

Manager Update

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



**Faculty of Finance
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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.

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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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Ian Turner is Professor of Management Studies and Director of Graduate Business Studies, Henley Management College.

Country risk and the cost of capital



Investors are faced with an ever-increasing set of choices when it comes to investing their money internationally. Investments in foreign markets may offer many potential benefits, but how can we accurately assess the risks? The research reviewed identifies many different ways of assessing the risk of investing in a country. Investors are encouraged to look at country-specific as well as project-specific issues. **Roger Mills** reports.

The challenge of capturing risk within an investment appraisal has been reviewed in previous *Manager Updates*, focusing extensively upon internal challenges relating to matters such as beta selection and assessment.

In this article, we review the challenges of country risk assessment with special reference to the expansion of the European Union (EU) to 24 countries due this year.

Country risk

John Ries gives a good definition of country risk: "Country risk relates to the likelihood that changes in the business environment will occur that reduce the profitability of doing business in a country. These changes can adversely affect operating profits as well as the value of assets".¹

Many country risk service providers analyse country risk in both economic and non-economic terms, which are weighted to try and provide a quotient capturing a certain country's risk. The fundamental question for anyone considering making an investment overseas is how can country risk be taken into consideration? According to Aswath Damodaran, a renowned valuation specialist, the rational response is quite straightforward: "We believe that while barriers to trading across markets have dropped, investors still have a home bias in their portfolios and that markets remain partially segmented. While globally diversified investors are playing an increas-

ing role in the pricing of equities around the world, the resulting increase in correlation across markets has resulted in a portion of country risk being non-diversifiable or market risk".²

An important question relevant to the topic of EU accession is whether the movement to a single currency in Europe has eliminated country risk. Significantly, in the absence of country risk, the influence of national effects upon a company might cease to be important. In fact, Mark Barnes et al found that while sectors are gaining in importance, country effects remain important both in euro zone and non-euro zone regions³, and they argue that many structural reasons impact individual security returns, including language, cultural and political differences. The authors also argue that various obstacles, like high unemployment caused by rigid labour markets and low labour mobility, make full economic convergence very difficult.

How to measure country risk in investment appraisals

If, then, country effects remain significant in spite of apparent convergence, how can country risk be measured? Damodaran says the risk premium in any equity market can be written as shown in Equation 1 (see page 4).

The country premium, then, should reflect the extra risk in a specific market, yet the approach raises two questions:

Country risk relates to the likelihood that changes in the business environment will occur that reduce the profitability of doing business in a country

Damodaran reviews three main approaches for estimating the country premium

- what should the base premium for a mature equity market be? and
- should there be a country premium and, if so, how do we estimate it?

In response to the first question, Damodaran argues the US equity market is a mature market and that there is sufficient historical data in the US to make a reasonable estimate of the risk premium. He uses a geometric average premium earned by US stocks over treasury bonds of 5.51% between 1926 and 2000. He chose the long time period to reduce standard error, the treasury bond to be consistent with his choice of a risk-free rate, and geometric averages to reflect our desire for a risk premium that we can use for longer term expected returns.

Such an approach could be used for any market for which there is sufficient historical data to determine a base premium. Yet, following this approach does presuppose that any appraisal will be undertaken in the currency associated with the base premium. In other words, following

Damodaran, the cash flows relating to the investment appraisal will be converted into US dollars, such that US dollar cash flows for the prospective opportunity will be discounted at a US dollar denominated discount rate that captures the systematic country risk.

Once the base premium is selected, Damodaran reviews three main approaches for estimating the country premium:

- default risk spreads;
- default spreads plus relative standard deviations; and
- relative volatility.

Default spreads are one of the simplest and most easily accessible approaches, and are obtained from the rating assigned to a country's debt by the major ratings agencies (S&P, Moody's and IBCA all rate countries). These measure default risk (rather than equity risk) but also take into account many of the factors that drive equity risk, such as a country's political and monetary stability and its budget and trade balances.

Table 1

Equations 1-4

EQUATION 1

Equity risk premium = Base premium for mature equity market + country premium

EQUATION 2

Country equity risk premium = Country default spread x $\frac{(\text{Standard dev. equity returns})}{(\text{Standard dev. country bond returns})}$

EQUATION 3

Brazil's equity risk premium = 4.83% x (30.64%/15.28%) = 9.69%

EQUATION 4

$Ke = (Rf_{US} + \text{Credit spread}) + (\text{Adjusted } \beta * Rp_{US} * \acute{a})$

Where:

Ke = Estimated cost of equity
 Rp_{US} = US market risk premium
 Rf = Risk-free rate
 Adjusted β = $\acute{o}_i / \acute{o}_{US}$ ie the standard deviation of stock market returns in the country of the prospective investment divided by the standard deviation of US stock market returns
 \acute{a} = Adjustment for the interdependence between the risk free rate and the market risk premium

A further advantage of ratings is that they come with default spreads over the US treasury bond.

Ratings may provide a convenient measure of country risk, but there are costs associated with using them as the only measure. For example, ratings agencies often lag markets in responding to changes in the underlying default risk and their focus on default risk may obscure other factors that could still affect equity markets.

What, though, are the alternatives? Some, such as *The Economist*, have developed more comprehensive numerical risk scores, where, for example, 0 is no risk, and 100 is most risky, to rank emerging markets. Alternatively, country risk can be estimated from the bottom-up by looking at economic fundamentals in each country, although this requires significantly more information than the other approaches.

According to Damodaran, the country risk measure captured in the default spread is an intermediate step towards estimating the risk premium to use in risk models. The default spreads that come with country ratings provide an important first step, but still only measure the premium for default risk. Intuitively, Damodaran argues that we would expect the country equity risk premium to be larger than the country default risk spread.

To address the issue of how much higher, he uses the volatility of the equity market in a country relative to the volatility of that country's bonds. This yields the estimate, shown in Equation 2 (opposite), for the country equity risk premium.

Damodaran takes Brazil as an example. In March 2002, Moody's rated Brazil B2, resulting in a default spread of 4.83%. The annualised standard deviation in the Brazilian equity index over the previous year was 30.64%, while the annualised standard deviation in the Brazilian dollar-denominated C-bond was 15.28%. The resulting country equity risk premium for Brazil is shown in Equation 3 (opposite).

The third alternative is to assess country risk using a relative volatility approach. For example, the modified US\$ CAPM approach has been used by major investment banks and starts from the perspective that the results of beta analysis for emerg-

ing markets often give unexpected outcomes. For example, based upon the analysis of equity returns of individual countries against a world portfolio, Stephen Godfrey and Raman Espinosa⁴ found that:

- all developed countries have betas higher than 0.5;
- 15 of 26 emerging market countries have betas below 0.5;
- four emerging market countries have negative betas, implying costs of equity below risk-free rates; and
- risk premium in emerging market countries is lower than the risk premium for the US.

By comparison, Godfrey and Espinosa found that the volatility of the emerging markets, from the analysis as measured by the standard deviation of mean equity returns revealed a picture far more in keeping with expectations. This, together with other reasoning, led to the proposed use of the modified US\$ CAPM.⁵ According to this approach, adjustments to the risk-free rate are made for country risk by the addition of a credit spread, and to the beta for the volatility of the market in relation to a US reference point, as measured by the relative standard deviation, see Equation 4 (opposite).

This approach makes a number of important and questionable assumptions. First, that the equity risk premium in the US market is an important performance benchmark; second, the equity risk premium (ERP) demanded by investors in local markets can be inferred from the ERP of the US, adjusted for the volatility of the local markets relative to US; and, third, that there is an interrelationship between the risk-free rate and ERP.

Damodaran reviews all three approaches and argues for the second because the larger risk premiums that result are the most realistic for the immediate future. In addition, he recognises that country risk premiums will decline over time: countries can mature and become less risky over time just like companies, he says.

This has been confirmed by Michael Gangemi et al⁶ who examined the 25-year period up to 1994 using monthly data on 18 countries from Morgan Stanley and which included running-mean, reversion-based regressions of one period's beta

Ratings may provide a convenient measure of country risk, but there are costs associated with using them as the only measure

Countries can mature and become less risky over time just like companies

The results of analysis show a degree of mean-reversion in country betas

estimate on the immediately prior period's beta estimate.

Their research drew upon earlier work by Marshall Blume (1971)⁷ who found asset betas to have a 'regression' tendency; that is, over time, the estimated betas tended to regress toward the grand mean of unity. For instance, an asset whose beta is estimated to be extremely low in one period will tend to have a less extreme beta estimate – closer to unity – in the next period.

In Gingemi et al's research, the basic Blume approach was directly applied to a sample of country-level data, allowing an assessment of the mean-reversion properties of beta from an international investor's perspective.

The second and related objective was a comparison of the performance of several alternative beta forecasting schemes, including a simple mean-reversion model.

Generally, the results revealed a degree of mean-reversion in country betas, quite similar to that documented for individual company betas.

In the second part of the analysis, Gingemi et al compared the forecast ability of country betas based on:

- a random walk forecast;
- a beta = unity forecast;
- a '50/50' forecast; and
- a regression-based forecast.

A comparison of the four schemes for forecasting was provided, based on the mean forecast error, the mean absolute forecast error, and the mean squared forecast error.

The general finding of this analysis was that the 50/50 forecast performed best, while the regression-based approach was included to provide an optimal benchmark for comparative purposes.

Table 2

Three alternative approaches to assessing country risk

1. Assume that all companies in a country are equally exposed to country risk. Take, for example, Brazil, with its estimated country risk premium of 9.69%. The cost of equity for Aracruz Cellulose, a paper and pulp manufacturer listed in Brazil with a beta of 0.72, in US dollar terms would be (assuming a US treasury bond rate of 5% and a mature market (US) risk premium of 5.51%):

$$\text{Expected cost of equity} = 5.00\% + 0.72 (5.51\%) + 9.69\% = 18.66\%$$

Damodaran recognises that the biggest limitation of this approach is that it assumes all firms in a country, no matter what their business or size, are equally exposed to country risk.

2. Assume that a company's exposure to country risk is proportional to its exposure to all other market risk, which is measured by the beta. For Aracruz, this would lead to a cost of equity estimate of:

$$\text{Expected cost of equity} = 5.00\% + 0.72 (5.51\% + 9.69\%) = 15.94\%$$

3. Allow for each company to have an exposure to country risk that is different from its exposure to all other market risk, as follows:

$$\text{Expected return} = R_f + \text{Beta (Mature equity risk premium)} + k (\text{Country risk premium})$$

Using this rationale, Aracruz, which derives the majority of its revenues in the global paper market in US dollars, should be less exposed than the typical Brazilian firm to country risk. Using a (k) of 0.25, Damodaran illustrates a resulting cost of equity in US dollar terms for Aracruz of:

$$\text{Expected return} = 5\% + 0.72 (5.51\%) + 0.25 (9.69\%) = 11.39\%$$

Three different expected returns are the result of applying the three different approaches. The higher the percentage, the greater is the assessment of country risk and the lower would be the resulting net present value in a discounted cash flow analysis.

Assuming the Morgan Stanley country indices to be good proxies for the investment opportunity set facing the internationally focused investor, the practical implications of these results for their portfolio decisions are that:

- mean-reversion models should be used for assessing international beta risk;
- the potential effect of major market movements, such as the crash of October 1987, in the analysis should be acknowledged in any analysis; and
- a simple '50/50' weighting scheme should be considered, whereby a half-weighting is applied to the global unity prior and the other half-weighting is applied to the previous period estimate of beta.⁶

Damodaran argues that the reversion can be achieved by taking the result from the second approach that he recommends (default spreads plus relative standard deviations) and adjusting this downwards to either the country bond default spread or the country premium estimated from the relative volatility approaches.

The implications are that, over time, the lower beta resulting from mean-reversion will lower the cost of equity, ie, the percentage that is used to discount prospective future cash flows. With a lower discount rate, higher value will result.

There is, it seems, a real need for substantial research to test the different approaches. This is further confirmed by a paper by Pablo Fernández on '75 common and uncommon errors in company valuation'.⁸ As he points out with reference to Ukrainoil: "How to calculate the cost of equity is far from clear. There is not consensus in the finance literature."

In fact, Fernandez illustrates eight formulae that have been developed for estimating the cost of equity in emerging markets, including two of those reviewed earlier. None of these yields identical results, demonstrating that we are a long way from having established a scientific method for determining the cost of equity in emerging markets.

From country risk to project risk

Assessing country risk, then, is a challenge. But, there is yet another very real problem – evaluating how individual companies of a particular country are exposed to that country's risk. Damodaran illustrates three alternatives (see Table 2, opposite).

Country risk in context

From the above, it is all too easy to see the challenge of country risk for investment appraisal purposes as being an abstract issue quite different from the realities of the foreign investor focusing upon a prospective opportunity that needs to be evaluated. A useful postscript that places the above in context is an article published in *The Financial Times* on March 6, 2003 entitled 'Cost of capital puts the brake on Lula's Brazil' by Jonathan Wheatley.⁹

"Brazil's basic interest rate is among the highest in the world. The latest increase on 19 February 2003 raised it to 26.5% a year. Worse, bank spreads – the difference between lending and borrowing rates – are astronomical. The average cost of working capital to businesses reached a record 42.5% in January 2003, says the central bank.

Finance for investment is all but non-existent from Brazil's financial markets. The few companies that can tap international markets must either face severe exchange rate risk, or pay for expensive hedges. The government says it will introduce measures, such as laws on bankruptcy and foreclosure, to help reduce bank spreads. But with businesses cut off from investment capital, the latest interest rate increase has left many wondering when conditions will improve. While finance remains scarce, Brazilian industry is unlikely to grow at anything like its potential."

Measuring country risk is an important challenge and, as this article illustrates, there seems to be no single correct approach. Further research is, it seems, clearly required in this area. **MU**

For references, see page 8

The challenge of country risk can be seen as an abstract issue

There seems to be no single correct approach to measuring country risk... further research is required

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Profiting from customer fun

Generating supportive customer behaviour (eg repeat purchases and the purchase of new product offerings) and avoiding negative customer behaviour (eg deserting or talking negatively about a company) are key goals of marketing. The research reviewed suggests that customer emotion is critical. To ensure customer support, it is important to deliver not only satisfaction, but also a sense of enjoyment or fun. **Susan Foreman** says that this can be achieved in many ways.

According to Paul Nunes and Frank Cespedes¹, customers were once reasonably predictable in their purchasing habits. Following a market segmentation analysis, companies could generally see where their customers would shop, how they would buy and which retailers they would use. They would be able to understand the channels of distribution they needed to access to move their products through to the customer. Yet the reality is a little more complex, as marketers face a number of issues involving the assessment of customer satisfaction and the implications for branding and especially differentiation.

How can companies differentiate their products and services in the marketplace in a lasting and meaningful way and ensure customers are satisfied? Companies need to understand customers' emotions and know how to deal with and recover from any negative expressions of emotion. This is particularly so when the emotions are of dissatisfaction or, more importantly, when these feelings turn to anger.

Most companies, of course, work in crowded market places and must deliver products and services of the highest quality and operate their businesses efficiently to stay competitive. In addition to the usual differentiation strategies, however, some could consider riskier tactics, and think about injecting a sense of fun into the 'shopping' experience. Today, customers are more knowledgeable and more experienced than ever, while companies are, according to Nunes and Cespedes, 'newly naked'. Any fault by the

company is transparent to the 'unfettered' customer who is free to switch loyalties.

Angry customers

A significant amount of research in marketing shows that specific behaviours are associated with certain emotions. Roger Bouggie, Rik Peters and Marcel Zeelenberg², for example, ask how people behave when they are unhappy with service experiences. For example, some dissatisfied customers remain passive, while others won't hesitate to go straight to a manager to complain about poor service or a faulty product.

Bouggie, Peters and Zeelenberg investigate whether dissatisfaction and anger are really distinctive and lead customers to behave differently, in order to help managers identify which customers 'don't come back' and which 'get back' at the organisation – in other words, those which switch business to competitors, complain or spread negative word-of-mouth to other potential customers.

Common sense, of course, suggests that there is a difference between the two emotions. Anger is more distinctive and more pronounced, and the words used to express it more aggressive and powerful. Dissatisfaction, however, is more general and relates to a lack of fulfilment or unhappiness. Bouggie, Peters and Zeelenberg also test to see how complex these issues are and to examine the different effects that anger has on dissatisfaction and vice versa and, ultimately, their impact on behaviour.



Companies need to understand customers' emotions

Anger is more distinctive and pronounced... dissatisfaction is more general and relates to a lack of fulfilment

This information can help companies estimate customer reactions

Bouggie, Peters and Zeelenberg assessed the nature of anger and dissatisfaction based on five components, or categories, of emotional experiences. Their research concentrated on feelings, thoughts, behavioural (the authors refer to this as 'action') tendency, actions and emotional goals. They found that dissatisfaction caused by a service deficiency does not always lead to harmful behaviour such as negative word-of-mouth but, conversely, that anger is a significant predictor of negative and destructive actions. Customer surveys concentrate on establishing the key components of satisfaction or dissatisfaction but rarely ascertain the emotional state of the customers. This information, if properly accessed, could help companies estimate customer reactions to the organisation, understand purchase patterns, improve their service delivery mechanisms and assess profitability.

While both angry and dissatisfied customers can switch to competitors, angry customers' reactions are more violent and need to be managed with special care. Front-line staff, therefore, need to be trained to deal with confrontational situations, as it is their actions which can turn around a difficult situation. Dealing effectively and in a calm and efficient manner with such situations can make the difference between retaining a customer and ensuring they switch to a competitor.

Front-line staff need to be trained to deal with confrontation

Fun as a differentiator

Grocery shopping, stopping for petrol or buying a quick lunch are routine experiences that are just part of the busy working day. Such 'neutral' experiences are sometimes best kept that way, since customers will re-purchase automatically. According to Ivor Morgan and Jay Rao³, however, some organisations need not only to differentiate their services to compete, but should also add elements of fun into their marketing toolkit. On its own, clearly, this isn't enough, but there are some famous examples of organisations in the US where fun is part of the marketing approach:

- *Jordan's Furniture* – is used regularly in the US as a performance benchmark because its inventory turnover is six times greater than the industry average. In four shops the turnover is \$300 million, achieved through a combination of innovative – sometimes 'mad-cap' – advertising and

customised in-store theatre⁴ which, depending on the location, uses rock music and laser shows, Mardi-Gras and street performance effects, or strobe lighting and robots. Importantly, this is coupled with a friendly and relaxed internal marketing policy for employees, matching the informality of the external environment.

- *Commerce Bankcorp* – its stock price increased considerably between 1999 and 2001, and the bank added 35 branches to its network at the start of last year when all of its competitors were cutting back. It attributes its success to a mix of internal and external factors such as 'personal touch,' long and convenient opening hours for clients and special events – while balloons, acrobats and massages all provide a light touch. This is coupled with strong leadership and careful attention to the selection, recruitment and reward of like-minded employees; and
- *Stew Leonard's* – a supermarket chain, is perhaps the most well-known example of a company adopting this approach. In 2002, the company generated revenue of \$300 million and a 3.5% return on sales, compared with the industry norm of 1%. The company holds competitions and events, offers free samples and tries to bring the food experience alive by integrating the production and consumption of food, such as through having its own dairy and baking its own bread.

The internal marketing aspect of the experience is key in all these examples, as the companies also focus on the management of service staff and employee satisfaction. Yet, as Morgan and Rao point out, the approach offers no guarantees, as highlighted by the failure of electrical retailer Tandy's exploration of the 'fun' retail experience. The authors thus urge caution and stress the need to assess the impact and potential success rate of the approach. Organisations, they say, need to consider the nature and complexity of the business.

For example, the business needs to change activities regularly in the case of multiple customer visits in a short time scale to maintain the interest and enthusiasm of the customers. Where there are multiple sites the basic service experience needs to be homogeneous, and the entertainment quotient should be comparable. But above all, they say, the basic business proposition needs to function to a high standard regardless of the

fun differentiators and so for many, a more cautious approach may remain the most appropriate.

Branding the differentiator

Branding has become an important management priority in the last few decades. Organisations see brands as a way of differentiating themselves from competitors and developing closer relations with customers. Yet, as David Aaker⁵ points out, the world of brands is crowded, with many unable to differentiate themselves from competitors. This means, then, that brands are similar to unbranded products, only with the expense of building and developing their identities and values. The key, Aaker states, is to brand the 'differentiator'.

What is a true differentiator? It is something that has meaning to customers, an important feature or attribute of tangible or emotional value that is significant to people who use or experience the brand. For Aaker, it can be a part of the brand or a "feature, service, programme or experience". To brand a differentiator in this way can illustrate the commitment the organisation has to the associated product or service, sending the message that the company thinks it is worth the investment. It also indicates longevity – conveying to customers that this is a brand they can rely on and which the company will invest in. The brand name of the differentiator helps consumers recognise and remember the attributes or the benefits of the brand and the company. Furthermore, by providing a name and a personality to a differentiator, it can sometimes be possible to improve communication.

'Branded features' can be used to show how adding an additional branded feature can enhance a core brand. They also signal to the customer exceptional overall performance, and they can be used to emphasise the company's core values and origins. For example, the consumer electronics maker, Sony, brands new high-tech advancements to products to alert the world that it continues to innovate.

'Branded services' can be a helpful way to rejuvenate products and services in mature markets. Indeed, advice and support lines for products have been a popular way of extending the total offering in recent years. Sometimes, the addition of new branded ser-

vices can also become part of a wider transition as a company moves from a narrow product focus to that of the wider service provider. Accounting firms, for example, have moved into management consulting; delivery companies into supply chain management organisations; and, photocopying companies into companies specialising in information and knowledge management.

'Branded programmes', such as loyalty schemes, have provided additional customer benefits and helped to create additional links and connections for businesses with their customers. The internet has also created 'communities of interest' around certain products with additional features and expert advice for the product and related activities, which encourage repeat purchases.

'Branded ingredients' help to demonstrate the quality of the integral feature of a product, emphasising how it contributes to the overall quality.

So far, the brand differentiators discussed have all been produced and managed internally. Some companies, though, prefer to extend their differentiation by partnering with established brands. To be distinctive and to be differentiators there must be an exclusive agreement – therefore, according to Aaker, Intel, Gore-Tex and Dolby don't qualify, as they are available for use by competitors. External differentiators can be economical as they take less investment and risk.

However, the trade-off is in control and power: while the short-term financial benefit is initially attractive for many, the longer-term benefits of owning the differentiator are ultimately preferable. Branded differentiators can revitalise jaded brands, yet they must be developed and researched with care to ensure the differentiator will be associated with your brand and not that of a competitor.

Unfettered customers

Thus, some companies pursue different ways of differentiating themselves by, for example, injecting fun into the purchasing experience and/or by branding the differentiator because they have realised that the conventional rules of the marketing game have changed. Nunes and Cespedes, when discussing the retailing environment, are convinced that customers feel free to select at will among the many channels available to

Organisations see brands as a way of differentiating themselves from competitors

A differentiator is something that has meaning to customers, an important feature or attribute of tangible or emotional value

Companies need to be smart, flexible and increase their visibility in the market place

them. In other words, they no longer gradually progress step-by-step through the traditional decision-making process of attention, interest, desire and action. They use all available channel options at all times. They buy direct, switch between retailers, shop on-line, or by post.

Thus, instead of thinking of customers in conventional ways, they say, companies should follow the advice of Professor Assael (New York Stern University) who argues behavioural buyer groups are becoming more important and that shoppers should be thought of as:

- *habitual shoppers* – rely on long-standing preferences, are loyal to key brands and are passive shoppers who use the same channels on a regular basis;
- *high-value deal seekers* – rely on multiple sources of information to aid decision-making, including brand information and advice from friends and sales assistants, as they look for the best price possible;
- *variety-loving shoppers* – are shopping for fun, investigating various channel options, but also making impulse purchases; and

- *high-involvement shoppers* – are thoughtful and consider the retail options that best suit their needs. They plan their purchases and shop based on clear needs and life-goals, requiring lots of information to make their decisions.

These shopping habits are indicative of how customers' behaviour has changed and the authors highlight the need for organisations to adapt accordingly. As Nunes and Cespedes state, customers are not as predictable as they once were, and their personal characteristics can no longer be used as a predictor of behaviour.

They will consume products and services differently, depending on how they feel at the time, their personal circumstances, the level of risk they are willing to tolerate and the money available at the time rather than, for example, their overall financial status. Companies need to be smart, flexible and increase their visibility in the market place and, as Nunes and Cespedes state, "accept that unfettered customer behaviour is inevitable. Never get between your customers and the way they want to shop". **MU**

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Understanding job satisfaction

Much has been written about job satisfaction, employee motivation and excessive working hours. But what are the real links between these concepts? Evidence from meta analyses suggest that while a significant proportion of satisfaction, motivation and hours worked relate to personality type and is therefore partially hereditary, much can still be done to influence these concepts. **Richard McBain** says that it is important to provide employees with high levels of autonomy and social support while avoiding excessive job demands.

Most people work because they need to, but many also derive a wide range of possible benefits from their work. Such rewards may, for example, be extrinsic to the person, like financial compensation, or intrinsic in terms of the individual's sense of satisfaction or identity. This article considers a number of recent studies focusing on job satisfaction and motivation, and the reasons why individuals invest time in their work.

Two use the increasingly important technique of meta-analysis, which allows researchers to draw on the results of many different studies, and to provide new insights into established questions such as the origins of job satisfaction and the impact of the workplace climate. Others consider new issues of work-life balance, the role of job design and social support networks in motivation and fatigue, and what attracts and retains knowledge workers. The first study approaches the subject of job satisfaction from what may be a relatively controversial perspective in organisational psychology.

Can job satisfaction be inherited?

Research into the origins of job satisfaction has identified a range of important situational and personal characteristics. Studies have shown, for example, that a person's level of satisfaction can be quite stable over time in different situations, and that an individual's own personality traits may, in fact, be linked to their own job satisfaction. Timothy Judge, E Locke and C Durham's¹ core self-evaluation

theory provides one framework for understanding the link between personality traits and satisfaction in terms of the impact of an individual's fundamental, positive self-concept. A further stimulus to a dispositional approach is a developing understanding of human genetics.

Remus Ilies and Timothy Judge² analysed existing research to answer the question of the degree to which personality provides a link between our genetic make-up and job satisfaction, examining two widely researched models of personality that have been linked to job satisfaction. The first of these, the five-factor model, provides a comprehensive taxonomy of personality traits in terms of five major dimensions: neuroticism (or emotional stability), extraversion, openness to experience, agreeableness and conscientiousness.

The second model focuses on affects or emotions and distinguishes between positive affectivity (PA), such as experiencing enthusiasm and cheerfulness, and negative affectivity (NA), reflecting emotional states such as fear, hostility and anger.

Prior research has indicated that between 35% and 49% of the five-factor traits, up to 40% of PA and up to 55% of NA, are heritable. Heritability is the proportion of an individual's characteristics that can be explained by his or her underlying biochemical and genetic code (the 'genotype'). This genetic influence operates on personality directly through biological processes and indirectly



Research into the origins of job satisfaction has identified a range of important situational and personal characteristics

Personality links our genetic make-up and job satisfaction

More than two-thirds of job satisfaction still remains attributable to non-genetic factors

through environmental influences. The key conclusions from the authors' meta-analysis of a wide range of studies are that:

- 29% of job satisfaction is heritable;
- the five-factor model of personality explains 41% of job satisfaction, and mediates about 24% of genetic influences on job satisfaction; and
- the PA-NA model explains 55% of job satisfaction and mediates approximately 45% of the variance in job satisfaction due to genetic influences.

The genetic influence on job satisfaction is, therefore, a significant one, although more than two-thirds of job satisfaction still remains attributable to non-genetic factors. Furthermore, the PA-NA model explains more of the variance in job satisfaction due to genetics than the five-factor model does, suggesting that genetic influences are mediated more by affective traits than by broader and more behaviourally based personality factors.

Of course, there still remains a significant proportion of the genetic influence not explained by personality models. Job satisfaction, like intelligence, may be heritable because of reasons other than personality, and the PA-NA and five-factor models neither capture the cognitive nor the affective components of job satisfaction. The study of genetic effects on human behaviour may be controversial for research into behaviour in organisations, yet it does underline the potential limitations of organisational interventions that attempt to improve job satisfaction.

Working excessive hours – the role of satisfaction and identity

There is a growing recognition that working excessive hours can pose risks to psychological and physical health as well as reduce productivity at the work place. Yet, working long hours persists in certain countries such as the US and in specific industries like financial services. Jeanne Brett and L Stroh³ test four potential explanations for why managers and professionals continue to overwork:

- *work-leisure trade-off* – managers make a rational decision to work longer hours if it leads to higher compensation because the opportunity cost of leisure time increases;

- *social contagion* – managers are influenced to work longer hours by the culture in certain companies or industries, leading them to change their behaviour and work more;
- *work as an emotional respite from home* – changes in home life, such as in male and female roles, have made, for some, the family a stressful environment and working longer hours may be a means of avoiding this tension; and
- *work as its own reward* – work provides managers and professionals with a sense of identity, satisfaction and self-esteem.

In a study of 471 men and 86 women working at least 35 hours per week, the authors found that male managers do not trade work and leisure hours but engage in similar levels of leisure-time activity, regardless of the number of hours they worked or their income. Also, those managers working the longest hours felt the least stressed by their family, even though they did feel significantly more alienated from their family than those who worked shorter hours. Much of the explanation for the work behaviour of male managers lies in their financial and psychological rewards.

Unsurprisingly, those who worked the longest hours received significantly more financial compensation, greater job satisfaction and job involvement. For female managers, however, the situation seems more complex since multiple factors seem to affect their decisions to work long hours. The results from the small sample of female managers were consistent with all hypotheses except the family stress hypothesis. Working long hours did not appear to be psychologically more rewarding for women.

One potential flaw of this research was that it didn't investigate the outcomes of long hours on productivity, burnout, ill-health or work-family stress, for example. The authors do argue, though, that the challenge facing organisations is to find ways of retaining the financial and psychological rewards of working extreme hours whilst reducing the potentially harmful effects of such working.

They note, for example, that there are managers who work fewer hours in industries where the hours are longest and who remain highly effective. Innovative approaches to restructuring work may result in a more equitable and productive workplace, and one

There is growing recognition that working excessive hours can pose risks to psychological and physical health

where employees are able to achieve a better balance between work and home life.

It is also interesting to compare this study with another that looked at the motives of a sample of 623 working men and women as predictors of their investment of time in work and family roles. Here, the authors, Nancy Rothbard and Jeffrey Edwards⁴, found that people invest more time in roles that are meaningful to them. In addition, and perhaps paradoxically, people spend more time in roles that are either pleasurable or displeasurable to them – the latter finding suggests that people may invest extra time in an attempt to solve or cope with problems in their jobs that give them stress.

Other findings, however, are more difficult to interpret. For example, the authors found time investment in one role, such as work, may reduce time invested in others, such as family time. Yet, for men, it seems greater levels of work identification actually lead to more time at work and more investment in family time. Men who are highly identified with family actually spend more time at work. On the other hand, feelings of pleasure or displeasure with one role, as opposed to the other, led to reduced time spent in the other. One possible explanation for the differential results for men and women is that, in general, women still have a higher level of household work and therefore less discretionary time than men.

The impact of workplace climate on individual outcomes

Unsurprisingly, it is the workplace itself, in addition to an individual's personal characteristics, that also influences job satisfaction levels. Indeed, these personal and situational factors interact with each other. One significant situational characteristic is the shared perceptions of organisational policies, practices and procedures that comprise the 'workplace climate'.

Typically, this is researched with a specific focus in mind, such as the service climate, for example. Individuals interpret their environment and specific workplace climates have been found to be intervening factors between features of the work environment and an individual's responses to it. In contrast, research on overall climate, relating to the organisation as a whole and its goals, has had less success in identifying links

between broad dimensions of climate and individual-level outcomes such as job performance, psychological well being, and withdrawal or absenteeism. The contribution of J Carr, Aaron Schmidt, J Ford and Richard DeShon⁵ is to have developed and tested a model of 'molar' climate that seeks to do just that. The model uses Cheri Ostroff's⁶ climate taxonomy comprising three facets with four, more specific dimensions in each:

- *affective* – concerned with interpersonal and social relations and comprising perceptions of levels of participation, co-operation, warmth and social rewards;
- *cognitive* – primarily related to the self-knowledge and psychological involvement in work activities and comprising perceptions of growth, innovation, autonomy and intrinsic rewards; and
- *instrumental* – concerned with task involvement and getting things done, and comprising perceptions of achievement, hierarchy, structure and extrinsic rewards.

Their model suggests that these three facets have a direct impact on two process variables, job satisfaction and organisational commitment, and in turn these impact directly on three outcomes: job performance, psychological well-being and withdrawal. This research also used meta-analytic techniques and is based on 51 studies with a total of 70 different samples. The main findings are that:

- the impact of climate on outcomes is largely indirect, through the attitudinal variables of job satisfaction and organisational commitment;
- the authors found a direct link between instrumental climate and withdrawal, so that the more positive the perception of instrumental climate, the less likely the individual was to demonstrate 'withdrawal' behaviour;
- the three facets of organisational climate were strongly related to each other, but there were differential relationships between the facets and job satisfaction or organisational commitment;
- the biggest influence on job satisfaction is the affective climate, followed by the instrumental and, then, cognitive facets. Organisational commitment is also influenced most strongly by the affective facet, but the next strongest predictors are the cognitive and then the instrumental aspects. All the relationships are positive;

People invest more time in roles that are meaningful to them

Personal and situational factors interact with each other

- there was a high degree of correlation between job satisfaction and organisation commitment; and
- while higher levels of organisation commitment were negatively correlated to withdrawal, job satisfaction was related to all three outcome variables. In particular, it was most strongly related to a reduction in withdrawal outcomes.

Research shows it is important to give employees enough autonomy to manage higher job demands

Yet, some potentially important factors were not included in this study. Work motivation, for example, may be a factor alongside job satisfaction, and organisational citizenship behaviours could be considered as an individual-level outcome. Furthermore, organisational size and individual characteristics may impact on the strength and direction of the relationships. Nevertheless, this study is significant as it helps to provide a more complete picture of the key levers for change in an organisation and can help businesses identify where to focus intervention to achieve specific outcomes.

The relationship between job demands, motivation and fatigue

Other situational characteristics at work are also important, as demonstrated by N Van Yperen and M Hagedoorn⁷, who, in a study of 555 nurses, examined the impact of three such factors on levels of fatigue and intrinsic motivation:

- *job demands* – the quantity of work to be done and the time in which to do it;
- *job control* – the level of personal control the employee has on when and how a job is done; and
- *job social support* – the level of help from co-workers and supervisors.

Effective social support networks may help individuals cope with stress

Previous research has suggested that it is not high job demands as such that lead to strain, but its combination with low levels of control. In addition, effective social support networks may help individuals cope with stress. The authors main findings are that:

- high job demands lead to greater fatigue and that, while more job control can limit fatigue, levels of social support do not appear to have any effect;
- high job control increases levels of intrinsic motivation as job demands increase;
- high levels of social support can lead to high levels of intrinsic motivation, even when job demands are low;

- as job demands increase either high control or high job social support is needed to enhance intrinsic motivation; and
- no gender effects were noted.

This research supports the view that it is important to give employees enough autonomy to manage higher job demands. This, for example, could include enhanced individual discretion over day-to-day operational decisions and increased levels of team discretion. In addition, employers could help to develop supportive social networks and enable employees to identify and use their social networks. The consequence of enhanced job control and social support should be enhanced productivity.

Motivating knowledge workers

The final example considers the case of 'knowledge' workers, whose importance to organisational performance is increasing. Knowledge workers have a number of distinctive characteristics: as individuals they require high levels of technological literacy and cognitive ability. They often work relatively autonomously or in teams dealing with important organisational problems.

Their level of importance is often matched by higher-than-average levels of advancement and mobility, and a commitment to an occupation rather than to an organisation. Many resist traditional command-and-control cultures at some organisations, while knowledge-intensive firms themselves have been characterised by flatter and more networked structures.

Unsurprisingly, knowledge workers are seen as a leading group in terms of the changing nature of the 'psychological contract', which is moving from a more relational to a more transactional basis.

F Horwitz, Chan Teng Heng and H Quazi⁸ carried out an exploratory study of 44 knowledge intensive firms in Singapore in order to identify the most effective human resources (HR) strategies for attracting, motivating and retaining knowledge workers. In common with findings elsewhere, knowledge worker turnover was higher than for other employee groups. Other findings suggest that the most popular strategies were not always the most effective, as was identified both by the organisations themselves and by the researchers:

- the most popular attraction strategies were related to recruitment, such as targeted media advertising, the use of headhunters, and on-line recruitment, as well as opportunities for career and talent development. However, the most effective strategies require a bundle of practices comprising, in order of importance: a very competitive total compensation package, proactive recruitment and internal filling of promotions. Least effective were on-line web recruitment and advertising jobs;
- the most effective motivation strategies involved a conducive work environment that includes the freedom to plan challenging work, a regular communication system that keeps the knowledge workers informed, and transparent compensation commensurate with achievements; and
- the three most popular and effective retention strategies were identified as: performance incentives and bonuses, a com-

petitive pay package and challenging work. Effective retention strategies all require top management leadership and support and are focused on providing opportunities for growth, a conducive work environment and transparent compensation awards.

Clearly, knowledge workers require a targeted approach as, in this case, one size does not fit all. There is much common ground between the strategies for motivation and retention, especially on issues of work design, challenge and personal control. A 'job crafting' approach that allows the individual to adapt the task or relational boundaries of their work can also help. Another key point is that the various aspects of the HR bundle must be integrated, and will need to fit with the organisational context including organisational size, strategy, ownership structure and industry group. **MU**

There is much common ground between the strategies for motivation and retention

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Identifying strategy fads and successes

The discipline of strategy is beset with fads. How can managers know which theories to embrace and which to reject? This article reviews empirical evidence from a number of sources to answer this question. It suggests that companies should have a clear and focussed strategy, execute this flawlessly, have a culture that encourages performance and have a flat and flexible structure. **Ian Turner** suggests that, more specifically, they should concentrate on outperforming others in terms of productivity improvements and embrace performance related pay.

What really works?

Management practice is beset with fads and there are strong incentives for academics and consultants to differentiate themselves, while at the same time promoting their own careers, through devising and promoting new management techniques: knowledge management, customer relationship management, supply chain management and business process re-engineering are just a few of the newer concepts which companies have grappled with in recent years.

Yet do we really know which, if any, of these techniques generate lasting value or if there are any specific principles that underpin successful companies?

Many best-selling management books such as 'In search of excellence'¹ and 'Built to last'² have sought to address this very question and leading management academic Nitin Nohria and his team have recently published their results of a five-year research project into this subject.³ Between 1986 and 1996, they tracked 160 companies, broken down into 40 groups of four, and in which each company started off in about the same position.

Interestingly, however, in each group of four one company emerged as an outright winner, another as an outright loser, one started off well on the path to success but subsequently failed (the so-called 'tumbler') while another one started off poorly but subsequently recovered (the so-called 'climber').

What, then, distinguished the winners from the others? The four 'primary practices' which the authors identified may seem unsurprising; namely, devising and maintaining a clear and focused strategy, executing the strategy flawlessly at an operational level, developing and sustaining a culture which encourages high performance, and keeping the organisational structure flat and flexible.

The detailed findings, though, reveal more interesting and, in some cases, counter-intuitive insights. For example, according to the research, it is extremely difficult to maintain a winning position over a long period of time – only about 5% of publicly traded companies manage to sustain superior shareholder value for a longer period than 10 years. Similarly, excellence in operational execution and implementation also seem to be unrelated to the use of any one, particular technique. What mattered, it seems, was sustained attention to operational efficiency and productivity improvements.

Thus, winners typically increased their productivity twice as fast as the industry's average (6% to 7% per year across all industries compared with an average of 3%). Nor was this productivity improvement necessarily related to investment in technology; it was based, more often, on consistent application of principles and knowing where best to invest the company's resources to deliver value to customers. Nohria's findings, in fact, echo the work of Clayton Christensen, reported in a

Management practice is beset with fads

Only 5% of publicly traded companies sustain superior shareholder value for more than 10 years

previous *Update*⁴, which suggested that exceeding customers' expectations is not necessary for sustaining success, particularly if the over-investment in quality drives prices higher than customers are willing to pay.

Winning companies, it seems, also closely link pay to performance and strive to identify and articulate clear company values that then underpin behaviours and policies. At such businesses, structures and processes are designed to be as simple as possible to facilitate rapid decision-making and encourage devolution of responsibility. Yet, it also seemed to make little difference whether the companies were organised along functional, geographical or product lines, or even whether the business units had their own profit-and-loss responsibility or similar autonomy.

Ultimately, to be successful, the authors say, a company has not only to embrace the four primary principles already mentioned but also combine these with two out of four 'secondary practices'. These secondary practices are:

- talent retention;
- radical innovation;
- leadership; and
- mergers and partnerships.

They have to be combined with the four primary practices to guarantee success but, intriguingly, it does not seem to matter which of the two practices are adopted. In addition, it seems, companies which adopted three or more of these secondary practices were not necessarily more successful than those which adopted only two.

Some of these findings reflect the work of earlier authors. For example, their suggestion that developing home-grown talent – rather than poaching from elsewhere in the industry – is more likely to lead to success was a conclusion also reached by Tim Collins and Jerry Porras in the 1990s. And, despite the current backlash against 'celebrity' chief executive officers (CEOs), their findings also affirm that top leaders can make a difference to business performance.

In fact, they say, as much as 15% of the total variance in a company's performance is down to the choice of chief executive, roughly as much, they point out, as is

accounted for by the choice of the industry in which a company competes. What is critical, they say, is to have a leader who can relate to people at different levels in the organisation and quickly spot potential opportunities and threats. Indeed, board members that are engaged in understanding the business and are motivated to make it a success negate the choice of corporate governance practices.

Finally, their findings on mergers and partnerships are broadly consistent with the research in this area. Only a small number of companies in their sample were able to develop this strategy into a so-called 'winning practice' and, these were usually companies which did deals with companies that were significantly smaller than themselves (less than 20% of their size) and usually on a regular basis (eg, two to three a year).

This, the authors say, was possibly because these companies had established effective processes and built up internal expertise in managing such relationships.

Asymmetries as a source of competitive advantage

Strategy has been dominated by the so-called resource-based school of competitive strategy since the early 1990s. It evolved, at least in part, as a backlash against Michael Porter's conception of strategy as being about positioning a company within an industry. In contrast, the resource-based school attempts to swing the pendulum back in favour of focusing on the company's internal resources.

Companies that could hope to achieve a sustainable competitive advantage were, according to this school, those that possessed resources, ie, physical assets, knowledge, processes, capabilities – which were valued by customers but, at the same time, which were rare, durable, difficult to copy and not easy to substitute with other assets or resources.

While many firms devoted significant time to the pursuit of this ideal, most found that in the real world, sustainable competitive advantage, as defined in the strict sense of the resource-based school, is extremely difficult to achieve. In addition, Danny Miller, who is a long-standing con-

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tributor to the resource-based school, has recently pointed to a major flaw in the theory. If, he says, the resources which confer sustainable competitive advantage are so difficult to secure, how can companies which do not possess them, but are looking to build a sustainable competitive position, ever hope to create them? Valuable resources that confer competitive advantage run the risk of being imitated or expropriated and if they are not easy to replicate, then they are unlikely to be attainable by those who are initially in a less advantageous position.

Miller suggests a way out of this is to change the starting point. A company should, he says, base its strategy not on what is valuable but on what is different. Even where, say, companies do not possess a source of advantage, they will often have resources which differentiate them from their competitors and which are difficult or impossible for competitors to copy because of their unique history and former investment decisions. Admittedly, though, in their current state these resources are unlikely to create value for customers and might even be liabilities. In other words, as Miller says, “inimitability, not value, is the herald of attainable advantage”.⁵

Even those companies that begin from an unpromising starting point can parlay their differences into long-term sustainable advantage, Miller argues. Consider, for example, the case of a small software company he cites. Its small size and late start in the industry led it to try and compete by taking on smaller jobs than its more established rivals.

While at this point the company's skills were no different from those of its competitors, it was gradually able to execute these jobs more skillfully and at a lower cost than its rivals. Over time, through internal specialisation and an unconscious gravitation towards certain market niches, the firm developed resources which its mainstream rivals found difficult to emulate.

Rather than playing ‘catch up’ with its more established rivals, the company chose to compete by investing in these asymmetric resource bundles and developing an organisational structure which “supported, leveraged and renewed the capability and pursued customers and businesses that best leveraged those capabilities”.⁶

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companies

Or, as Miller puts it later in his article, perceived disadvantages such as organisational newness, small size, inadequate capital and a lack of established clients can, it seems, “drive firms into promising underserved markets and technologies of the future”.⁷

Of course, such asymmetry will not automatically become a sustainable source of competitive advantage. Miller describes a virtuous circle involving client satisfaction, the recruitment of talented employees, capability building, reputation development and so on, which leads ultimately to long-term success. There is little new in this apart from his promotion of asymmetries – rather than market opportunities – as the most promising starting point for strategy.

Companies which wish to be successful, he maintains, should learn from their own past successes rather than look at the failures or successes of other companies. Clearly, this approach is still in its infancy and Miller admits that more work needs to be done in order to identify precisely which types of asymmetries are most likely to result in long-term sustainable advantage.

Thus, he posits that so-called knowledge and system-based asymmetries may have more potential than differences based on, for example, tacit knowledge or property-based asymmetries for creating competitive advantage.

Strategy in turbulent environments

The most recent research of Robert Grant, another major advocate of the resource-based school of strategy, looks at how the practice of strategic planning has evolved among major oil companies and, in particular, how these companies have responded to the increasing turbulence in their environment.⁸

There has been a dearth of studies recently into the real world of strategic planning in companies. Whereas the 1990s work of Henry Mintzberg, in particular, tended to suggest that formal strategic planning had seen its day⁹, Grant's research reveals that strategic planning is still very much alive, even if the emphasis has shifted since its heyday in the 1970s.

Grant analyses not only the ‘state of play’ in the strategic planning systems of large

multi-business companies, but also investigates how these systems have responded to increased volatility in their environment – in particular, whether they have moved away from the traditional top-down, formal and analytical processes first advocated by Igor Ansoff and others, towards a more emergent approach to strategy.

Interestingly, all of the oil majors engage in formal strategic planning processes based on an annual cycle. The key difference, however, is that whilst the centre often sets financial targets – and, in some cases, engages in detailed scenario planning – the strategy process in most of these companies now seems more bottom-up than top-down. Corporate planning departments have shrunk, and decisions on corporate strategy are now routinely devolved to top management teams in the operating divisions leaving planners to provide support, facilitation and communication of the strategy.

Corporate planning is now no longer regarded as a career in itself but, rather, as a staging post in the career of executives who subsequently return to line management positions. According to the research, the degree of formality in strategic planning varied from company to company, depending on the prevailing culture, as did the time horizon of strategic plans.

Yet, even with the increased unpredictability of the environment, a planning horizon of four to five years is still common, with some capital investment decisions and upstream planning having horizons of 10 or 15 years or more. In all cases, however, the 1990s saw a move towards speedier decision-making to respond to more rapid environmental changes, while less time was devoted to planning discussions and presentations.

On the one hand, performance targets are now routinely specified in operational and financial terms (a reflection of the pervasive influence of shareholder value as a driver in the 1990s and beyond) but, on the other hand, planning itself has become less precise and more flexible.

According to Grant, the oil majors now manage to avoid any of the so-called ‘fallacies of strategic planning’ identified by Henry Mintzberg. Indeed, Grant characterises these as examples of so-called

‘planned emergence’. Strategic planning in these companies seems to be less about producing accurate plans and more about improving strategic thinking. “It was clear that the strategies of the oil majors were not created by their strategic planning systems. Strategic planning systems were mechanisms for improving the quality of strategic decisions, co-ordinating through strategic decision-making and for driving performance improvement. However, the critical strategic decisions that fundamentally affected the business portfolios and direction and development of the companies were, for the most part, taken outside formal systems of strategic planning”.¹⁰

This approach to strategy seems to be a sensible adaptation to environmental change, although Grant does bemoan some of the losses involved in the transition. For example, he says, the lack of continuity in corporate planning leads to diminished analytical capability and an inability to apply the latest thinking in strategy and strategic analysis to the corporate planning process.

Equally, whilst the flexible bottom-up approach to strategy development has overcome some of the rigidities of the traditional approach, it would seem to have done little actively to promote innovation within large multi-layered organisations.

Strategic decision speed

Not all writers on strategy follow Grant in advocating that decentralised strategic decision-making is most appropriate in turbulent environments. Robert Baum and Stefan Wally¹¹, for example, have looked at the relationship between the speed of strategic decisions and firm performance. Their research has studied strategic decision-making in large organisations in the area of acquisitions, product development and process technology adoption.

The literature on strategic decision-making reveals that taking decisions quickly will lead to better performance in so-called high velocity or turbulent environments because it enables companies to get first-mover advantages, experience curve advantages or pre-emptive positions.

Yet, fast decision-making can lead to poor decisions and bad company performance if

Lack of continuity leads to diminished analytical capability

Taking decisions quickly will lead to better performance in ‘high velocity’ environments

it is at the expense of decision-making quality, particularly in more stable environments. Baum and Wally also hypothesise that strategic decision-making speed is positively related to the attractiveness or munificence of the industry and that faster decision-making, in turn, will take place in companies which have centralised strategic management and decentralised operations management.

Successful
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The results of the research confirmed the hypotheses. Successful chief executives in smaller organisations, operating in more dynamic environments, tend to make quicker decisions.

The conclusions also supported the work of Kathleen Eisenhardt and others who suggest that, when operating in dynamic environments, faster decisions are most likely to result where authority, particularly for strategic decision-making, is concentrated at the centre. "We believe that modern information systems and 'walking around' permits centralised decision makers sufficient information to be confident in their decisions".¹²

Managing by commitments

The test of
success is the
ability of top
managers to
make
commitments

For Donald Sull, the test of whether a company is likely to be successful in the future is the ability of top managers to make commitments¹³, which, he says, are any actions which bind the company to a particular course of action in the future. Such commitments can involve major investment decisions, personnel decisions, public announcements, strategic alliances – particularly involving contractual obligations – and the adoption of particular processes and systems.

Commitments are an essential part of management because they send messages to a company's customers, reassuring them, for example, about the company's investment in a particular product or technology. They also send signals to competitors about the firm's seriousness of intent and, not least, to the company's own employees about its ambitions in a particular business.

Sull's article describes the type of commitments that companies have to make in their formative years as well as the so-called 'reinforcing commitments' which are required for enduring success. This is close to the concept of 'path dependence' which pre-supposes that companies are often set on a particular strategy by virtue of the decisions that they have taken in the past. Sull uses the analogy of how a road system evolves. "At first it is merely a network of cart paths marked in the dirt as the paths become more established they are remade as dirt roads and finally paved as highways. Reinforcing commitments makes a business much more productive – you can drive much faster on a highway than on a cart path. On the other hand, they make it less flexible – the road determines your destination and your route."¹⁴

The problem comes when the environment shifts and the company finds itself constrained, by past commitments, in its ability to manoeuvre. In such a situation, companies, according to Sull, require 'transforming commitments'. Such commitments have to be – in his words – clear, credible and courageous. They typically involve the leader selecting a new, so-called 'anchor point'.

This could be a new strategy or reframing of an existing strategy or a new process or technology. To secure the anchor, the new commitment has to be promoted aggressively within the organisation in a consistent and determined fashion. Symbolic commitments, eg, moving headquarters from one location to another more appropriate for the new strategy, are important at this stage.

Finally, once the new anchor is secured as the basis for future strategy, the organisation needs to be aligned – eg, through restructuring or the adoption of new values. Critically, Sull believes that the secret of successful transformation of commitments lies in the personal characteristics and behaviour of the organisation's leader. The new commitment must be consistent with the leader's values and track record in order to be relevant and credible. **MU**

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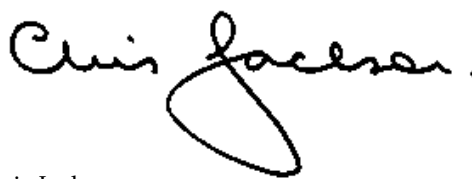
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