands are presented as the main attraction in an environment that is carefully stage-managed by manufacturers. A dose of reality is, however, added to this theme by Pradeep Chintagunta[3] who examines pricing approaches for brands and looks at category management in grocery chains.

One test looks at an organisation's many identities

Finally, we once again return to the big picture and explore the strategic nature of pricing decisions, examining the work of Shantanu Dutta et al[4], who show the importance of pricing strategically. These authors emphasise the links between marketing, human resources and information systems as a part of marketing that not only brings in revenue but also has an impact on the way an organisation is viewed in the marketplace.

Corporate identity

According to Balmer and Greysner, the proliferation of corporate mergers, acquisitions and alliances, the rise and equally spectacular fall of the dotcom companies, and a recent surge in corporate re-branding activities all point to the growing importance of managing corporate identity. The authors claim, however, that a multidisciplinary approach to support organisations is lacking, and their AC2ID Test, which looks at an organisation's multiple identities, can help fill this gap for both academics and managers.

The AC2ID Test examines identity from a number of perspectives, considering, for example, both the internal and external points of view. The authors highlight five forms of identity which, they say, interact to make up an organisation's corporate identity:

- *actual identity* – this encompasses the nature of the organisation, the values that are embodied in the style of management, the behaviour of employees, the organisational structure, the quality of the products it sells and the markets it serves, etc;
- *communicated identity* – this is derived from the messages designed and communicated by the company through, for example, media advertising, public relations, sponsorship, etc;

- *conceived identity* – how the company is perceived by targeted groups ie the corporate image, reputation and branding of the organisation;
- *ideal identity* – a rational view which, according to Balmer and Greysner, is the optimum position for the organisation; and
- *desired identity* – this aspect of identity is related to the vision of the future rather than a statement of the current position, and is thus more an aspiration than a reality.

Balmer and Greysner's aim is to understand these different identities and to help managers ensure that they are compatible with each other. Building a corporate identity is, of course, partly a deliberate and conscious effort like, for example, through media advertising or corporate sponsorship. Yet, corporate identity can also develop at a more unconscious level, through both the company's external and internal behaviour and actions. In fact, the authors argue, identity can be as much the product of history as it is of current actions.

The main task therefore, say Balmer and Greysner, is to balance the different aspects of identity. If different identities conflict with each other there can be confusion in the marketplace among customers and other stakeholders.

While aligning these different parts of identity is often clearly a difficult task, the framework adopted by the authors could assist managerial decision-making. For example, it may help managers gain a true picture of the company's current identity and manage change effectively in times of transition, such as mergers, alliances, acquisitions or divestment.

Themed flagship brand stores

Whilst managing identity concentrates mostly on the impressions made at the corporate level, there are also parallels with those organisation's that are developing themed flagship stores in which to sell their branded products.

According to Kozinets et al, consumers go to themed flagship brand stores not only to purchase the products; they also go to experience the brand, company and the products in an environment controlled by the manufacturer.

The authors then identify three types of stores to which brands are central. First, flagship brand stores are generally owned by the manufacturer and used to sell a single brand or product (though non-exclusive stores do exist). Obvious examples of this type include the Nike-Town stores, the Lego Imagination Centre, or the Sony Gallery in the US. In each case, the emphasis is not merely on clearing the products from the shelves but, also, on showcasing the brand and developing the corporate image of the company.

Secondly, themed entertainment brand stores such as Planet Hollywood or Hardrock Cafe are service-based stores that are often looking to develop further the merchandising side of their business. The third category themed flagship brand stores combine elements of both the preceding categories and are designed to promote the brand and provide entertainment. The ESPN Zone in Chicago, for example, aims to combine retail, sports, branding and entertainment that are all based on an intangible a cable TV network service.

This branding phenomenon appeals to both retailers and manufacturers, particularly within the US with its strong entertainment culture. Many of the companies using these marketing methods, proponents say, are thus now adding a theatrical, entertaining, interactive and memorable element to the retail experience. Indeed, in many ways companies seem to be using the retail experience as an integral part of the whole communications strategy. By combining retailing with sponsorship, advertising, merchandising and publicity companies hope to increase sales and generate revenue through the brand and entertainment.

Everybody recognises, of course, that brands are an influential element of consumer culture. Indeed, Kozinets and his colleagues recognise the anthropologists views that acknowledge the iconic value of brands and their importance as symbols to large groups in society. They also note, moreover, that the vocabulary of brands pervades our language and that they have become part of the fabric of our everyday lives. The retail experiences highlighted above obviously aim to add yet more vitality to brands. Manufacturers are adopting an approach which they perceive reflects the cultural traits of a society seemingly highly interested in entertainment, fantasy and escapism.

If different identities conflict, the market may be confused

Building themed flagship stores can add vitality to retail brands

Where the brand value is low, the themed approach may not be appropriate

With this development of themed entertainment brand stores, retail spaces have been created that are entirely devoted to the promotion of specific brands. No other products or brands can distract attention away from the main focus. This devotion of exclusive space, Kozinets and his colleagues believe, is an important retail phenomenon.

This themed approach, however, is not appropriate for all brands or organisations. Kozinets proposes a model in the shape of a pyramid to help managers make a solid assessment of whether this approach is, in fact, actually right for their business. The model brings together the retail orientation (contrasting the purchase of either experiences or goods), the brand orientation (contrasting the personalities of brands, ie whether they are multi-dimensional or uni-dimensional brands), and cultural orientations (contrasting the spectacular and the ordinary). Within this framework they identify four opportunities for themed flagship stores (*see below*).

The authors' work is important not simply for the understanding it gives of trends in the world of retail. It also gives clear implications of just how far brand managers may need to go to develop relationships with their customers. Inevitably, retail themes are appropriate to situations where customers have spare time, are perhaps keen to learn and develop themselves, or are merely seeking entertainment. For some brands, where, for example, the brand value is low, the themed approach may simply not be appropriate. Here, selection time and convenience are often more important to the customer than expensive retail developments.

Retail pricing

Whether themed or not, the importance of pricing decisions in retail outlets should not be underestimated. Indeed, a great deal of research has been undertaken in this area. Much of the work concentrates on the impact of the manufacturers decisions and the impact of the wholesale price, the use of promotional discounts, etc. It has also focused on the impact of competition in a particular marketplace and the impact of the amount of store-traffic in a particular store.

Many pricing studies, though, have treated each of these particular aspects of pricing in isolation. Chintagunta, however, has integrated both factors into her research of two grocery chains that dominate their marketplace. Interestingly, she also considers including in her study promotional side-payments funds made available by manufacturers to retailers to support their promotional efforts and the impact on retailers' pricing decisions.

Opportunities for themed flagship stores

- *Landscape* – Kozinets and his colleagues compare the landscape themed approach which sits at the bottom of the pyramid with going back to nature. This approach emphasises the origins and development of the brands. These are already quite commonplace and include, for example, a large number of factory outlets that seek to combine the authentic factory experience with shopping and entertainment.

- *Marketscape* – marketscape themed flagships, at a more conventional level, emphasise the importance of location and customisation to local needs, and value a sense of community. Themed flagship experiences could be used for estate agents, books, music and sports brands.

- *Cyberscape* – Kozinets and his colleagues highlight cyberscape themed flagships as closer to the top of the pyramid. These could be developed to simulate a conventional shopping experience. This might be, for example, through the use of technological innovation to develop all the sights, sounds, activities and sense of community but in a virtual retail setting. They state that 'it is themed flagship stores that will develop the most successful experiments in blending virtual and real worlds'. Here, an engagement of all the senses is combined with fantasy and entertainment. Cyberscape experiences could be applied to technological, telecommunications, health, travel and car brands.

- *Mindscape* – at the top of the pyramid where the spectacular cultural elements meet the purchase of experiences and brands with multidimensional personalities are the mindscape flagships. These are difficult to manage, being spiritual or developmental in nature. These places are all encompassing where consumers feel that they lose their sense of time. Themed flagship experiences here could be applied to travel, cultural, educational developmental or even religious brands.

These practices, particularly in the US, have been criticised for favouring the larger retailer at the expense of the smaller shops. Indeed, Chintagunta highlights the fact that other researchers like, for example, John Hauser, Duncan Simester and Birger Wernerfelt[5], refer to this practice in even stronger terms, equating it with gain sharing or bribery.

This research, which concentrates on brands in the analgesics category obtained from data provided by a large chain of stores in the US, shows some understanding of the factors that influence the pricing decisions of retailers. There are, for example, implications for the promotional strategies developed by manufacturers. Chintagunta discovered that side-payments do, in fact, influence the retail price for leading or well-known brands, but that it is difficult for manufacturers to ascertain precisely how much of the side-payments have been passed on and, thus, influenced the retail price.

From the analysis it is clear that one of the well-known brands (X) was more vulnerable than the nearest three competitors and had less clout or influence than the brands in its category. In fact, it was also considerably more vulnerable, and less influential, than the stores own label brand. However, when Chintagunta analysed the potential for side-payments it seems that whilst all four brands mentioned were making side-payments, the payments were largest for brand X.

Furthermore, when considering the issue of power between the retailer and the manufacturers, it is interesting to note that the smallest side-payment was seemingly made to the brand with the most influence!

In addition to the consideration of promotion and side-payments, this work shows the impact of the competition between the manufacturers and the retailers and, thus, between branded products and the own-label brands sold by retailers. In this research, it is clear that to gain market share for their own own-label brands the retailers price tends to be set at a lower level than other products and brands in the category. Thus, the retailers are pursuing a dual strategy of trying to maximise the value of the category as a whole, and their own brand within it.

Strategic pricing decisions

Whilst pricing decisions in the retail sector are often carefully considered and keenly researched, they are often neglected at the strategic level in many organisations. According to Dutta et al, these pricing decisions have frequently been regarded as tactical ones. This is, perhaps, because they are difficult to grasp at a conceptual level yet are seen to be relatively easy to manipulate and implement at a practical level. However, whilst the actions may be readily implemented the repercussions can be long lasting and broad in scope.

Pricing decisions may be neglected at the strategic level

Indeed, unplanned and sporadic pricing changes can lead to lost revenue, dissatisfied customers and open a niche in the market for competitors to exploit. Even when given the consideration they deserve, pricing decisions are often complex and heavily mathematical and so, unsurprisingly, frightening to some managers. Thus, Dutta et al suggest organisations must lay good pricing foundations. The starting point, they argue, is strategic direction. Next, it is necessary to invest in the human, systems and social capital of the organisation that should lead to the implementation of sound pricing decisions.
They suggest three key levels of investment.

1. *Human capital* – this could be developed in several ways, like, for example, through the recruitment of specialists and the professional development of existing employees. At management level this may mean high-level training and development in the technical nuances of pricing. Further down the organisation, it may also mean training or software support, so that those on the shop floor can assess the implications of decisions they are making. This support could come from foundations or academies inside the company, or external programmes from, for example, universities and business schools.

Investment in human, systems and social capital is important

2. *Systems* – the pricing experts and specialists require, of course, systems to support their work. These enable short-term actions to be taken in a structured manner when, for example, reacting to competitive moves. Furthermore, appropriate software and hardware are needed to collect, analyse and test pricing sensitivities in the marketplace, and also to conduct the sophisticated analysis

needed to perform the category management decisions mentioned earlier.

3 *Social capital* – This, say Dutta et al, is the glue that holds the people involved in making the pricing decisions together, and facilitates the acceptance of pricing decisions in the organisation. Whilst the previous two elements can be bought into the company from outside, this element, they believe, has to be built and nurtured. In many ways, they say, it is worth sacrificing a little technical expertise for people who can work internally with colleagues and externally with customers to get decisions implemented and accepted.

Marketing managers need to consider customers, brands and resources when pricing

The example used by the authors to show the management of these three elements of capital is that of Roche, the pharmaceutical company. Its growth through acquisitions has led to a random collection of pricing strategies, policies and structures.

The management, after examining this problem, established the Roche Marketing Academy in an attempt to build a coherent and controlled marketing and pricing structure. They installed software systems to manage and control their prices and recruited pricing specialists in an attempt to ensure the company's progress. This example clearly shows pricing is a challenging and important area. It is an area that, like others, requires managerial and financial commitment; simply ignoring it, as Dutta et al argue, can make pricing a strategic liability.

Pricing is one of the more sophisticated and developed aspects of marketing and, of course, economics. It is also one of the most misunderstood and mismanaged elements in marketing. Whilst some managers have met the challenge in, for example, the retail sector, others have opted for a tactical rather than a strategic approach.

Certainly, marketing managers in this area need to look beyond the simple revenue-generating role of pricing and consider the customer perceptions of value, the link with brand building, the wider impact on corporate image and the resources needed in the organisation to support its development into a source of strategic advantage. **MU**

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Changing business cultures

Despite much attention, many organisations are still poor at managing change. What else can be done? Do 'strong' corporate cultures help? Only in stable business environments, it would appear. When the environment is turbulent, strong cultures can inhibit necessary change. In any case, 'emotion management' can be important, both for low levels of staff and for their supervisors, the latter often feeling particularly vulnerable. Changing corporate culture is often seen as the key to the strategic transformation of an organisation, but if the industry culture is stronger than the firm's culture, it simply may not be possible. **Richard McBain** explains recent thinking.

This Update focuses on elements of the change management process. First, it examines the impact of an organisation's culture, particularly those firms with a strong corporate culture, on the ability to adapt to volatile operating environments.

This theme is further developed through a review of research that has studied the role of emotion management in organisational change. One source article, for example, considers how poor emotion management actually prevents and hinders change that is required in an organisation. Another considers how the effective management of emotions can help balance the competing, but nonetheless necessary, requirements of transformation and continuity during periods of radical change. The issues of whether, in fact, the management of culture is indeed possible, and to what extent culture may be considered a potential source of competitive advantage, are also addressed.

A further theme is how best employees can be positively engaged in the change process, and how an organisation can prevent, or reduce, perceptions that an employees psychological contract has been violated during periods of change?

Finally, we examine the role of managers in the change process. One of the source articles reviewed considers the apparently neglected role of the middle manager, whilst the final paper considers the impact of top managers, and their personality preferences, on creating an environment that is conducive to change.

Strong corporate cultures – benefits and limitations

It is well known that firms with strong cultures ie beliefs and values that are widely shared and intensively held throughout the organisation often outperform those with weak cultures. In general, this type of firm generates greater average levels of return on investment, net income growth, and growth in share price. These benefits, it is argued, are derived from three principal factors:

- consistent behaviour and better co-ordination and control within the organisation;
- improved goal alignment between the firm and its members; and
- increased employee motivation and effort.

Firms with strong corporate cultures often have better results

Jesper Sorensen[1], for example, has also found that organisations with a strong culture generally have a less variable performance than others in their industry. However, he also found that the level of volatility in the industry was a significant factor: while firms with a strong corporate culture generally had a superior and more reliable performance in a stable operating environment, this decreased with greater industry volatility. The key issue, says the author, is that a firms corporate culture affects the balance between exploration and exploitation.

A critical factor in the reliability of organisational performance is organisational learning – how firms learn from their own experiences and respond to changes in their operating environment. While weak culture firms are characterised by a diversity of beliefs within the organisation, strong culture organisations are generally able to minimise this heterogeneity. This enhances their internal reliability and reduces the costs of disagreement in a stable environment. This type of firm is also seen as better at refining and improving its competencies and exploiting incremental adjustments to organisational routines.

However, organisations with strong cultures can find innovation difficult

The downside, however, is that when radical or discontinuous adaptation is required, it cannot, by definition, come through incremental change. It requires exploration to discover, for example, new technologies, purposes and modus operandi. Strong culture organisations, though, are often ill-suited to exploratory learning. First, they have greater difficulty in recognising the need for change. Second, they are also reluctant to challenge traditional assumptions and existing ways of doing things, to support counter-cultures, and have difficulty transferring new ideas and knowledge to the dominant culture.

Surely, then, the answer is to develop and encourage companies with strong cultures also to embrace exploratory learning and innovation? Not so simple, says Sorensen, who argues that while such an organisation could indeed discover new routines, it would probably still find it difficult to discover a new set of values and norms that are appropriate to the new environment.

Managing emotions can hide the need for change

Emotions can play a major role in the life of an organisation

The role and importance of emotions in organisational life has also now been recognised. Indeed, as Jamie Callahan[2] argues in a study of a volunteer, not-for-profit organisation affiliated to the US military, while the expression of emotion may drive change, the management of emotion can actually prevent it. Emotion management is the active attempt to change an emotion and consists of two types of action:

- *evocation* – drawing forth an emotion that is not present; and
- *suppression* – eliminating or subduing an emotion that is present.

Callahan found that members of the organisation expressed their emotions vigorously around organisational goals and external issues. However, when dealing with internal and cultural issues they tended to manage their emotions. Most notably, women conducted more than twice as much emotion management as men. This pattern of expression and management of emotions, it was found, maintained existing power relationships and an underlying organisational culture. While comfortable for the dominant and ageing majority, this potentially jeopardised the future of the volunteer organisation.

Clearly, emotion management can have both beneficial and harmful consequences for individuals and organisations. In Callahans study, for example, it seems to have had predominantly negative consequences. From the perspectives of both the powerful and dominated or marginalised individuals emotion expression and emotion management together masked the need for change.

Emotional balancing – achieving continuity and change

Even during periods of radical change, an organisation must maintain some continuity such as, for example, the consistency of the service it provides to customers, or the availability of resources. Yet middle managers whose role in change efforts has often been either down-valued or derided have the key task of both implementing change while at the same time attempting to maintain some continuity.

Quy Nguyen Huy[3] has explored how middle managers do this by managing the emotional states of their employees in a radical change context a context that, of course, often generates intense individual and group emotions. According to the author, the process is called emotional balancing, and involves juxtaposing emotion-related activities intended both to drive change while also instilling a sense of continuity in a group of people. Managers clearly have the difficult task of not only managing their own emotions concerning change projects, but also to be aware of the emotions of their staff.

In a three-year study of 10 change projects in an organisation undergoing radical change, Huy identified two broad and seemingly conflicting approaches to emotional balancing by middle managers. The first promotes group-level change primarily through emotional self-management. The second promotes continuity, largely through the management of other peoples' emotions:

- promotion of change projects by arousing emotions in staff, such as excitement, and by reducing emotions such as disappointment; and
- maintaining work-group continuity by means of reducing feelings among staff of chaos, anger and fear, and by instilling emotions such as calmness.

Both approaches, Huy argues, facilitated the processes of adaptation and learning within a work group. He also found that reasonable work group adaptation to change and learning is more likely when actions demonstrating managers commitment to change, and also an awareness and attending to others emotions, are both present.

Thus, effective managers seek first to calm the emotions of their work groups such as through one-to-one listening, providing empathetic rather than judgmental responses, and holding regular small-group meetings before eliciting that groups support for change. In contrast to such effective approaches to emotional balancing, Huy found low emotional commitment to change led to organisational inertia while high commitment to change, with little attention to recipients emotions, led to chaos.

Huys study is significant for highlighting the crucial role middle managers can play in the management of change and continuity, due to their linking position within the organisational structure. Yet it also highlights the importance of developing emotion-related processes and routines within the organisation that facilitate organisational adaptation, what might be termed a kind of emotional intelligence for organisations.

Organisational culture – can it be managed?

An organisation's culture is clearly important. Indeed, a culture best described as the dynamic set of assumptions, values and artefacts whose meanings are collectively shared that is unique and distinctive has also even been seen as a potential source of competitive advantage. Recent research by Emmanuel Ogbonna and Lloyd Harris[4], however, suggests not only that the development of competitive advantage through culture may be problematic, but also that managing an organisation's culture, at least in the short or medium term, may not even be possible at all.

For example, in a study of two culture change initiatives within the UK food retailing sector – both of which sought to achieve similar objectives in spite of being separated by a time difference of 10 years – the authors observed some important similarities:

- the assumption that radical culture change was necessary for competitive differentiation;
- a focus on improving customer service and on changing employee behaviours and values;
- the use of techniques such as mystery shoppers and surveillance cameras to generate change;
- the involvement of senior managers in providing leadership; and
- the use of external consultants.

> It is important to develop emotion-related processes and routines

At the same time there were some key differences in the two change initiatives:

- wider involvement by senior managers in the later programme;
- an increasing sophistication of approach, which recognised that changing values is a longer-term process requiring persuasion rather than coercion;
- a longer-term and more extensive use of consultants;
- the earlier programme produced instrumental behavioural compliance while the later programme did seem to result in some change in behaviours as well as some limited and unpredictable value change; and
- increasing levels of cynicism among employees at all levels in the later programme.

Ogbonna and Harris conclude that, despite the increasing sophistication of the approach to culture change, the evidence is shaky as to whether the changes in culture occurred as a direct result of the change effort. In fact, they argue, for example, that different industries may have their own macrocultures as a result of industry concentration, labour market mobility, and operational and strategic imitation.

> Managing corporate culture may be possible, but it is more likely a long-term effort

Here, although some culture management may indeed be possible, it is more likely to be a long-term effort. In addition, the presence of industry macrocultures, they say, may also reduce the extent to which a particular organisation's culture can be a source of competitive advantage.

Breaking promises and dealing with the consequences

The psychological contract is central to the employment relationship

The notion of the psychological contract or employees' beliefs about the mutual obligations between themselves and their organisation is increasingly seen as central to an understanding of the employment relationship. Research has shown that the consequences of breaching an individuals psychological contract can be serious: it can reduce the employee's commitment and, ultimately, lead them to quit the organisation. Importantly, however, the increasing pace of change and need for an organisation to respond to todays rapidly evolving business environment may well mean such contractual breaches are likely to increase.

An individual's emotional and behavioural responses to a breach of the psychological contract will depend on their judgement of three types of justice within the organisation:

- *distributive justice* – concerning the outcomes or allocation of rewards or resources;
- *procedural justice* – concerning the particular procedures implemented; and
- *interactional justice* – concerning the quality of the interpersonal treatment and sensitivity received from the organisation. It is a form of procedural justice and is based on judgements about whether individuals believe that the reasons underlying decisions were clearly and adequately explained to them, and whether those responsible for implementing a decision treated them with respect and dignity.

Jill Kickul, Scott Lester and Jonathon Fink[5] believe that the psychological contract is multi-dimensional. Some aspects of the contract relate to intrinsic components, ie to the job itself, such as: challenging work, autonomy, participative decision-making, control, opportunities for development and support, etc.

Others, however, focus on extrinsic outcomes, which relate to the consequences of completing the job. These include pay, rewards, flexible work schedules and a safe work environment. Kickul and her colleagues also examined whether interactional or procedural injustice is more important in determining employee reactions to contract breach when intrinsic contract components are perceived to be violated.

Unsurprisingly, and consistent with previous research, they found that a breach in the psychological contract is likely to reduce job satisfaction, in-role job performance and organisational citizenship behaviours, and increase an employees intentions to leave the organisation.

More interestingly, however, they also found that perceptions of the type of justice influence outcomes. Intrinsic outcomes are more likely to be tied to interpersonal relationships built during employment, while extrinsic outcomes, which tend to be more quantifiable, are more likely to be associated with procedures. Significantly, a high level of one type of justice does not mitigate against perceptions of a low level of the other.

Importantly, then, this research demonstrates that an organisation must pay attention both to the formal procedures and to the interpersonal treatment that their employees receive as organisational decisions are communicated to them. When extrinsic outcomes are in question, special attention should be paid to procedures used to allocate the outcomes. When breaches of intrinsic outcomes occur, the most important information to communicate is that which reassures employees that they are still valued members of the organisation and that they will continue to be treated with respect and dignity.

Encouraging openness to change

Employees can be encouraged to accept change

How best, though, can employees be encouraged to accept change? In a 16-month study within a UK-based distribution company, Carolyn Axtell et al[6] examined the impact of exposure to new technology on employee openness to change, job satisfaction, and on anxiety and depression.

The key findings were that:

- greater exposure to change, through the provision of training in new technology, increased openness to change and reduced depression;
- operational employees showed more positive effects from greater exposure than did managers and engineering employees;
- increasing job complexity, rather than exposure to change, was responsible for improvements in job satisfaction; and
- exposure to change did not have any effect on anxiety levels.

One explanation for the different perceptions of managers and operational employees could be that the former were showing disappointment, given that the new technology had not fulfilled initial expectations. They may, however, have also felt threatened by a loss of operational control. By contrast, operational employees may have increased their openness to change as a consequence of feeling more involved and through having a degree of ownership as well as an interest in the new technology.

This study also demonstrated that realistic previews or trial runs can help gradually to introduce change, allowing employees to experience it first hand prior to the actual implementation.

Simple exposure in itself, however, is not sufficient. It is also important that employees do not feel disappointed or threatened, as this will reduce their openness. In addition, familiarity itself is not enough to improve job satisfaction; an enriched and more complex job seems to be required.

Top management personality and TQM

Total quality management (TQM) requires a continuous improvement in management style. TQM implementation often requires radical culture change, and it is therefore perhaps unsurprising that two out of three TQM implementations fail. The lack of top management support for these initiatives is frequently cited as a contributory factor. In a recent report, H J Yen, Dennis Krumweide and Chwen Sheu[7] have examined the impact of the personality of top management and national cultural differences on the implementation of TQM in Taiwan and US.

The researchers used the Myers Briggs type indicator (MBTI) to categorise the personality of top managers. This system identifies 16 personality types. based on preferences on four dimensions. These are:

- introversion (I) and extroversion (E);
- sensing (S) and intuition (N);
- thinking (T) and feeling (F); and
- judging (J) and perceiving (P).

Each of these preferences, moreover, can be associated with different leadership characteristics. For example, (S) and (N) preferences reflect short and long-term commitment, respectively. Managers with (I) preferences are essentially inward thinkers, while (E) preference managers are, as the above would suggest, energised from being around other people. (I) preference managers, by contrast, may be less likely to communicate effectively over a long time period.

Employees must not feel disappointed or threatened

Interestingly, previous research has shown that two thirds of all top managers in the US have the personality types ISTJ and ESTJ this appears to be at variance with the ideal behaviour characteristics required to implement TQM.

Similarly, the authors found from their research that the dominant profile in Taiwan and the USA was ESTJ. Other key findings were that:

- top managers with the (N) preference are significantly more active in creating an environment conducive to TQM. The (S) and (N) personality dimension, and its link to TQM practice, does not seem to be affected by cultural factors;
- the link between implementation of TQM practices and top managers with an (E) preference appeared strong in the US, but not in Taiwan. This, perhaps, could be due to cultural preferences;
- TQM implementation requires a long-term perspective typically at least three years; and
- TQM implementation in Taiwan was more successful where top managers viewed it as a management philosophy. In the US, however, results seemed to count more than an emphasis on philosophical issues.

Personalities of top managers can affect how change is implemented

What, then, should managers conclude from this study? Importantly, it clearly indicates that there is a potential link between the personality of business and change leaders, and the successful implementation of change.

What the authors do not contend, however, is that top managers with particular personality preferences are incapable of developing a culture conducive to TQM. Rather, they suggest that top managers without certain preferences need to emulate the characteristics of those that do, and the MBTI may well be a useful tool for developing an awareness of this. **MU**

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Rejuvenating strategic planning

Strategic planning is too often bureaucratic and mechanistic. New life can be breathed into the process, however. Strategy presentations can become 'conversations' among fewer people, separated from budgeting. They can also become more 'improvisational theatre'. Strategy awaydays, while useful, can be improved by professional facilitators. Future pictures of the business can be drawn on a 'strategy canvas'. At the same time, content is as important as process. The debate continues on whether to focus or to diversify in seeking growth and profit. **Ian Turner** says that, while both can lead to improvement, it seems that creativity and innovation are still necessary.

How should companies conduct their strategic planning process? This Update reviews several articles that deal with this long-running debate. Authors Eric Beinhocker and Sarah Kaplan[1], for example, have researched how large blue-chip companies currently conduct their strategic planning. They concede that formal strategic planning is often criticised and that, even in the more successful companies they investigated, the process can be overly bureaucratic and mechanistic.

However, they do make a good case for rescuing the formal planning process, arguing that it should be less about constructing strategy which, in most organisations, occurs in real time and in informal settings. Instead, they believe, the formal planning process should contribute to two over-arching goals: first, to enhance key decision makers understanding of the business to allow them to respond quickly to changes in their business environment; second, to increase the level of innovation in the company's strategy.

While the authors concede that few companies are good at both activities they do give some helpful indications of best practice. For example, they urge companies to turn conventional strategy presentations into more interactive strategy conversations, between a small group of informed and engaged managers. Strategy discussions, they stress, require significant time investment and companies should make ample provision for this. Indeed, among the CEOs they interviewed it was acknowledged that one-third of these executives' time, or roughly 80 days a year, was spent on strategy matters.

Several other key implications were clear from the research. For instance, the most constructive meetings were often those held on the site of the business unit. This helped avoid the impression of a corporate centre summoning the business unit to account for its actions at head office. In addition, the strategy process should be divorced from and, ideally, chronologically follow the financial budget process. Not unsurprisingly, those people charged with executing strategy should also be those involved in formulating it. Both the business unit team and the corporate strategy team should, of course, also be fully prepared for the meetings. The authors, moreover, advocate a problem-centred approach to meetings, with all participants feeling they are on the same team and confronting common challenges.

The formal planning process should enhance decision-making and increase innovation

In addition, according to Beinhocker and Kaplan, a good strategy process should also encourage greater creative thinking. They thus urge companies to experiment strategically by, for example, pursuing a number of strategic options in parallel, with each designed to test hypotheses about future opportunities. Indeed, their approach here is similar to that of Rosabeth Moss Kanter[2] who recently argued for strategy as improvisational theatre. Thus, a skillful strategist might not know at the outset what the answers to all the questions will be, but rather when the ideas start coming up from the bottom, they will be in the position of being able to say 'I'll know it when I see it'.

Top-down initiatives can contribute to creative strategy

However, Beinhocker and Kaplan also believe top-down initiatives can contribute to creative strategy and that here the CEO and senior managers can obviously add value to a company. They have produced a framework for how companies should address strategic issues, by plotting intensity of issue on one axis and the number of people involved on the other.

Thus, in some situations, like, for example, the decision to merge or acquire a competitor, the question needs to be dealt with quickly by a relatively small number of senior individuals. In others, such as addressing the question of how a company can double revenue from new products, this may be the outcome of strategic conversation involving a whole range of different people across the organisation.

Strategy awaydays

One approach to generating new strategic insights is to take senior management off-site to concentrate on reviewing and formulating strategy. As Kathryn Roy[3] has recently argued, without setting aside time to craft an intentional strategy that incorporates the input of the entire executive team, many companies find themselves pursuing an ad hoc strategy resulting from a string of tactical decisions often by one or two individuals.

The entire executive team should contribute to strategy

These strategies rarely have full executive buy-in[4]. To make awaydays or offsites more effective, she advocates using impartial, trained, strategy facilitators rather than internal management or the CEO. This, she believes, optimises open discussion and can help avoid power politics or manipulation. Moreover, independent facilitators can often draw on their own expertise and experience to offer a more detached insight that can help a company address its strategic issues.

Clearly, though, the quality of the strategy facilitator is paramount and they should possess a key combination of skills. For example, they should be both skillful and relatively self-effacing, but also have sufficient credibility to deal effectively with strong personalities. They should not only be intelligent (at least as bright as the attendees!) but also quick on their feet, with the ability to respond and intervene quickly in discussions when required.

Advocates of strategic planning

Of course, not all companies adopt the same approach to strategic planning. Indeed, this is not only inevitable but also probably desirable, given differences in payback periods, stability of marketplaces, etc. Emerson, a US electronics company based in St Louis, Missouri, is famed both for its consistently profitable performance and commitment to rigorous top-down strategic planning.

The company has a strong commitment to planning and a well-functioning system of control and review, as well as a relentless determination to be the lowest-cost producer in every market in which it competes. The planning process is central to this no nonsense style of management, and the CEO spends up to 60% of his time engaged in strategy meetings with the heads of approximately 65 divisions. The Emerson CEO is famed for relentless questioning and adhering to deeply conservative assumptions about growth and pricing[5].

Does this mean, then, that the strategy process in Emerson is purely designed to extract more profit and cash from the existing operations? While this is clearly a factor, the process is also geared to expansion and has, for example, successfully identified future markets in Asia that the company has been able to exploit as part of its longer-term strategy.

Charting your company's future

But, as Chan Kim and Renee Mauborgne argue in a recent *Harvard Business Review* article[6], it is common for many companies not to possess a clear strategic vision of where they are going. Indeed, all too often, they believe, traditional strategic planning processes have actually exacerbated this, encouraging weighty strategy documents and spurious analyses, graphs and spreadsheets that add little true value.

Better, they say, to adopt a more visual approach to strategy that relies upon drawing a picture of the business, or what they term a strategy canvas. Their simple but apparently effective approach can be broken down into the following four steps.

1. To change strategy successfully, companies must first have a clear and common understanding of their true position vis-a-vis that of their competitors. This, they say, should be done by using a simple, visual measurement device with different dimensions of competition, price, service, speed, etc on one axis, and high/low on the other and simply mapping the company against its key competitors to see how the competitive profiles differ. This, it is argued, should reveal whether, in fact, the company's strategy is coherent or muddled. Good strategies are characterised by focus, distinctiveness and a compelling tag line ie they should be capable of being communicated in a succinct, punchy fashion. A lack of any one of these three properties is usually a clear indicator that change is required.

2. The second phase is visual exploration. Here, managers go into the field and attempt to experience the business from the position of existing, potential and non-customers. In this way, it is argued, senior management should be in a better position to identify what competitive dimensions really matter to their key external stakeholders.

3. The third stage is the visual strategy fair, during which competing teams of top executives are given 10 minutes to outline their new strategic recipes to a panel of judges composed of key stakeholders. Again, it is argued, the company will then be in a better position to be able to redefine its mission and strategy following the judges feedback.

4. The final stage visual communication then involves distributing before and after strategic profiles on one page, to indicate how the new strategy differs from the old strategy.

This appears a deceptively simple process but, as the authors acknowledge, does not preclude strategists from subsequently having to document the strategy and put numbers on it. Moreover, it is possible to imagine that this emphasis on visualisation could, in fact, be taken a step forward.

For example, participants in the strategy meeting could be invited not simply to depict the strategy graphically but also to draw a picture of the company and its strategy at the start of the strategy process in Stage 1 and then, again, on the new strategy at the end of the process. This visualisation is important because it relates to a different part of the brain. Similarly, there are obvious linkages here with the evolving area of strategy as story telling[7].

A clear strategic vision should be part of the process for all involved

Strategy for a turbulent world

In a recent *McKinsey Quarterly*, Lowell Bryan[8] has argued for an approach to strategy that takes account of risk. In fact, his portfolio of initiatives approach closely parallels the real options method to managing strategy under uncertain conditions that has been discussed in a number of previous Updates[9]. Bryan argues that, in a world characterised by increasing levels of risk particularly post-11 September strategy should now be aimed at transforming risk into opportunity through increasing the deep familiarity and knowledge that an organisation has of a particular product, market or technology.

Thus, for example, if a company can operate in what is perceived to be a risky situation because its own knowledge and familiarity enables it to treat the risk as lower than is generally perceived this can be a source of competitive advantage. This is called asymmetric risk or, more popularly, loading the dice. Bryan argues that many companies operating in risky environments initially put too little effort into adapting their core business. Often, they are then forced into making momentous decisions in a short period of time without having previously made the small-scale investments that would have better enabled them to assess risk.

Strategy planning should take account of risk

At any one time, Bryan argues, a company that wishes to continue to grow and master risky initiatives should be managing some 10 to 20 projects designed to build new businesses, adapt core business or acquire or divest businesses. Clearly, of course, not all of these envisaged businesses will be successful, and it is key that, as more knowledge is acquired, companies should be willing to change direction and abandon a flawed project. In this context, Bryan argues for a rigorous approach based on three distinct elements:

- first, identifying initiatives that promise a higher reward based on familiarity;
- second, a continuous process of management of the portfolio of initiatives; and
- finally, a so-called process of natural selection which rather than an overarching vision should determine where, how, and when the organisation will compete in the future.

Risks can be plotted against timing

In fact, Bryan has constructed a portfolio model that plots risk down one axis (with gradations from familiar to uncertain) and timing along the other axis (with short-term payback initiatives at one end and longer-term prospects at the other). Such a matrix should enable companies senior management to obtain an overview of the various initiatives and diagnose whether the current situation is, in fact, really appropriate.

It should also help avoid extremes, like, for example, too little investment in long-term growth opportunities or insufficient focus, as well as enabling a company to review the risk/reward ratio periodically.

Focus versus diversification

Focus or diversify? It depends on circumstances

Historically, one well-established method of handling risk and uncertainty in a company's environment was to diversify its portfolio, thus following the old maxim of not putting all ones eggs in the same basket. However, from Peters and Waterman onwards, advocates of focus dominated the 1980s and 1990s. Proponents of the focus school argued that, prior to the telecoms crash, companies like Nokia only came to world prominence through discarding their conglomerate diversification and focusing on a core business with future growth potential, ie mobile telecommunications. Their critics, however, counter that Nokia had also previously lost huge sums of money adopting just this strategy when the company focused solely on the television market[10].

Still the debate continues. Dominic Swords[11] has recently made the case for focus as a means of coping with environmental uncertainty. But can an organisation be too focused? Yes, say Neil Harper and S Patrick Viguerie of McKinsey[12], who argue that while focused companies will generally out-perform diversified ones, moderate diversification may, in fact, be the best approach of all. For them, a certain amount of diversification is necessary for organisations to generate growth and value in the longer term.

When, however, to focus and when to diversify? The authors maintain that companies in emerging and growth industries should focus on their core businesses, whereas corporations in maturing industries are much more likely to benefit from modest diversification.

Diversification, however, should not be seen as a once and forever activity: rather, the authors advocate active portfolio management, claiming that successful companies separate out businesses, even successful businesses, more frequently and at an earlier stage than unsuccessful businesses.

Disruptive innovation

Following his book 'The Innovators Dilemma', Clayton Christensen[13] has become well known for his path-breaking work on business innovation. Christensen has valuable insight into how to manage innovation and growth in companies and his current research is particularly noteworthy because, unlike much strategy research, it is prescriptive. Christensen along with several colleagues believes he has identified certain rules of thumb that govern how companies should act under certain conditions. And, in a recent article, he outlines both the methodology for this and a working example of how it can be applied[14].

Innovations can be disruptive or sustaining

The key to understanding Christensen's work is, first, to appreciate the distinction he makes between disruptive innovations and sustaining innovations. Sustaining innovations, for example, can be incremental product improvements or even technological breakthroughs.

The key here, however, is that they help incumbent companies to earn higher profit margins by moving their products up market. He concludes that industry incumbents almost always win when the innovation is sustaining, because they have more to lose than new entrants and, generally, more resources at their disposal.

Disruptive innovations, by contrast, generally appeal to customers who are not targeted by the incumbents because they are not attractive, ie the incumbents are unable to generate good returns with their existing business models by targeting these customers. In such circumstances, new entrants almost always beat the incumbents because their motivation to win in this market is much stronger incumbents will generally retreat and refocus. Indeed, this is because of another key element in Christensen's thinking the notion of asymmetries of motivation.

In his most recent article, Christensen focuses on how companies can create growth, and asserts that the probability of creating a successful new growth business through disruptive innovation is greater, by a factor of 10, than through sustaining innovation. To create a successful disruptive innovation, companies should focus either on parts of the market that are not currently served by the existing competitors because products or services are too expensive or not sufficiently customer friendly and/or at customers who desire a simple product which can be delivered at far lower cost than the offerings of existing competitors.

The other test is that disruptive innovation needs to go with the grain of existing customer needs and help them to do more easily and effectively what they are already doing, rather than simply trying to re-educate customers. Take digital cameras, for example, says Christensen. For him, this products potential has not been fully realised precisely because consumers have been challenged to change the way they consume photography.

The other successful model for growth through disruptive innovation is to target the low end of the market. Here, for example, there might be consumers who feel over-served by existing products and would look favourably at cheaper and less sophisticated products. Clearly, however, this approach hinges on customers viewing existing products as more than good enough.

Thus, if companies are able to sustain price increases when they introduce product improvements this would suggest that customers are not, in fact, over-served and disruptive innovation is unsuitable for that particular market segment. Similarly, a new entrant requires a different business model from the incumbent to take advantage of disruptive innovation. For example, the innovator must have a cost structure which enables it to generate high net asset returns even when profit margins are thinner, thus generating superior returns on capital employed.

Disruptive innovation can lead to growth

By adopting a distinct business model, innovators can then create asymmetry of motivation incumbents operating with higher-cost business models will retreat from the bottom of their market to higher-margin activities. The important test questions for new entrants to ask are:

- how much lower does the price need to be to obtain good market penetration at the bottom of the market? and
- how does the business model cost structure need to be adjusted to generate adequate profits?

Christensen and his colleagues successfully apply this model to the Xerox/Hewlett Packard situation in printers, making some astute observations about the success of innovation en route.

Thus, Christensen says, and contrary to popular belief, companies should not lavishly fund new ventures but keep the purse strings tight. Having barely enough cash, he argues, forces a ventures managers to flounder around with actual customers, rather than in the corporate treasury, for ways to get money[15].

Companies should keep the purse strings tight on new ventures

Equally, Christensen is scornful of companies who believe that innovation requires patience, arguing that managers should be patient about size but not about profits, ie that new ventures should be urged to generate profits within a couple of years but should resist the urge to expand too quickly.

Christensen also urges companies to divest new ventures from the existing business and not to seek to apply the same measures or controls in new ventures as, for example, are appropriate in mature businesses. Finally, he describes a process through which new innovations can be systematically developed. This so-called aggregate project plan seems to have much in common with Lowell Bryan's portfolio of initiatives approach, in that it starts by identifying how many such new ventures are likely to be necessary to sustain a particular growth path for the industry in the coming years.

Indeed, this brings us once again near to the strategic experimentation advocated by Beinhocker and Kaplan at the start of this article! **MU**

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