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WHAT REALLY INFLUENCES CORPORATE PERFORMANCE?

A New General Management Frame of Reference

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The debate continues: Which set of factors – industry forces or company capabilities – matters more to corporate performance? This staff paper suggests that ever-more-elaborate refinements to this debate are less important than the explicit consideration, in any analysis, of two additional elements: global forces and uncertainty. These elements, while obviously important, are often ignored or addressed only after they have become manifest at the industry or company levels – typically too late. This paper reviews the company/industry debate, explains why global forces and uncertainty must be addressed separately and systematically, and describes how to apply all four forces, detailing the roles, processes, and tools necessary to help companies formulate a robust organizational approach. The authors hope to provide a new frame of reference that, when handled with a sensitivity to the particulars of a company's context, provides a clear and effective alternative to the deluge of one-size-fits-all management solutions that have dominated executive bookshelves for two decades.

Edited by Saul Rosenberg (New York)

CONTENTS

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INTRODUCTION

Corporate performance is often described as an effect of just two factors: where and how a company competes – or, more formally, its industry and its capabilities. Debate over the relative importance of these two factors has proved heated and long-standing. On one side, industry proponents contend that being in the right place is what matters, juxtaposing, say, the recent profits earned by oil companies with the losses that have bludgeoned airlines. On the other, advocates for the importance of company factors claim that performance differences within industries are the more powerful element, pointing to success stories even in hard-hit industries – Southwest Airlines, for example, as compared with traditional network carriers.

There is truth on both sides. The fundamental claim of this staff paper, however, is that even a thorough analysis of industry and company factors has become insufficient. Taking two additional forces into account – global forces and uncertainty – is now a prerequisite for companies looking to preserve, and particularly to gain, competitive advantage. Failing to react to a global trend or making decisions that do not fully incorporate uncertainties will sink the corporate ship as quickly as will a poor understanding of the industry situation or the company's abilities. Similarly, recognizing and exploiting a global trend early or managing uncertainty more effectively than others can lead to real competitive advantage.

Global trends and uncertainty are not new phenomena. But the introduction of a frame of reference for strategic analysis built around these four forces – company forces, industry forces, global forces, and uncertainty – is timely, for three reasons.

First, in recent decades, companies have become increasingly subject to global trends and to a growing range of uncertainties. Some 30 years ago, companies faced little danger from, say, an interruption in the flow of U.S.-bound parts sourced in China. Now, even a minor such hiccup could prove almost immediately destructive. Devising a performance strategy based on only company or industry elements – or even on both – is insufficient given the complexities of today's business environment.

Second, the increasing specialization we see in business consulting, while obviously beneficial, has left business thinkers and practitioners without any reliable, up-to-date general framework through which to view a company's situation. Years ago, the Firm looked to James O. McKinsey's General Survey Outline.[1] Later came the Touchstone[2] and 7-S frameworks,[3] the McKinsey/General Electric 9-box matrix (itself a response to the BCG 4-box matrix),[4] and important aca-

demic frameworks such as Michael Porter's "five forces."[5] Each offered a comprehensive way of assessing a company's challenges and opportunities, and of elucidating its optimal strategic course. Whether a study focused on an operational, organizational, or strategic problem, a conversation with the client would begin from a broad general management perspective that typically covered industry outlook and company position, as well as the client's goals, organization structure, policies, facilities, capital, procedures, and personnel. Now, our conversations with senior colleagues suggest that we diagnose companies' problems through the lens of our individual specializations.[6] These niches are often further constricted by a similar narrowness of perspective on the client side: The VP of HR believes building capabilities is critical, the head of business development believes entering and exiting industry segments is critical, and so on.[7]

Third, the business world has in the past 20 years become infatuated with easy answers, deluged with one-size-fits-all approaches that disguise narrow, myopic solutions as comprehensive, clear-sighted ones. These solutions have their impetus in a number of "management delusions" *(see sidebar)*, the most basic of which is that correlation equals causality. Specifically, a given factor may be present in a successful company without being a driver (and certainly not "the" driver) of that company's success. They may be correlated but not exist in a causative relationship; both may be the result of a third force. Or causality may be present but may run in the opposite direction from that assumed. Subscribing to the idea that correlation equals causality, however, means that almost anything can be credited with the success (or failure) of a company. The prevalence of this tendency has led to dozens of candidates being put forward as *the* driver of successful performance.[8]

It is easy to see the damage such ill-anchored speculations cause. Many automakers have invested considerable effort in incorporating one or another element of Toyota's well-known Toyota Production System (TPS) into their operations – none with results even remotely resembling those Toyota has achieved.

Southwest Airlines is another example of a company that competitors have sought to emulate. Southwest set out to compete with surface transportation on price and flexibility for short-haul distances and rapidly gained profitable market share with a low-cost, no-frills business model. Larger carriers have attempted to follow suit, borrowing many of the elements of Southwest's model – but have never matched its success.

What goes wrong in these cases? Toyota and Southwest are particularly good examples of companies whose success is intimately related to an overall company culture. TPS is a completely integrated expression of the total culture of Toyota: Companies cannot succeed by isolating and imitating any particular element of it. Similarly, even if a large carrier could match Southwest's low labor rates, it would be unlikely to be able to incorporate key elements of Southwest's culture successfully. Southwest's specific emphasis on fun and employee satisfaction probably has much to do with the personality of its founder and with the company's size.

Some might argue that if a company were to go very deep in its analysis of the company or companies it sought to copy, it could succeed. Putting aside that emulating another company to this degree is presumably impossible, this argument at least recognizes that it is the entirety of a company, including the context in which it finds itself, that lies behind its success or failure.

This is not to suggest that there is no value in a case-based approach to improving performance: Lessons and examples, from whatever source, will always be useful in providing practitioners with courses of action to consider. But what the above examples suggest is that companies should avoid pursuing the purported paths others have taken to success. Instead, they should recognize that they work in a context uniquely theirs, and, beginning with that context, take the measure of the forces acting upon them and proceed accordingly.[9] The four-part frame of reference we offer supports such a proceeding. In fact, we no longer believe, in the advanced state of today's global economy, that companies can rely on a single framework to meet the corporate-performance challenge successfully. At earlier periods, and in different contexts, 4- and 9-box matrices may well have been sufficient – but they have become outdated. And the proof is in the plethora of business books that champion one-size-fits-all solutions, which are about as useful as their self-help counterparts on the neighboring shelves.

MANAGEMENT DELUSIONS

We have suggested that the allure of business fads rests on their tendency to put forward false proofs from one or another company's success. In *Hard Facts, Dangerous Half-Truths and Total Nonsense,* Stanford's Jeffrey Pfeffer and Robert Sutton analyze six different "half-truths" about financial incentives, leadership, strategy, change, talent, and work-life balance that have been advanced as business panaceas. They show where the claims might be true and where they are not, arguing that managers must analyze the assumptions behind each claim and seek evidence as to whether those assumptions will hold true in their own context. They note that this requires a new mindset and a lot of effort. They quote Peter Drucker: "Thinking is very hard work. And management fashions are a wonderful substitute for thinking."[10]

In *The Halo Effect,* Professor Phil Rosenzweig of the International Institute for Management Development goes into greater detail on which research techniques pass muster, taking issue with the approaches used by many of the most venerated business books. Most of these works, Rosenzweig believes, show a "tendency on the part of the experts to point to the high financial performance of a successful company and then spread its golden glow to all its attributes – clear strategy, strong values, brilliant leadership, and outstanding execution. In fact, the things that the experts claim drive performance are often simply attributions based on prior performance."

Rosenzweig raises a number of concerns about popular studies of high-performing companies. Among these are the "delusion of correlation and causality" and the "delusion of single explanations," discussed above. Other delusions include the effect of sample selection on outcomes, the conviction that high performance can last forever, the idea that absolute rather than relative performance matters, and the "delusion of the wrong end of the stick": that the most successful companies pursue a narrow strategy doesn't mean a narrow strategy leads to success. The opposite is usually the case: Examining the whole universe of companies using this tactic indicates that more would fail than succeed. Rosenzweig suggests that studies that avoid these delusions will result not in a list of half a dozen big, colorful actions that promise huge performance boosts but rather in a list of actions that provide a moderate boost in a specific situation or situations. Such lists are not as attractive as the promises in the more popular business books. But they are the result of more rigorous analysis, and so are far more likely to lead to impact.

The key is to understand the company's context at a very detailed level: not only those actions that have and have not worked historically but also those that make sense in the context of the company's capabilities, its industry or sub-industry, the trends affecting the company overall and the subtrends affecting each region, and the specific uncertainties it faces. Further, the company must make decisions in a dynamic fashion – not once but continually. Again, all of this argues against the simple application of a single framework to each company's situation.

This paper is organized into four parts:

- **Origins of the performance debate.** We begin with a review of the debate about company and industry factors, including a summary of empirical analyses that show how the relative weight of company and industry factors varies by industry, by company, and over time. Included here is a sidebar on McKinsey's contribution to the debate *(see p. 7)*.
- **An expanded frame of reference for thinking about corporate performance.** This section expands the discussion beyond company and industry factors to global forces and uncertainty, explaining why all four forces must be fundamental elements of the performance equation.
- **How to apply the four forces.** This is the most important section of the paper. It advises readers on methodologies and ways of thinking that will help their clients stay on top of all four forces.
- **Organizing for success.** Finally, we offer advice about the structures, processes, and incentives companies must put in place so that they can periodically review all four forces, prioritize them, and determine the appropriate set of actions in response.

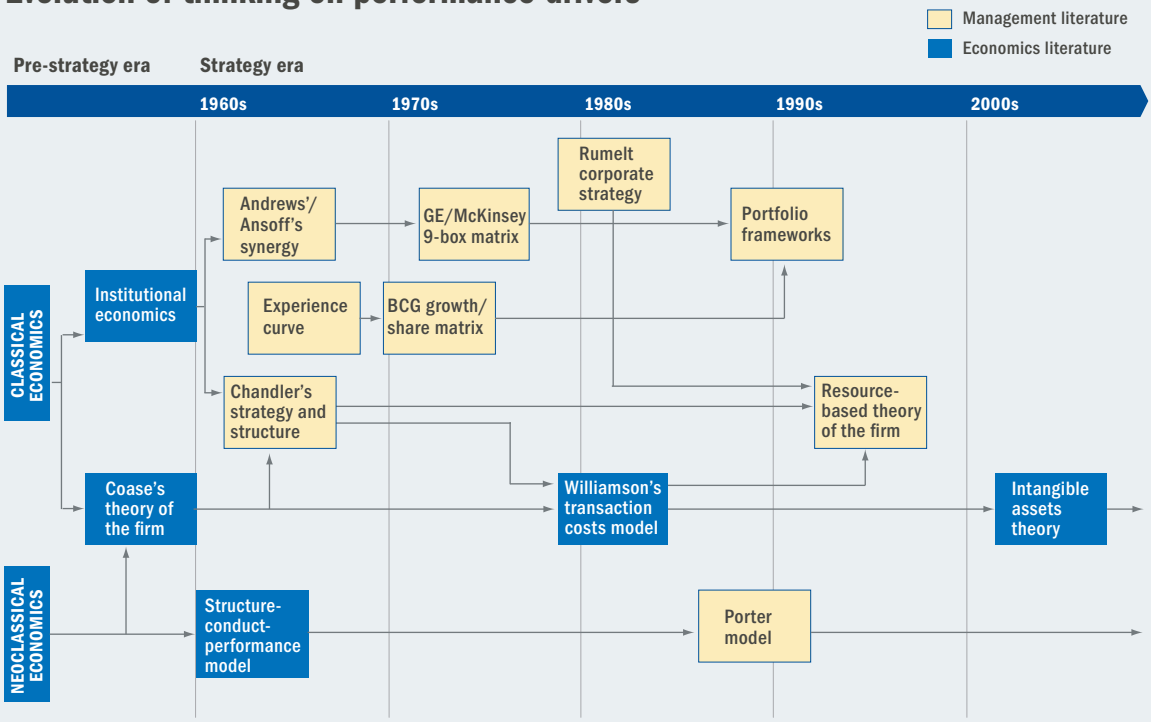
ORIGINS OF THE DEBATE: COMPANY FORCES VS. INDUSTRY FORCES

Before delving into what is missing from the current corporate-performance discussion, we begin with a review of the terms of the company/industry debate. As a perennial strategic concern, often referred to by clients as "where to compete" vs. "how to compete," an understanding of the effects of company and industry forces on an individual company's success is important for all consultants.

The discussion about performance has run for more than 200 years, beginning with what are now called classical and neoclassical economics *(Exhibit 1)*. In classical theory, production conditions are the most important drivers of profit; in neoclassical theory, market structure is the most important driver.[11] Indeed, the ability, on an almost one-to-one basis, to map production conditions to company factors and market structure to industry factors suggests that the debate has hardly changed since it began.

Exhibit 1

Evolution of thinking on performance drivers



Source: "Some Thoughts on Strategy: Where From? What Have We Got? Where To?" John Stuckey (Asia-Pacific Strategy Meeting, July 2004)

Classical economists such as Adam Smith and David Ricardo assumed that free mobility of capital and labor would lead to a gradual elimination of inter-industry profit differentials.[12] This process of company rivalry, they thought, could be influenced by company behaviors such as advertising, pricing, or adjustments to production quantity, which would in turn confer learning advantages.[13]

In contrast, neoclassical economists such as Alfred Marshall believed that companies were mainly passive – that changes were wrought by external forces, to which companies simply responded.[14] They believed that the intensity of competition depended primarily on the structure of an industry: For example, a larger number of companies in a given industry would lead to effective competition and more modest profitability, while a smaller number would lead to oligopolistic behavior and thus a larger margin of profitability. This perspective was further fleshed out in the 1930s, when Edward Mason described the structure-conduct-performance (SCP) model for understanding the influence of industry structure on performance. Thus, well before contemporary academics and consultants restated the debate in terms familiar to today's business practitioner, theorists had begun to analyze and make claims for company factors (Smith and Ricardo) and industry factors (Marshall and Mason) – and even, quite early on, both company and industry factors (Alfred Chandler).[15]

The first salvo in the modern corporate-performance debate was fired in 1980 with Michael Porter's *Competitive Strategy.* Porter argued, along with the neoclassical economists, that industry dynamics drove the lion's share of variance in profits.[16] He claimed that five forces – the bargaining power of customers, the bargaining power of suppliers, the threat of new entrants, the threat of substitute products, and the intensity of competitive rivalry – combine to determine the attractiveness of an industry as a source of profit.

The most compelling rejoinder to Porter's reintroduction of the industry perspective came from the "resource-based" view of the company. Proponents of the resource-based view claim that sustainable competitive advantage is driven primarily by a company's resources, including anything from physical assets to capabilities or knowledge – essentially a restatement of the case for company rather than industry forces. Birger Wernerfelt coined the term in 1984, building on work by Edith Penrose, and suggested that resources may provide barriers to competition that rival the industry barriers suggested by Porter.[17] Jay Barney formalized this theory in 1991 by categorizing the four requirements for earning abnormal "rents" from resources: They must be valuable, rare, imperfectly imitable, and nonsubstitutable.[18] A more popular version of this theory was offered in 1990 by Gary Hamel and C. K. Prahalad, who cited "core competencies" that are hard to imitate and can be leveraged widely across products and markets.[19]

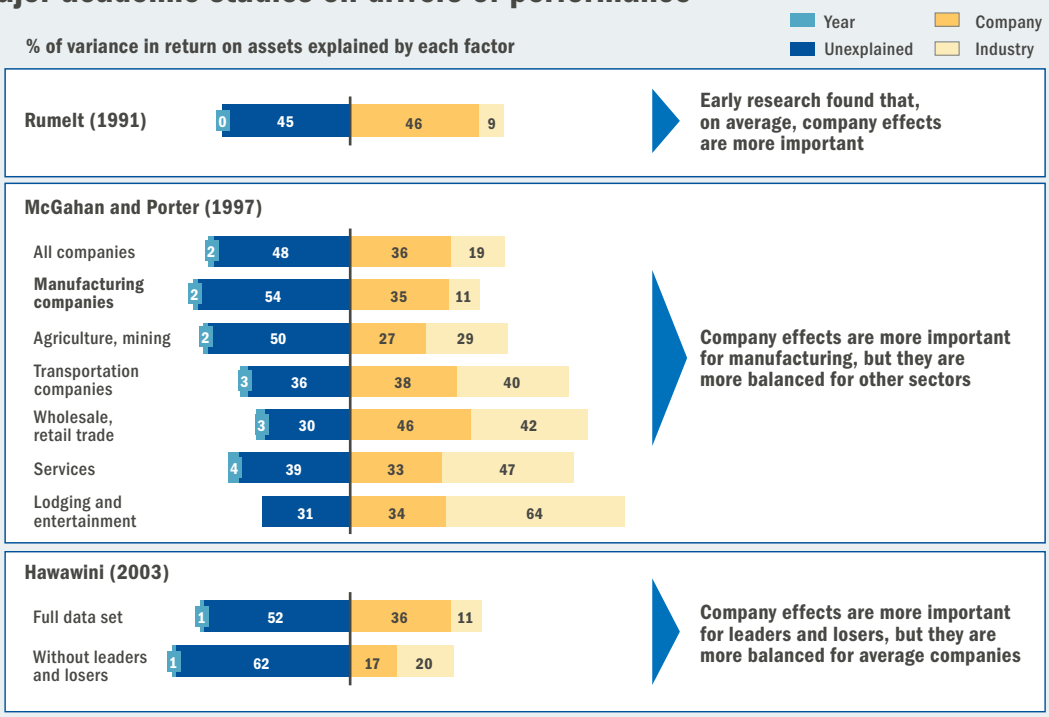
Up until this point, theoretical rather than statistical arguments had predominated. The debate became more thoroughly anchored in data (and rigorous empirical analysis) in 1991, when Richard Rumelt published a landmark study demonstrating that the company is a much bigger driver of performance than the industry in which it operates. Rumelt's analysis of many manufacturing companies revealed that company factors explained 46% of profit variance, while industry differences explained only 9% *(Exhibit 2)*. Rumelt concluded that "business units within industries differ from one another a great deal more than industries differ from one another." Thus, the most important sources of profit are resources or market positions rather than membership in an industry.[20]

Michael Porter responded in 1997 with the observation that the relative importance of company and industry factors depended on the industry:[21] Manufacturing, the focus of Rumelt's study, was particularly susceptible to company effects. But even Porter and his co-author, Anita McGahan, conceded that company effects were twice as important as industry effects. Intriguingly, however, Porter and McGahan reclaimed the intellectual high ground with the observation that industry effects are more persistent than company effects, since industries take longer to change. In 1999, they quantified their claim by demonstrating that industry effects persisted at an average rate of 66% to 83%, as compared with 46% to 63% for company effects.[22]

A new wrinkle was discovered in 2003 by Gabriel Hawawini, who found that the relative weight of company and industry effects depended on a company's performance ranking within its industry.[23] Company effects were more important than industry effects for industry leaders and laggards, which – whether for good or ill – tend to have atypical managerial capabilities. But industry effects were the more important factor for averagely performing companies, which

Exhibit 2

Major academic studies on drivers of performance



Sources: Rumelt, "How Much Does Industry Matter?" (*Strategic Management Journal,* 1991); McGahan and Porter, "How Much Does Industry Matter, Really?"(*Strategic Management Journal,* 1997); Hawawini et al., "Is Performance Driven by Industry- or Firm-Specific Factors? A New Look at the Evidence" (*Strategic Management Journal,* 2003)

are likely to have average managerial capabilities. Porter refined this point even further with the observation that company effects were more important to the *emergence* of high performance, while industry effects were more important to the *sustainability* of high performance.[24] (Company effects were found to be more important to both the emergence and the sustained nature of low performance.[25])

MCKINSEY'S CONTRIBUTION TO THE DEBATE

McKinsey developed a balanced perspective early in the debate: In the 1970s, the Firm introduced the McKinsey/GE 9-box matrix, which included measures both of the attractiveness of an industry and of a business unit's ability to compete within it. A little later, however, different parts of the Firm took differing positions. Upon its creation, the Strategy practice focused on where to compete. The Organization practice focused on how to compete. The focus on how to compete predominated for about 20 years. This shift to the resource-based view was driven in part by an emerging sense of the increasing importance of intangibles.[26] John Stuckey's and Jessica Hopfield's observation that the argument for industry had become less compelling as "macroenomic forces such as deregulation and new technologies are making many previously cozy markets much more competitive, driving out surplus returns" is representative.[27] Lowell Bryan's more recent work, particularly in *Mobilizing Minds,* reaffirms the primacy of the company, showing that on average,

(continued on next page)

DEBATE (continued)

the top 30 companies by market capitalization earned $83,000 per employee across many industries, while the next 30 earned only $53,000 per employee.[28]

More recently, however, the industry view has been reemerging. Sven Smit, Patrick Viguerie, and colleagues in the Strategy practice's Growth service line analyzed 200 large companies around the world and found that market growth and inorganic activity were responsible for nearly 80% of growth differences in companies, while out-execution of market growth was responsible for only 20%.[29] Although many management teams spend a great deal of time focused on execution, they spend relatively little time examining their company's portfolio of businesses and how it might be modified. The key to understanding the precise importance of where to compete for any company, the authors suggest, is to consider differences not only among major industries as a whole but also among subsectors within them – a fineness of distinction that contextualizes a business in 1 of 450 subsectors, rather than in 1 of 20 industries. Then the importance of choosing well becomes even clearer.

For the present, then, our own pendulum has swung. Practically speaking, however, as consultants draw from these different internal perspectives, it would be wise to maintain, with John Stuckey, that "both special capabilities and industry structure are important."[30] And to be convincing to our clients (and ourselves), we must understand the sources of our even-handed position.

EXPANDING THE FRAME OF REFERENCE: GLOBAL FORCES AND UNCERTAINTY

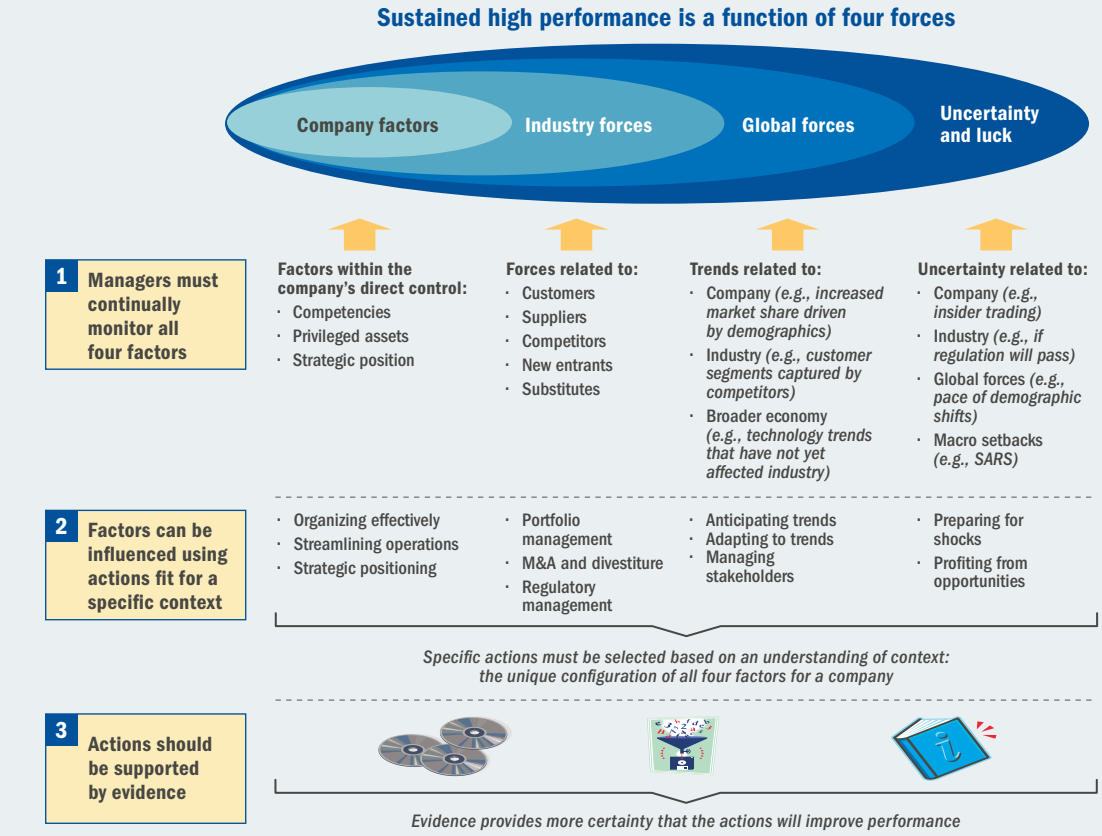
We have suggested that industry and company forces are not the only factors to consider when analyzing a company's situation. A comprehensive frame of reference must explicitly take into account global forces and uncertainty as well *(Exhibit 3)*.[31]

The boundary between these four factors can at times seem porous – there is certainly overlap among them. Uncertainty might be related to a company force (e.g., the possibility of insider trading threatening a company's well-being); to the industry to which the company belongs (e.g., whether a given set of regulations will pass); or to a global force that may affect the company (e.g., the fact and pace of demographic shifts). Alternatively, a broader uncertainty could resonate in all three areas – the sudden emergence of SARS (severe acute respiratory syndrome), for example, or avian flu. Nevertheless, even though the boundaries are sometimes blurred, what should be clear is that global forces and uncertainty cannot simply be regarded as *embedded* within the company or industry categories; they must be discussed separately.[32] If senior executives wait until a global force or an uncertainty manifests itself at the industry and finally the company level – as, if it is to affect the company at all, it ultimately must – they will have waited too long.

For instance, we interviewed a senior executive of a North American electronics company that considered itself first and foremost in the intellectual property business: It depended on inventions to sustain itself. Accordingly, its large, global asset base was mostly given over to R&D expenses. At one point, the CEO asked the company's risk team to examine the potential for dis-

Exhibit 3

A frame of reference on drivers of performance



Source: McKinsey analysis

continuities that might seriously disrupt its business. The team looked for balance-sheet and income-statement vulnerabilities, and scrutinized the asset portfolio. The company was not overextended with regard to debt. It was well hedged against its extensive currency exposure. On the income-statement side, its revenue base was relatively well diversified, with only modest exposure to any one market. In fact, 75% of its revenues came from outside North America, with no single country accounting for more than 10% of its total market share. As long as the company hedged itself intelligently, even cyclical macroeconomic issues seemed to pose little threat of serious damage: Nothing other than genuinely freakish events could make it vulnerable.

The company also looked at its cost exposure. It carefully examined how each plant sourced raw materials. It even considered a list of factors that we would call global trends – changes in demographics, changes in consumer behavior that would affect its industry, shifts in the capital markets, and even regulatory shifts in India and China as these two countries became increasingly important to its business.

In short, all seemed well. And then the team realized that 65% of everything the company manufactured relied either on Chinese materials or on processes undertaken in China. Neither a study of raw-material sourcing nor a study of the sourcing of components had yielded cause for concern – yet it suddenly became clear that any significant threat to the smooth interaction between the company and its China-based supply chain could effectively shut down the company's business.

This was in 2004, and avian flu was in the news. The team determined that, were an outbreak to close China's borders, the company would be in bankruptcy within two months.

The details of the company's response are not relevant here. What matters is that a traditional company- or industry-based analysis failed to detect this threat. Only the fact of an enterprising individual going beyond his investigatory mandate brought the problem to the company's attention. A product-by-product exposure, of the kind various business units conducted periodically, would have missed the risk the company faced across product lines. Even an industry-by-industry view would not have triggered the crucial realization. The risk exposure became evident only when the question was asked, "What is our total exposure to China?" Such a question would only arise from explicit consideration of the uncertainties the company might face or of the impact of a particular global trend – in this case, the growing importance of China to Western companies.

A second example: One night in March 2000, a lightning-induced fire at an electronics company fabricator plant – the ultraclean environments in which silicon chips are made – knocked out two of the company's four fabricators. The electronics company contacted two of its larger customers to alert them that chip deliveries would be delayed. The first treated the call as a potential crisis and escalated the matter to top management. The second moved much more slowly – and by the time it had identified the implications for its cell-phone business, its competitor had locked up every shred of spare capacity, forcing it to look for alternatives. The second customer reported hundreds of millions in losses in the quarter after the disruption and significantly more for the year. It ultimately ceded significant share of the handset market to its rival.

A number of aspects of this story are interesting. Most pertinent, both customers – sophisticated companies – depended on a single supplier for a crucial element of a fast-moving consumer-goods business. There are sometimes good reasons for a single-supplier model. But here, it raised the possibility of serious chip-supply problems, since a major problem at just one company could compromise both customers' businesses. No doubt the likelihood of a major disruption to the operations of a well-run chip supplier with multiple fabricators is very low. Yet "act-of-God" events, such as lightning strikes, happen every day and hence have measurable, if very low, probabilities. (The failure to account for them is of course more apparent at the second company. Senior management at the first company may well have thought through how to respond to a potential problem at the supplier, and promptly implemented its solution when such a problem arose.)

These are not isolated cases. Business history is littered with examples of companies that missed important trends and uncertainties. Some of these trends and uncertainties were consequential enough to affect whole industries – and sometimes more than one industry. Consider digitization. Music producers slow to respond to digital music sales and file sharing have seen sales plummet. In telecom, significant shares of the mobile-handset market shifted in the mid-1990s as handsets shifted from analog to digital. In the camera-film industry, digitization completely reshaped the business.

Companies do not always miss trends – but they can still misread them. Monsanto, although aware of significant concern among the European public about genetically modified foods, advanced a European strategy that bet heavily on them – and failed to win market acceptance at significant cost. Much earlier, very famously, Digital Equipment Corporation lost its lead in the computer business by missing the shift from minicomputers to personal computers and was ultimately acquired by Compaq. Atari missed the direction of the personal-computer trend as well, rejecting a proposal in the late 1970s by employees Steve Jobs and Steve Wozniak, who designed and built the original Apple computer with Atari components.

More broadly, recent research suggests that the proportion of companies facing at least one setback (defined as a drop in market value of at least 20%) increased from 15% in 1994-1995 to 52% in 2002-2003 (rising as high as 67% during the bursting of the tech bubble in 2000-2001). In the same time frame, the average number of setbacks faced by each company increased from 3.4 to 5.4 and the average recovery time increased from 5.4 months to 7.7 months. As these setbacks become more frequent and severe, companies must learn to understand their sources and to recover from them more quickly *(Exhibit 4, overleaf, and sidebar on p. 13)*.

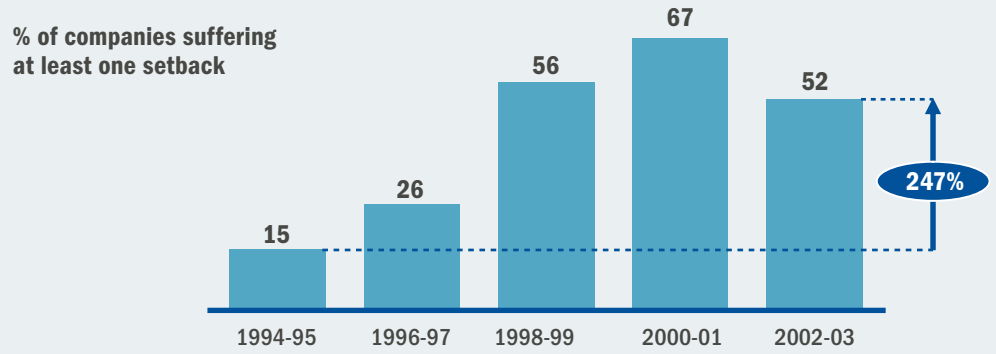
Of course, the flip side of anticipating trends or uncertainties to protect the company from loss is anticipating them to generate profit. Over the past 20 years, Wal-Mart has consistently been ahead of the curve on global technology trends, thus enjoying significant advantages over retail peers such as Sears and Kmart. In 1983, Wal-Mart became the first major retailer to track sales at the level of individual items, collecting bar-code data at point-of-sale terminals in its retail sites – and a few years later sending that information directly to suppliers so that inventory management could be automated and inventory costs dramatically reduced for both the company and its suppliers.[33] More recently, it has been leading the charge to replace bar codes with RFID tags (radio frequency identification microchips), which can be tracked by radio waves instead of manual scanning and which allow the development of real-time insights into demand patterns. We noted earlier that all trends become industry and finally company effects. That is true here – but only when the first company in the industry adopts the technology, by which time a crucial first-mover advantage is lost to all other players.

Wal-Mart illustrates the impact of a trend on a company's supply side. Chico's, a clothing chain, demonstrates the impact on demand. The retail company was founded in 1983 to target a new demographic segment: baby-boomer women 35 and older. The goal was to sell them clothing that was comfortable but still regarded as fashionable.[34] Although growth started to slow in

Exhibit 4

Setbacks: more, and more severe

Drop of 20% in market value*



	1994-95	1996-97	1998-99	2000-01	2002-03
Average number of setbacks	3.4	4.7	5.1	6.0	5.4
Average recovery period in months	5.4	5.2	7.1	6.7	7.7

* Month to month

Note: Averages calculated for companies with at least one setback; the basis is a global data set of more than 20,000 companies

Sources: Global Vantage; McKinsey analysis

2006, the company earned average annual returns of 68% from 1996 to 2005 and ranked at the top of the WSJ 1000. During that time frame, Chico's outperformed well-established competitors that had clearly missed a critical demographic trend.[35]

But companies can go further than anticipating trends: They can actually harness these trends in a way that materially alters the context in which they operate. This pertains particularly to global trends that are linked to the way societies perceive companies. For instance, widely held concerns about climate change are affecting public opinion about large oil and car companies. In each of these industries, some companies have clearly managed to shape the debate – and their place in it – more than others. This puts them in a position to respond to the climate-change trend in a way that benefits both their company and society, and to suffer less if the perception of their industry suffers.

As an earlier staff paper observes, most companies tend to see global trends as threats rather than opportunities and to respond only when they must, rather than when they might.[36] Companies that identify an opportunity early can establish themselves in strikingly positive ways in the public's perception and influence the contours of the debate in a manner that maximizes their ability to move forward profitably. An excellent example is Toyota's early championing of the hybrid automobile: Although sales of its hybrids remain a modest fraction of Toyota's total output, the Prius has cast a "green" glow over the entire company. Other important examples,

MORE ON SETBACKS

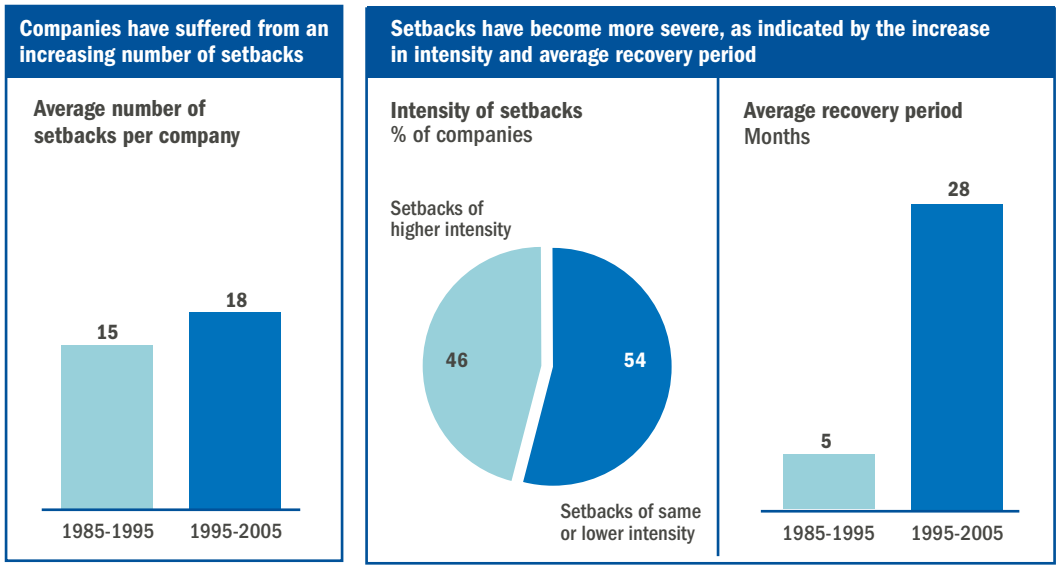
Setbacks deeply affect a company by generating crises of confidence, driving customers away, destroying monetary value, tarnishing reputations, and ultimately causing serious declines in performance.

The increase in the frequency and severity of setbacks shown on a global basis in Exhibit 4 has been even more pronounced in the U.S. in the past two decades. An analysis of approximately 1,850 U.S. publicly listed companies reveals that the average number of serious setbacks experienced by a company has increased from 15 in 1985-1995 to 18 in 1995-2005. Perhaps more worrisome is that the intensity of these setbacks has increased substantially. Out of the 1,850 companies that suffered setbacks during 1995-2005, 46% suffered more severe setbacks than in the previous decade; 87% of companies suffered at least one setback in 1995-2005 – and almost 37% suffered a threat to their survival.

The persistence and the amplification of setbacks is a result of a number of significant transformations in the global business landscape. Heightened corporate interdependency now means that one company's problems can rapidly become another's. Increasingly interdependent supply chains can cause even minor disruptions to ripple through several other companies. Compounding matters, the rapidity with which news and information travels, and the length of time it stays "in print" on the Internet, still confounds many companies. (Wendy's reputation and sales continue to be affected in the aftermath of the "finger" incident, when a customer alleged that she found a severed finger in a serving of chili – a finger it seems she had herself placed there. A suitably narrow search on the Internet yields more than 20,000 relevant responses.)[37]

– Janamitra Devan, Abhijeet Dwivedi, and Tsun-yan Hsieh

Frequency and severity of setbacks have increased in the U.S.



Source: McKinsey analysis

some more and some less comprehensive to the company's strategy, are GE's "Ecomagination" initiative, Wal-Mart's "zero-waste" strategy, and BP's and DuPont's incorporation of climate-change thinking into their operations. Such proactive choices are particularly important in shaping, rather than being shaped by, the regulatory regimes that can make or break a company's profitability.

It is worth noting that none of the successes listed here might have been relevant or available to other companies – even those in the same industries. Each company must filter the general set of threats and opportunities it faces through the context of its particular situation.

APPLICATION OF THE FOUR FORCES

In this section, we offer consultants, and the executives they serve, ways of thinking about all four forces. What companies can do structurally to support these ways of thinking and to ensure that the right reward systems are in place is discussed in the section on organizational change that follows.

Before delving into specifics, an important caveat: Many companies that think they are on top of elements like global forces are, in fact, anything but. In most companies, there is a chasm between what executives say about global forces and what they actually do in response. In a recent survey by the *McKinsey Quarterly,* 65% of executives agreed that in the next five years, the growth in emerging-market consumers would have an important impact on their company's profitability, but only 36% had taken steps to address this trend.[38] Similar gaps existed with regard to most of the 14 trends studied *(Exhibit 5)*. Even when executives are aware that certain forces are important, they continue to base their resource-allocation decisions on the previous year's budget – or on political factors such as alliances among business unit heads.[39]

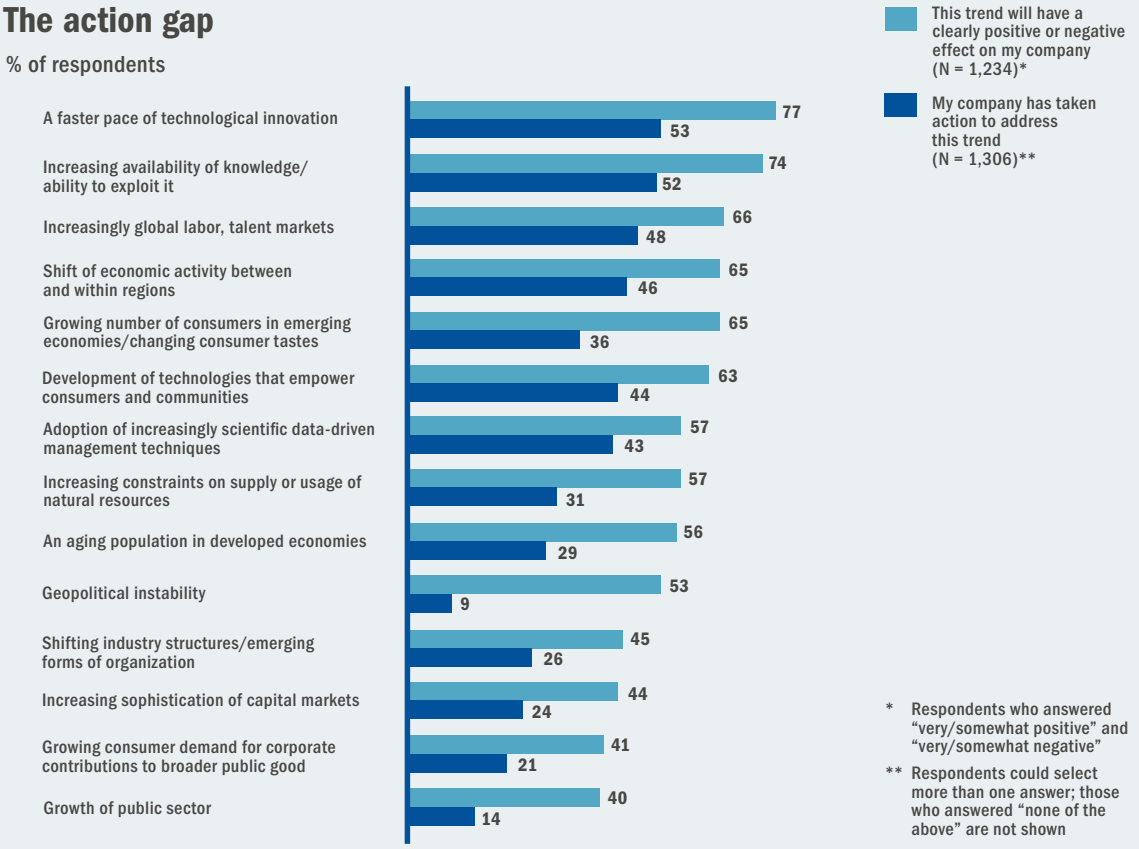
As for the management of uncertainty, recent events on Wall Street demonstrate that even the most sophisticated executives paid insufficient attention to the probabilities that brought many banking firms low, and one firm down.

To move from being at the mercy of these forces to mastering them, companies must begin by understanding the scale of the challenge. In interviews with 12 senior executives from large companies, we discovered several reasons top management has proved slow to act. First, we found that they weren't always good at thinking through the ways global forces and uncertainties might prove relevant to their company and industry. They were correspondingly weak in articulating to operational leaders at lower levels how these leaders should behave differently in response to these factors. One executive told us that the advent of Sarbanes-Oxley required fundamental changes to certain standard operating procedures in the global accounting industry. As a practical matter, however, managers in the group continued to use the same SOPs for several years.

Exhibit 5

The action gap

% of respondents



Source: "How Companies Act on Global Trends: A McKinsey Global Survey" (ID# 736059), April 2008

Second, these companies found it difficult to keep the attention of their senior line and functional executives focused on all four forces. The executives tended to focus on the company at the expense of the industry, global forces, and uncertainties. Managing the more tangible company factors fell neatly into the executives' "comfort zone."

Third, the senior executives conceded that there was a reason for this behavior: Paying attention to global forces or uncertainties was not rewarded by their companies. Here, the fact that all elements ultimately manifest themselves as company forces posed a particular challenge. Over time, a well-spotted and acted-upon global force should lead to a set of particular actions that either protect or contribute to the company's bottom line. But the reward is routinely bestowed upon the person most closely associated with that contribution. In one global financial management company, the executive who launched a successful new wealth-management product was richly rewarded. The executive who pointed out why an emerging demographic force would create demand for this new product, and who then mobilized the forces to create a favorable environment for such a launch, was not.

Clearly, then, persuading top management to think carefully about all four elements of the performance equation presents a significant challenge

Responding to company and industry forces

This topic has been covered exhaustively elsewhere. Here, we highlight the most important elements.

When considering *company forces,* consultants and managers should think about distinctive competencies (e.g., organization design or processes), privileged assets (e.g., intellectual property the company owns), and competitive position. For example, pharmaceutical companies have been aggressively pushing to improve the effectiveness of their field sales forces and marketing capabilities. To achieve the right brand positioning in light of individual doctors' needs, these companies' sales forces must be supported by granular information and territory management systems, as well as adequate performance evaluation and incentive schemes.

A discussion about the relative importance of distinctive competencies, and therefore the extent to which resources should be allocated to each, can be found in "Is Your Core Competence a Mirage?" by Patricia Clifford, Kevin Coyne, and Stephen Hall.[40] The authors suggest focusing on competencies that are truly superior to those of actual and potential competitors; that are highly sustainable because of their rarity, lengthy development time, and the difficulty competitors will have in understanding their source; that will generate a great deal of value in comparison with other economic levers; and that possess a high degree of importance to the customer.

Industry forces include the underlying growth and profitability in the sectors in which a company operates. A company can affect its own growth and profitability by making portfolio decisions about which sectors to stay in, enter, and exit, and by influencing industry characteristics such as barriers to entry, concentration, cost structure, or product differentiability. For example, News Corporation faced industry factors, such as the emergence of the Internet, that simultaneously drove a need for new revenue streams and provided opportunities through the rise of social networking and other Web 2.0 phenomena. Actions taken included investment in online businesses such as MySpace.

The attractiveness of different industry segments is described here using the taxonomy of factors in John Stuckey's "Perspectives on Strategy" staff paper. These factors draw from concepts first identified by many of the pivotal thinkers in modern economics. The biggest drivers of attractiveness are the industry growth rate and the degree of product differentiability, but other factors include a high degree of industry concentration, high barriers to entry and exit, low fixed costs, an attractive position in the industry chain relative to suppliers and customers, and an attractive moment within the evolution of the industry. When looking to enter new businesses, it is critical for a company to analyze the subsectors it wishes to enter based on these seven characteristics. In addition, management must seek out discontinuities occurring or likely

to occur in the industry and attempt to be the first to take advantage of them. The goal is to claim monopoly advantages, however fleeting they may be in competitive industries.

An approach to the global-forces challenge

Most managers assume they have minimal influence over global forces. They are right that they can do little to change a demographic trend or a widespread shift in consumer consciousness. But they can react to such forces, or, even better, anticipate them to their own advantage.

Executives should systematically track all forces external to their company and industry at three levels: global, regional, and national. This is the easiest way for a company to apprehend whether a force will have global relevance – and it is a method that is also well aligned with the way most large companies already think about their business. Executives must learn to distinguish between forces that have global implications – like the rise of China or the explosion of the Internet as a major channel for retail sales – and those that are principally regional, such as regulatory trends in the face of ASEAN or MERCOSUR regional integration. Alternatively, forces can be country-specific. Education and literacy are examples of national trends that might be of concern to country-specific players (e.g., Southwest Airlines, CVS, and China Merchants Bank).

Exhibit 6 *(overleaf)* shows a heat map that companies should create for each of their business units. The heaviness of the shading identifies which forces are most threatening or relevant to the future of the business unit in question. The exhibit maps three types of business units of companies we interviewed against the country, regional, and global forces that might affect these businesses. As the exhibit shows, we recommend that companies look at each force over two time horizons. Our interviews suggest that two-to-three-year and three-to-seven-year time horizons are meaningful because they compel executives to apply a long-term as well as a short-term focus.

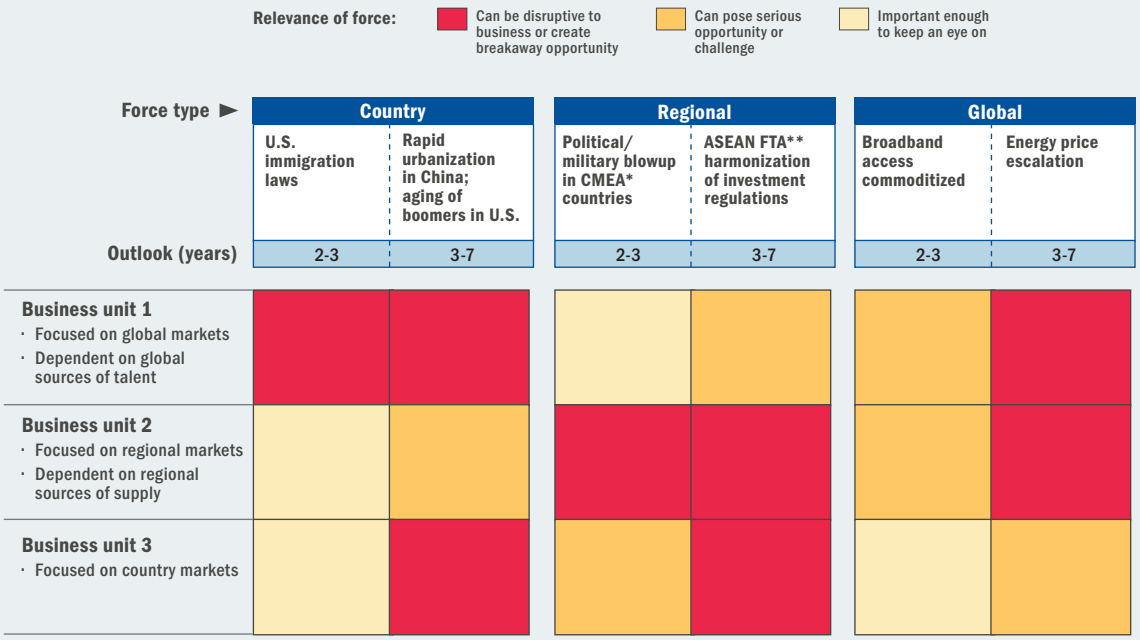
These heat maps should be developed on a "bottom-up" basis, beginning with business units and ending at the corporate level. Every business unit should perform such scans, as each usually serves different markets and may be subject to different contexts and pressures. Also, corporate headquarters alone cannot be expected to possess the informed perspectives business unit leaders have on their own businesses. What is crucial, however, is that the corporate center must take the cross-business unit, cross-functional view that no individual business unit would.

There are complications, of course. The future of U.S. immigration laws may appear to be a country-specific force but actually has a clear impact on business on a global scale. One company we interviewed hired foreign nationals and trained them in the U.S. before sending them to its overseas marketing and sales destinations. But our experience would suggest erring on the side of analyzing all forces that might ultimately affect the company. By doing so, a company will maximize its chances of identifying the forces that matter.

How should a company integrate its thinking about global forces into its overall strategy? The Strategy practice's Global Forces service line recommends a three-step process.[41] First, the con-

Exhibit 6

External forces identification matrix: applied to a diversified manufacturing company



* Council for Mutual Economic Assistance
** Association of Southeast Asian Nations free-trade agreement

Source: McKinsey analysis

sulting team should challenge senior managers by presenting the future landscape as it might affect their business. This can be done by presenting the facts on emerging trends and then facilitating a question-and-answer session with the client. By putting facts about global forces in front of the client, the team can elucidate how macro-level trends might translate into positive or negative microeconomic impact.

Second, the team should work with the client to "co-imagine" a possible future. This is often done through a two-to-three-day workshop focused on scenario generation, identifying "white-space" opportunities, and defining how the company must change in order to respond to scenarios or take advantage of new opportunities.

Third, following such a workshop, the consulting team can help the client build long-term success by developing 5 to 10 potential strategic initiatives for further investigation. These initiatives could include anything from the strategic positioning of a specific business unit to new market entries, identification of divestment opportunities, or talent-sourcing strategies.

This last step is critical. In many companies, discussions of global forces stop at the corporate level and never make their way into operational plans. At one technology company we interviewed, an external firm was brought in to run a workshop on megatrends, sparking an interesting discussion but no follow-up action. Some trends were simply used to justify the company's existing strategy (e.g., an increase in family dispersion confirmed that previous investments in online communities made sense). Part of the problem was that the only staff formally charged with monitoring global forces were the market analysts who monitored competitor activity and market-share trends. (We discuss structural responses to this kind of problem in the last section of this paper.)

One global financial services company we interviewed uses a two-step process to ensure that identifying trends leads to action. At the corporate level, the company analyzes flows of wealth and demographic shifts. The company complements this activity with a bottom-up approach to operationalize the opportunities that analysis of those forces suggests. For example, when the corporate team identified Internet retail as an interesting opportunity for the company, analysts in Asia looked at the income levels of those driving the Internet retail boom in the U.S. so that they could estimate when these effects would also become relevant in Asian markets.

Dealing with uncertainty

Uncertainty is another force most managers have little hope of influencing. Once again, they are right. But they can, and should, make an effort to understand the range of possible scenarios – and be ready for them. One useful way to think about uncertainty is to divide it into two categories of risk: continuous risk and "extreme-event" risk.

As Eric Lamarre and Martin Pergler explain in their primer on corporate risk, continuous risk has to do with historically precedented changes in the business environment that may improve or damage business performance.[42] For an aluminum provider, these might be changes in the cost of alumina or in energy prices, or the pace of economic development in China, a purchaser of aluminum on a vast scale. For an energy utility with nuclear plants, the relevant factor would be the price of natural gas. For a distributor, it would be the effects of CO_2 regulation. These are all risks that have a nontrivial probability of materializing and that may well have predictable effects.

A second, more difficult category is extreme-event risk, such as the advent of SARS or a terrorist attack. The effects of these risks are much harder to foresee, as there is unlikely to be much in the way of precedent. Extreme-event risks are high-impact/low-probability events. For instance, Singapore Airlines reported its first-ever loss at the height of the SARS outbreak, which did what the industry and the competition could not: sent its revenues tumbling 35% in a single quarter. Even the relatively small outbreak of SARS in Toronto in 2003 cost the region's tourism industry roughly $1.5 billion in income and jobs.[43]

Of course, the simplicity of this taxonomy conceals some challenges. Not all risks are easily classed into one type or the other. For an airline, an upward move in the price of oil due to some

noncatastrophic development would typically fall into the category of continuous risk. But how does management identify whether such a price increase is a spike or a long-term change – the latter of which is nearer to extreme-event risk? The difference is not trivial: Oil-price increases that turned out to represent a new regime rather than a temporary phenomenon elevated Continental Airlines' fuel costs by more than $1 billion each year from 2003 to 2005, with devastating effects on the airline's profitability. Those on the other side of the industry were luckier: The market capitalization of ConocoPhillips rose from $24 billion to $84 billion over the same period, and drilling-rig demand soared, driving the market capitalization of Transocean from $7 billion to $17 billion over two years. Closer to home, Southwest Airlines, having hedged against fuel-price increases, brought in almost $1 billion in additional revenue in 2005 alone.

Whether or not ConocoPhillips and Transocean had good protocols in place for managing uncertainty is impossible to glean from this example – but it is clear that Continental did not have them in place and that Southwest did.

How should companies respond to the uncertainties they face? Hugh Courtney, Jane Kirkland, and Patrick Viguerie developed one of the most effective ways of thinking about this in a *Harvard Business Review* article.[44] The article begins with the insight that many managers make decisions as if they were in environments of greater uncertainty than the ones they actually face. In such a situation, they tend to assume that the uncertainty cannot be managed with familiar tools, and so often base their decisions on gut instinct. An equal and opposite danger is to invest too much faith in too limited a set of tools, or the wrong ones. Failing to recognize that the tools being used do not apply to the uncertainties in the environment, managers often plunge forward with discounted-cash-flow-based net-present-value decisions suitable only where safe forecasts can be made.

The first step in dealing with uncertainty, then, is to reduce it to "residual uncertainty" – the uncertainty that remains when the best possible analysis of the situation has been undertaken. Once this analysis is complete, the situation can be sorted into one of four categories.

Level one encompasses situations in which the future is clear enough to be addressed using traditional, single-point forecasting tools. Here, a discounted-cash-flow-based NPV analysis may be sufficient.

Level two concerns situations in which the future may fall into one of a number of scenarios. Typical examples are industries subject to regulatory decision making, or companies whose performance depends heavily on which of several outcomes their competitors pursue. Here, scenario planning will be adequate. The creation of scenarios then returns the planner to a level-one approach: For each scenario, a forecast can be made. Of course, the existence of multiple scenarios means that resources must be assigned depending on the probability attached to each scenario, rather than to the single scenario of level-one uncertainty. A second necessary step is to put in place a monitoring regime: As the situation unfolds, the level of uncertainty is likely to drop, and resources can be focused more narrowly. (In a smaller set of situations, the level may actually rise, and the planner may find herself facing a level-three situation.)

At level three, a range of potential futures can be defined, but these futures cannot be mapped to discrete scenarios. The probability distribution is continuous. This level is typical of companies in emerging industries or companies entering new markets. Here, too, however, a set of scenarios describing alternative ranges of futures can be identified, with the goal of identifying which range is, or is becoming, more likely than the others. Once again, this effectively reduces the category of uncertainty by one level, at which point scenario planning can be brought into play.

Level-four uncertainty applies to situations where it is simply impossible to identify the range of possible outcomes. These instances are rare, however. What kind of situation warrants the description "level four"? Consider investors thinking about the market for Internet search in the late 1990s. It is hard to imagine any kind of analysis that would have successfully combined all the variables to predict Google's emergence as the superpower of the industry, with longer-established companies such as Lycos practically disappearing from view. The good news is that level-four situations tend to be unstable. They usually "decay" into level-three situations in a reasonable period of time.

These uncertainties can therefore be actively managed (rather than just analyzed) through the development of scenario ranges, traditional scenario planning, and even point forecasts. But there are three additional tools that can be used.

The first tool is the simplest and best known: insurance. Every company carries a wide range of insurance. It is most obviously useful against extreme-event risk. A company might, for instance, pay a small amount every year to prevent being put out of business if an earthquake were to destroy a manufacturing plant.

The second tool is hedging. Financial hedges involve accepting a lower return to reduce the effects of uncertainty. A good example is the oil increase that hit Continental so hard, but that Southwest Airlines had hedged itself against because it recognized that big fuel hikes would make it impossible to maintain its low-cost profile. Hedging also involves instruments that are not strictly financial: For example, a company might write a contract that allows it to cancel a deal in certain situations. It might also create a "human capital" hedge – a cadre of individuals that would allow for a much more rapid realignment if one of its businesses were to suffer a terminal collapse. There are also strategic hedges, such as those in which a company bets on two competing technologies simultaneously.

The third tool, related to strategic hedging, is diversification. A good example is Microsoft's activities around the time Windows was launched. As Eric Beinhocker explains in *The Origin of Wealth,* Microsoft had a number of other efforts under way – its collaboration with IBM on an operating system, its creation of different versions of its Office software for the Mac, its UNIX- and Sun-related efforts – that meant it could thrive regardless of which scenario prevailed.[45] When there is uncertainty about customer needs, a company typically responds with a portfolio of products or services. When there is uncertainty at the macroeconomic level, a company situates plants in different countries.

Diversification is also considered a good tool for dealing with cyclicality. In theory, being in different businesses with different cycles effectively insures the company against a big loss. In practice, however, conglomerates are not generally effective managers of a diverse group of businesses – and are usually punished by the market accordingly. Thus the cure may be little better than the disease.[46]

Finally, a number of ways of managing uncertainty that are not generally thought of in such terms warrant mention. A company can always accept particular kinds of uncertainty and live with the results, putting aside capital as appropriate – the proverbial "rainy day" strategy. The company can pass the effects on to the customers if it is willing to accept the risk that it may push the customers beyond their price elasticity and lose them. It can also modify its approach in response to sudden developments. For example, when pulp prices spiked, some paper companies reacted by changing the number of sheets in a standard toilet roll. Another strategy worth noting: vertical diversification along a value chain. Aluminum companies have used this strategy to ensure the availability of core supplies at a manageable cost.

We do not mean to suggest that all uncertainties can be managed, hedged, or responded to in ways that will render them harmless. There are level-four uncertainties in particular that cannot be rendered harmless. In such cases, the notion of resilience becomes important. The business press famously celebrates high-performance companies. Yet few companies are high performers all the time. High performance matters. But what matters just as much – or more – is the ability to survive the shocks that hit every company at some time. The factors that contribute to resilience include cash reserves to ensure liquidity, backup IT systems, management-succession plans, crisis-management teams, and strong relationships with business partners and the government.[47]

TXU, a Texas-based utility company, offers a good example of an effective approach to considerable uncertainty after its near-collapse in 2002, following years of falling wholesale electricity prices. Since power prices in Texas are based on natural gas prices, TXU faced a significant natural gas exposure compared with other oil and gas companies in the U.S. In addition, the company was highly leveraged and burdened with a negative outlook from credit-rating agencies, meaning it had limited access to capital. One way to respond would have been to hedge strongly and directly against natural gas prices and move as quickly as possible to pay down debt. The new CEO chose a more aggressive strategy. John Wilder determined that the company was in fact already hedged: By staying in the generation business (which many competitors exited), the company would be able to retain a reliable source of supply should wholesale prices rise. And the company could survive a retail electricity-price downturn if it could support its existing (and suddenly high) retail prices through strong marketing (as, in fact, it did).

Essentially, Wilder hedged – but internally. Obviously, however, such a strategy could not have been undertaken without ensuring the company could withstand the potential shock of a significant rise in the cost of the feedstock that TXU's generators used. Accordingly, Wilder divested noncore businesses and used the proceeds to pay down debt. Along with outsourcing and oper-

ational improvements, this created $18 billion of value for the company by May 2004. More important, the company would have had significant reserves to keep itself in business had events gone against it.

Probably the most famous example of the successful management of uncertainty is Shell's long-standing use of scenario planning, which has been applied to world-changing events ranging from the first oil-price shock to European integration to the collapse of the former Soviet Union. Using global scenarios to put the possible macroeconomic frameworks in place, the company narrows the strategic funnel by analyzing both demand trends in specific energy markets and the strategic behavior of competitors. It also conducts a risk analysis that cuts across all the major elements that affect the company: technological, regulatory, environmental, and so on. For example, in its 2004 group strategy review, Shell's executive committee outlined several key strategic decisions based on scenario planning, including increased capital spending on exploration and production of oil and gas against the background of a higher price outlook, and redeploying capital to new growth markets in line with the expectation that Asia's share of oil consumption would rise to approximately 40% by 2010. Shell continues to use scenario planning to gain a better understanding of critical uncertainties in the interplay of technological, regulatory, environmental, and supply factors, and combines these scenarios with a real-options valuation approach for selecting individual investment projects.

ORGANIZING FOR SUCCESS: PUTTING THE RIGHT INFRASTRUCTURE IN PLACE

In accordance with a premise of this paper – that each company's situation is unique – every company will need a different organizing structure to integrate analysis of the four forces into its activities. Nevertheless, a number of broad recommendations can help companies establish an infrastructure that both protects and allows them to benefit from shifts in the four forces.

Three elements of such an infrastructure are worth particular attention: roles, processes, and incentives.

Roles

All companies should establish clear organizational responsibilities to ensure that the four forces are assessed holistically. The key elements are a central risk management group and a senior management committee charged with looking beyond next year's planning process. At least yearly, and more often for industries in flux, the group should scan the environment for all potentially relevant factors and should examine how the four forces might interact: What large-scale social changes are under way in the world? How might these changes affect the company's industry and the company itself? What specific uncertainties must be accommodated in the

planning process? What should the company do with regard to uncertainties it cannot currently identify? What are the implications for action?

The senior management committee should be supported by executives designated to track the four forces on an ongoing basis. Most companies will have a chief strategy officer, whose job should explicitly include analyzing global as well as company and industry factors. A chief risk officer should be tasked with managing risk at the enterprise level, identifying uncertainties that must be addressed. In addition, chief knowledge officers can fight the insularity that keeps crucial knowledge outside a company's walls. Chief learning officers should focus on building capabilities. These functional leaders should not operate independently, but rather as part of the overall risk management group or senior management committee, providing input into decisions made collectively by the senior management team.

Senior management attention at the center is critical. But mechanisms are also required that will make sure that these monitoring functions operate at the business unit level as well – they may be performed by the director of strategic planning for each business unit, for example – and that the information is both used at the business unit level and fed back to the corporate center. Our discussions made it clear that what corporate sees is often invisible to business units and vice versa.

To ensure that all relevant business unit and corporate roles are taken seriously, companies should establish reporting relationships that go clearly and quickly to the top. Ideally, the senior-most roles in these areas would report regularly to the CEO and to the board of directors. Several of those we interviewed indicated that success in the kind of management approach we advocate here is highly correlated with the participation of the chief executive and the board. When the board becomes involved in the information flow, concrete action is much more likely to be taken. For example, the leadership team of a diversified manufacturer recommended that the next board meeting take place in its fastest-growth market – in this case, China – rather than in New York City. The direct exposure to the Chinese market created by this decision resulted in significant global operational changes in talent policies and in risk mitigation related to China sourcing.

Finally, companies must ensure that middle management is sufficiently involved. Our interviews revealed that if role definitions connected to monitoring the four forces are limited to senior levels, organizational change, of which middle management is the linchpin, will not take hold. Below, we offer more detail on incentives that will motivate middle management to focus on the four forces.

Processes

Companies must regularly reassess priorities and strategic direction in a dynamic fashion that draws on evolving performance data and external information. Processes of this kind must go beyond addressing the minimum requirements for legal or regulatory compliance to simulate the projected impact of risks on corporate performance, using key financial indicators such as cash flow and earnings at risk. These simulations must determine the risk-return profiles of

strategic actions under consideration. How do they compare with those that investors wish to see implemented? How do they compare with those that competitors are taking? Although five-year plans are fortunately a thing of the past, even yearly plans must be supplemented by a dynamic, continuous process of this kind.

Finding the resources and the focus to maintain such a process is hard. One way to make it easier is to think of a company's activities as a portfolio of initiatives in need of constant updating as the company responds to change. One of the advantages of the Firm's portfolio of initiatives (POI) framework is that it can be used to manage all types of initiatives, from entering new markets to building capabilities.[48] In a POI process, each initiative is revisited, new initiatives are introduced, and the whole slate is reprioritized, all on a regular and frequent basis. Each time the slate is reviewed, the company must ask itself if the context that governed its most recent set of decisions is still valid – and if not, how the context has changed and what the implications of those changes are. This requires constant dialogue among the agents leading these efforts.

Such a process essentially amounts to a frequent reexamination of the company's strategy. To some extent, this can be facilitated by technology capable of sifting through large amounts of information in search of meaningful patterns (for example, a pharmaceutical R&D unit might automatically monitor the latest bibliometric and technometric results of a particular research program to assess whether or not a breakthrough that might change its strategy is likely to occur). But there is no substitute for human involvement in this process.

Consider the case of DSM, a Dutch specialty-chemical concern that completely revamped its strategic-planning process. In the 1990s, the company introduced business strategy dialogues, a new process aimed at developing an in-depth understanding of the broad environment in which DSM was operating, so that the company could tailor its strategic posture accordingly. In addition to collecting comprehensive information about market and competitive dynamics, the approach also involved a formal facilitator and challenger, whose task was to stimulate the generation of a wide range of strategic options and to question the assumptions and analyses underlying the company's strategy in light of new trends. To monitor implementation of these insights in its market-facing activities, the company creates strategic value contracts that contain performance indicators such as market share, customer satisfaction, and cost per unit for each initiative. Poor indicator results spur a revision of the strategy.[49]

Incentives

Finally, as noted above, it is important to put in place performance measures and incentives that will ensure middle managers pay attention to the four forces. Senior managers often have stock options and other long-term incentives. It is middle managers who are most at risk of focusing on the short term and ignoring broader forces at work. We also know from discussions with large global financial and audit companies, manufacturing conglomerates, infrastructure

companies, and regional real estate developers that their weakest link is usually the middle rung of management – weakest in acting to identify and take advantage of external forces or to mitigate risks to their businesses. These issues often seem too far away from such managers' daily roles. Middle managers are also not rewarded for spending time identifying where the next force is going to come from. This needs to change.The companies we see in the vanguard are those that have instituted longer-range incentive measures. Such measures should include both quantitative as well as qualitative elements.

Quantitative elements might involve extending the reward structure beyond a company's fiscal year: Middle managers should be rewarded for delivering on performance over two years, three years, and, for some businesses, even up to five years, rather than just quarterly or annual profit growth (just such a mechanism has been suggested to address some of the dysfunction in the banking sector today). In this way, managers quickly become motivated to introduce and track longer-term factors that can affect their business unit's performance. The longer the wait before profitability is realized, the larger the reward should be. Where turnover is high, mechanisms must be designed that reward a long-term perspective by translating into shorter-term signals the indications that such a perspective is being taken, and noting whether or not action likely to lead to incremental profits or cost savings follows. This way, executives can be rewarded even if they are not there to see the ultimate results.

Some of the companies we interviewed have incorporated qualitative elements as well. Here, the most important variable is ideas – ideas that, after an appropriate gestation, lead to opportunity and future profit. An East Asian global electronics manufacturing company uses idea competitions and handsomely rewards ideas that are ultimately implemented – and that generate revenue or cut costs. One recruiting middle manager was rewarded for recognizing the need for a change in hiring requirements because of different subject emphases across universities in East Asia. The company shifted its recruiting focus to countries that emphasized the subjects most relevant to the company, simultaneously improving its level of talent and reducing its recruiting cost. Another company looked at the number and severity of risks identified and averted by a manager's preparations over three years. A third financial services company regularly rewards middle managers for identifying new market niches in the ever-more-minutely segmented body of high-net-worth individuals seeking new financial instruments to protect and enhance their wealth.

* * *

As consultants, we should always have all four forces in mind when speaking with clients. Instead of starting each client relationship by focusing only on our fields of specialization, we must help our clients think more broadly about the forces at work on their companies, including the next unforeseen turn, the next setback, the way the next global or industry-specific trend may threaten the company's core business or present a new one – and how the company's capabilities might best be deployed to handle the situation.

Different managers have different perspectives on where they would prefer the CEO to focus. They may never come to agreement on how all forces influence one another and how much of the company's resources should be dedicated to each. As consultants, we can give them guidelines for more unified action, but we cannot guarantee that we will produce perfect consensus. If we persuade them that they must think about all four forces rather than just company capabilities and industry attractiveness, put in place the roles, processes, and incentives that will allow them to stay abreast of developments among the four forces and prioritize their response accordingly, and persuade them to support the whole operation by improving the information provided to senior executives, we will have done our job.

ENDNOTES

1 Marvin Bower, *Perspectives on McKinsey,* McKinsey & Company, 1979, p. 15.

2 The genesis of the Touchstone was the Single Business Leadership (SBL) Strategy Project started in 1988 under the leadership of Dick Foster. One effort of the SBL, led by Kevin Coyne and Roger Ferguson, was to develop an integrated view on business unit strategy, which included a number of important strategy frameworks such as the strategic game board, the value delivery system, and the structure-conduct-performance model application. The Touchstone has been updated several times over the past couple of decades and continues to be an important framework for business unit strategy development.

3 Thomas J. Peters and Robert H. Waterman, Jr., *In Search of Excellence: Lessons from America's Best-Run Companies,* New York: Warner Books, 1982, pp. 9-11.

4 BCG devised the "growth/share" 4-box matrix in the late 1960s and early 1970s. At the time, GE was looking at concepts and techniques for strategic planning. They liked the visual approach to depicting the positioning of a company's businesses but objected to certain limitations of the matrix. GE accordingly asked McKinsey to develop a portfolio approach with a wider dimension than that of the BCG matrix. In 1971, the Firm developed a business screen that would allow GE to differentiate the potential for future profit in each of its 43 strategic business units. This GE matrix is also known as the industry attractiveness/business strength matrix and the 9-box matrix.

5 Michael Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors,* New York: Free Press, 1980, p. 6.

6 This is why in 2000 the functional capability groups, under the direction of Ron Hulme, embarked on an ambitious research agenda called the Corporate Performance Special Initiative (CPSI) that reemphasized the general management approach to consulting. The initiative led to the development of BASICS (an acronym for "Build new business, Adapt the core business, Shape the industry, Influence and Communicate with stakeholders, and Set the pace of change") and Lowell Bryan's portfolio of initiatives framework.

7 Even similar frameworks can have conflicting messages: Harvard Professor Pankaj Ghemawat describes a study in the 1970s where 4 different portfolio techniques applied to a group of 15 strategic business units resulted in only 1 unit falling into the same portion of each of the 4 matrices – with the overall success rate only slightly higher than random classification ("Competition and Business Strategy in Historical Perspective," *Business History Review,* 2002). We expect that the results would be similar if we applied a range of today's newer frameworks to the same businesses.

8 Phil Rosenzweig, *The Halo Effect … and the Eight Other Business Delusions That Deceive Managers,* New York: Free Press, 2007.

9 Additional useful works on context include Tsun-yan Hsieh's discussion of the concept in "The Zen of Organization: A Perspective for the Disciplined Practitioner," Staff Paper no. 63 (ID# 715151), and the material referenced in note 5.

10 Tom Davenport, "A Meeting of the Minds," *CIO,* September 15, 1997. Quoted in Jeffrey Pfeffer and Robert Sutton, *Hard Facts, Dangerous Half-Truths and Total Nonsense: Profiting From Evidence-Based Management,* Boston: Harvard Business Press, 2006.

11 Persefoni Tsaliki and Lefteris Tsoulfidis, "Alternative Theories of Competition: Evidence from Greek Manufacturing," *International Review of Applied Economics,* May 1998, vol. 12, no. 2, pp. 187-204.

12 Smith's famous *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) is generally considered the first modern work on economics. It focuses on the three main concepts that form the foundation of free market economics: division of labor, pursuit of self-interest, and freedom of trade. David Ricardo is famous for *Principles of Political Economy and Taxation* (1817), which is important for the labor theory of value and the theory of comparative advantage, which argues that countries should specialize only in what they are best at producing.

13 Despite the profundity demonstrated by both Smith and Ricardo, their work also marks the beginnings of a tendency toward simplification that has limited the predictive power of economics. The most famous of these tendencies is the assumption of the rational man, *homo economicus,* in economic theory. The absence of pure rationality in economic decisions has, in turn, recently led to the whole new discipline of behavioral economics.

14 It should not be thought that the classical economists were immediately followed by their neoclassical descendants. Here, as always, neoclassical indicates a kind of return to something of "classic" status after a field has departed from it. Classical economics was in significant part based on the idea that the value of a product depended on what it cost to produce it. Later economists departed from this view by emphasizing what value, or "utility," a consumer placed on the product in question, a view associated with the utilitarianism of John Stuart Mill. A further step away from classical economics came in the form of the marginal theory of value, which posited that consumers made decisions based on the "marginal" value of products. Thus, a consumer would place greater value on a dining room table if he did not already own one. The emergence of neoclassical economics traditionally dates from William Stanley Jevons's *The Theory of Political Economy* (1871), Carl Menger's *Principles of Economics* (1871), and Leon Walras's *Elements of Pure Economics* (1874-1877).

15 The work of Alfred Chandler bears further discussion. In his seminal book, *Strategy and Structure,* Cambridge, Mass.: M.I.T. Press, 1962, he posited that management first spends a significantly large portion of time on strategy. It then organizes and deploys available resources to implement the strategy. Later, he demonstrated through a series of case studies that strategy also gave companies focus. In 1977, he reinforced this notion in his book *The Visible Hand,* Cambridge, Mass.: Belknap Press, in which he established the power and practices of management in general. In 1990, in *Scale and Scope,* Cambridge, Mass.: Belknap Press, he studied the way in which corporations operated in the U.S. and also in Europe (Britain and Germany, in particular), demonstrating that strategy and management were also influenced by cultural and other influences at the national level. In 2001, in *Inventing the Electronic Century,* New York: Free Press, he added the influence of prior knowledge and capabilities as influencing the role of strategy and management in defining the activities of the company. We would assert that Chandler was the first to acknowledge explicitly that forces outside of company and industry can affect performance.

16 Michael Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors,* New York: Free Press, 1980.

17 Edith Penrose, *The Theory of the Growth of the Firm,* New York: John Wiley & Sons, 1959. Birger Wernerfelt, "A Resource-Based View of the Firm," *Strategic Management Journal,* April-June 1984, vol. 5, no. 2, pp. 171-180.

18 Jay Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management,* March 1991, vol. 17, no. 1, pp. 99-120. There are many definitions of rent (Ricardian rent, monopoly rent, etc.). A succinct one is as follows: Rent represents payments to a factor of production (that is, an input in the production process of a typical company) that are in excess of the amount necessary to keep it in its current employment. This raises the question of why there should be any excess at all. The answer has to do with the forces that can result in a price above "market value" being paid for something. These forces may be political, or they may derive from monopolies – anything, in short, that disrupts the workings of an efficient market.

19 Gary Hamel and C. K. Prahalad, "The Core Competence of the Organization," *Harvard Business Review,* May-June 1990, vol. 68, no. 3, pp. 79-93, and *Competing for the Future,* Cambridge, Mass.: Harvard Business Press, 1996. This point of view is also reflected in Jim Collins, *Good to Great: Why Some Companies Make the Leap … and Others Don't,* New York: HarperBusiness, 2001, and in Collins, *Built to Last: Successful Habits of Visionary Companies,* New York: HarperBusiness, 1994.

20 Richard Rumelt, "How Much Does Industry Matter?" *Strategic Management Journal,* March 1991, vol. 12, no. 3, pp. 167-185. Key percentages summarized in Gabriel Hawawini, Venkat Subramanian and Paul Verdin, "Is Performance Driven by Industry- or Firm-Specific Factors? A New Look at the Evidence," *Strategic Management Journal,* 2003, vol. 24, no. 1, pp. 1-16. Table 3, from which the figures come, is on p. 12. Note that Rumelt's methodology, which was later used by Anita McGahan and Michael Porter, as well as by Gabriel Hawawini, measures factors, not all of which management can influence. But if management can influence some of these factors even modestly, substantial differences in profits can result.

21 Anita McGahan and Michael Porter, "How Much Does Industry Matter, Really?" *Strategic Management Journal,* July 1997, vol. 18, pp. 15-30.

22 McGahan and Porter, "The Persistence of Shocks to Profitability," *The Review of Economics and Statistics,* February 1999, vol. 81, no. 1, pp. 143-153.

23 Hawawini, Subramanian, and Verdin, "Is Performance Driven by Industry- or Firm-Specific Factors?" In this study, Hawawini also used three dependent variables: return on assets, economic profit/capital employed, and total market value/capital employed, finding little difference in the results.

24 McGahan and Porter, "The Emergence and Sustainability of Abnormal Profits," *Strategic Organization,* February 2003, vol. 1, no. 1, pp. 79-108.

25 It is worth noting that in a recent *McKinsey Quarterly* article, "The Elusive Goal of Corporate Outperformance," it was shown just how difficult it is to sustain performance over time. Selecting revenue growth and profitability as the measures of performance, the authors used nonparametric statistics to pick companies that qualified as high performing over a sustained period of time and astonishingly found that only 9 companies out of over more than 3,000 listed companies were able to sustain both high growth and high profitability over a 10-year period. And the list of the companies that did manage to sustain performance looks different from the more popular lists derived from the rankings of the popular press, including companies such as Danaher, Walgreens, Harley-Davidson, and Capital One. While the article's assessment does not differentiate between how company and industry forces affect sustainable performance in the long term, to the extent that performance is measured by profitability and growth, performance is clearly a difficult phenomenon

to sustain. The study does not suggest that managers cannot affect performance. There is ample evidence that managers can and do affect performance all the time. But, while their short-term effects are clear, the longer-term effects are clearly a challenge to sustain. For more, see Janamitra Devan, Matthew B. Klusas, and Timothy W. Ruefli, "The Elusive Goal of Corporate Outperformance," *The McKinsey Quarterly* 2007 Number 3 (ID# 726821).

26 This is readily visible in Andrew Doman, John Stuckey, and Rob Thwaites, "Distinctive and Leverageable Competences," Staff Paper no. 53, 1992 (ID# 607557), and in Jessica Hopfield and Stuckey, "Configuring the Corporations of the Future: The New Microeconomics of Strategy and Organization," Staff Paper no. 59, 1999 (ID# 510675). It is also discussed at greater length in Lowell Bryan et al., *Race for the World: Strategies to Build a Great Global Firm,* Cambridge, Mass.: Harvard Business Press, 1999. All three of these publications emphasize the increasing importance of differences among companies' capabilities, and in particular, the increasing importance of intangibles as globalization takes hold.

27 Hopfield and Stuckey, "Configuring the Corporations of the Future." More generally, John Stuckey also put forward a magisterial discussion of the various forces that should drive a successful strategy in "Perspectives on Strategy," Staff Paper no. 62, April 2005 (ID# 710000), to which this paper is heavily indebted.

28 Lowell Bryan and Claudia Joyce, *Mobilizing Minds: Creating Wealth From Talent in the 21st Century Organization,* New York: McGraw-Hill, 2007, p. 11.

29 Mehrdad Baghai, Sven Smit, and Patrick Viguerie, "The Granularity of Growth," *The McKinsey Quarterly* 2007 Number 2 (ID# 726928). This does not make a definitive case about the drivers of profitability, of course, as growth is only one piece of the story (and arguably the profit driver that is most influenced by industry).

30 Stuckey, "Perspectives on Strategy," pp. 15-16.

31 In the development of our own thinking on global forces, we would like to acknowledge the importance of *Race for the World,* by Lowell Bryan, Jane Fraser, Jeremy Oppenheim, and Wilhelm Rall, Boston: Harvard Business School Press, 1999, and the work of McKinsey's Global Forces team. Our discussion of uncertainty is significantly indebted to that of Martin Pergler and Eric Lamarre, both of McKinsey, and Hugh Courtney, of the University of Maryland, and also an alumnus of the Firm.

32 See Rumelt (1991) and Hawawini (2003). It is true that these two additional factors appear to some degree in academic analyses. For example, most of the academic estimation models discussed above use a variable to represent year-to-year macroeconomic conditions that are assumed to influence all companies in the same way. Unfortunately, macroeconomic conditions are only a weak proxy for global forces, as they are annual in form, while global forces can act over several years. The analyses also talk about the "unexplained" portion, or the "error" term, that captures the fluctuations of performance attributed to shocks, or for that matter, any other variables not easily observed empirically. As McGahan and Porter (1997) explain it, "the error arises because profits are subject to shocks, a portion of which may carry from one year to the next." But the analyses don't provide much guidance on what these shock factors include, how important they are, and how to deal with them.

33 Thomas Friedman, *The World is Flat: A Brief History of the Twenty-First Century,* New York: Farrar, Straus and Giroux, 2005, pp. 128-141.

34 Angela Moore, "Women Over 35: An Untapped Market," Reuters Web site, us.labs.reuters.com, September 29, 2005.

35 "Shareholder Scoreboard: The 50 Best Performers," *Wall Street Journal,* February 27, 2006.

36 See Scott C. Beardsley, Sheila Bonini, Lenny Mendonca, and Jeremy Oppenheim, "Bringing Society Into Strategy: The 5 R Framework," Staff Paper no. 64, 2006 (ID# 721725).

37 The team thanks Piotr Kulczakowicz for contributing this sidebar. For a more detailed discussion of shocks and how companies should respond to them, see Janamitra Devan, Abhijeet Dwivedi, and Tsun-yan Hsieh, "Shocks: Capitalizing on a Nemesis" (ID# 736758).

38 Adarsh Pandit and Elizabeth Stephenson, "How Companies Act on Global Trends: A McKinsey Global Survey," *The McKinsey Quarterly* April 2008 (ID# 736059).

39 For more on resource allocation, see Massimo Garbuio, Dan Lovallo, and Patrick Viguerie, "The Political Landscape in Resource Allocation Decisions." Unpublished article.

40 Patricia Clifford, Kevin Coyne, and Stephen Hall, "Is Your Core Competence a Mirage?" *The McKinsey Quarterly* 1997 Number 1 (ID# 514171).

41 See Wendy Becker and Elizabeth Stephenson, "Challenge, Imagine, Build: From Global Trends to Business Transformation" (ID# 726434), and Becker, "Transforming Strategic Mindsets: Challenge, Imagine, Build" (ID# 716967).

42 Eric Lamarre, Martin Pergler, et al., "Corporate Risk Initiative: Risk Basics" (ID# 715623).

43 Sherry Cooper, "A Preview of Disruption," *Harvard Business Review,* May 2006, vol. 84, no. 5, p. 36.

44 Hugh Courtney, Jane Kirkland, and Patrick Viguerie, "Strategy Under Uncertainty," *Harvard Business Review,* November 1997, vol. 75, no. 6, pp. 66-79. Courtney eventually expanded the topic into a book, *20/20 Foresight: Crafting Strategy in an Uncertain World,* Boston: Harvard Business Press, 2001.

45 Eric D. Beinhocker, *The Origin of Wealth: Evolution, Complexity, and the Radical Remaking of Economics,* Boston: Harvard Business Press, 2006, pp. 335-336.

46 But "Perspectives on Strategy" offers advice on how a company may profitably diversify. See note 27, above.

47 For more on resilience, see Hsieh, "The Zen of Organization," and Aaron de Smet, Mark Loch, and Bill Schaninger, "Improving Enterprise Health: Achieving Sustainable Excellence by Managing Performance and Health" (ID# 718062).

48 Charles Roxburgh, "Corporate Strategy: Old and New Perspectives" (ID# 615379). For more on POI, see Lowell Bryan's "Strategy as a Portfolio of Initiatives," Staff Paper no. 61, 2005 (ID# 707511).

49 Marjolein Bloemhof, Philippe Haspeslagh, and Regine Slagmulder, "Strategy and Performance Management at DSM," in *Management: An Introduction,* ed. David Boddy, London: Pearson Education, 3rd ed., 2005, pp. 167-192.

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