1.1

THE NEED FOR SMART STRATEGY

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Why Strategy?

Without a goal in life, it is tough to achieve much. Mindless wandering rarely delivers great results. As the Cheshire Cat said in Lewis Carroll's *Alice's Adventures in Wonderland*, ''If you don't know where you are going, any road will get you there.'' [1]

The goal of any business is to deliver **superior sustainable performance**. ''Performance'' means return on investment; firms are in business to make a profit. ''Sustainable'' means profit over the long term rather than to meet the next quarterly earnings targets. It's easy to deliver a short-term burst of profits by failing to invest for tomorrow and stealing from future performance. Delivering a sustainable stream of income is much harder. ''Superior'' means better than competitors; firms who always strive to win are less likely to be blindsided by competition, and more likely to survive and prosper. Winners also gain better access to resources (e.g. people, capital), increasing sustainability.

To deliver superior, sustainable performance firms need a *good* strategy. This requires good strategy formulation: the integration of choices on where and how to compete. It also depends on good strategy implementation: the marshalling of resources and integration of actions to deliver the strategy. Formulation and implementation both require good leadership to ensure that the right choices are made, the right assets are deployed and the right actions are taken.

Why Smart Strategy?

There is no such thing as strategy in isolation; it must be consistent with the competitive environment. This is always changing, so strategy must

change too. Firms must constantly be steering purposefully in a winning direction; this is the definition of Strategic IQ. Those with moderate IQ keep up with the pack, but the smartest firms don't simply react to change; they drive it, shaping the competitive environment to their advantage. To do this, they need *smart* strategy.

Firms that fail to change their strategies in a timely fashion put themselves in grave danger. The longer the delay, the bigger the strategic problems become and the harder they are to fix. The more a firm invests in tactical responses that do not address the underlying strategic problems, the more resources are diverted from much-needed strategic change and the more the firm is distracted from the strategic issues it should be addressing.

It is easy to get caught in this trap. Sales and profits can continue to grow for many years before strategic weaknesses show through. Firms become complacent and defer expensive and painful changes until later. But once financial results collapse, shareholders have little patience with investing heavily in solving long-term problems; they want a quick fix. It becomes very difficult to make the necessary changes and the firm struggles on, squeezed between impatient investors and an increasingly hostile competitive environment until it finally fails. Far better to diagnose the disease early and treat it before it becomes critical; better still to avoid catching it at all. **Part One: Smart Strategy** of the book aims to help firms to do this.

In this chapter, we provide an overview of **Part One**. We examine the pathology of strategic inertia and identify a number of levels of Strategic IQ. We start with firms demonstrating low IQ: they either don't know what strategy is or are incapable of changing it. This begs the question ''What is Strategy?'' We address this briefly. We then move on to firms with moderate IQ, which have recognized the need for strategy and are developing skills in strategy formulation and execution. Finally, we identify those with high IQ, constantly striving for better strategy. The remaining chapters in Part One examine each of these topics in more detail.

Low Strategic Intelligence

Developing and implementing a strategy is a non-trivial task, so it is not surprising that firms are reluctant to change once they have discovered one that works. But for some the problem is deeper than this; they've never had a strategy and don't know what one is; they deliver profitable growth

without really knowing why. They are the **strategically blind**, **blissfully ignorant** and sit at the bottom of the Strategic IQ ladder.

It may seem amazing to some that firms without a strategy can do well, but it is often easy to grow sales and profits when there is little competition; all ships rise on a rising tide. When competitive pressure rises, the need for strategy becomes more apparent, but the blissfully ignorant don't know how to deal with it. And when profits are suffering, it is harder to invest time and money in figuring out what to do. **The time to develop a strategy is before you realize you need one**.

There are other forms of strategic blindness. Some firms play **let's pretend** and fool themselves that they have a strategy, using all the jargon, but what they are doing has precious little to do with building and sustaining competitive advantage. Then there are those with **strategic amnesia**; they once had a good strategy but have forgotten it and are now running on autopilot. All of these firms are strategically blind; they don't really know what their strategy is, so it is tough for them to know when to change it or how to do so. The challenge is to open their eyes to the need for strategy and build commitment to developing one.

The next rung on the ladder of low Strategic IQ is the peculiar behaviour of **strategic denial**. Such firms are wilfully blind; they have a clear strategy that has worked for them in the past and they refuse to give it up despite the fact that they can see the need for change. Some try to ignore the data, like the proverbial ostrich with its head in the sand; others accept it but do nothing, awaiting their fate like a bunny in the headlights. Others exhaust themselves with tactical diversions such as overhead cost reductions and reorganizations in order to drive short-term profits rather than fix the long-term problem. Firms caught in denial must be encouraged to confront the fact that they have a strategic problem and accept that they must now move on to survive. They must also put mechanisms in place to prevent this behaviour from being repeated.

Strategically incompetent firms are one rung up on the IQ ladder from those who are in strategic denial, because they admit they have a strategic problem but they don't have the competence to solve it. Some firms are **lost in the dark**; everyone can ''feel'' the problem, but they don't know what it is. Others find themselves **squabbling** because there are a wide range of strongly held views on the issue and no real agreement on how to proceed. Some cannot agree on the problem, others on a solution. In either case, this

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is probably just as well since incompetence leads to poorly framed problems and ineffective solutions. In the absence of understanding and alignment, all these firms continue with the old strategy, or invest excessive effort in tactical palliatives. The firms in greatest danger are those that agree on the problem and on the solution, but don't really know what they are doing. They march off in the hope of victory even though they are headed in the wrong direction.

There is a temptation amongst the incompetent to hire consultants to develop a strategy for them. In a changing world, this doesn't solve the long-term problem because the strategy will soon need to change again. It merely creates dependence, effectively ***outsourcing to advisors*** the critical decisions on how to compete. Strategically incompetent firms must commit to building the processes and the skills needed to formulate and implement strategy for themselves. Making this commitment is the first step to moderate strategic intelligence.

The challenges of low Strategic IQ and how firms can move towards moderate strategic intelligence are discussed in more detail in **Chapter 1.2: Low Strategic Intelligence**.

What is Strategy?

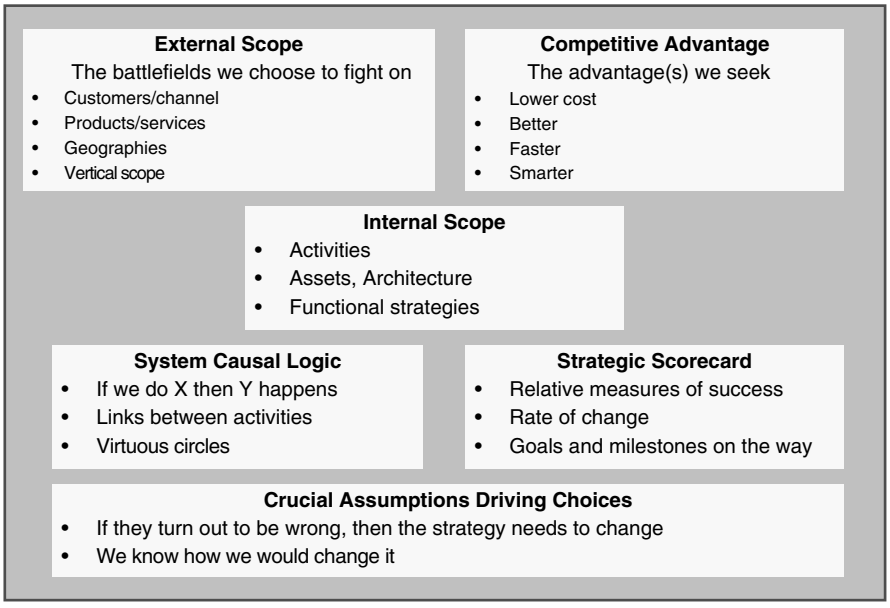
To commit to building strategic competence, firms must recognize that strategy is important and understand what it involves.

The objective of strategy is to deliver superior sustainable performance. Firms that achieve this attract more and better resources (e.g. people, investment). This makes them even more sustainable – a virtuous circle. Those that do not deliver this often wither and die. The importance of the distinction should not be lost on any firm committed to longevity.

The principles of how a company intends to deliver superior sustainable performance are captured in its strategic business model (Figure 4).[2] This summarizes the choices the firm has made about where to compete, what competitive advantage it seeks, what assets and activities it will invest in to deliver that advantage (its internal scope) and how it intends to organize these assets to do so.

The choice of where to compete is important because some businesses and business segments are more attractive than others. Firms must pick the right battlefields.[3]

Figure 4: Elements of a Strategic Business Model



But wherever they compete, they are likely to come across competitors, so they must make sure they build an advantage that will help them to win, to deliver superior profits. The two most important static advantages are lower cost and differentiation.[4] For firms with lower costs, it is relatively clear why they can make more money. Differentiation is more subtle; it means better, as defined by the customer. And to make more profits, it must also support a price premium that exceeds any extra costs involved.

Faster and smarter are two dynamic advantages. Firms that are faster to reposition to attractive battlefields or increase static advantages have an edge.[5] They can make superior profits until the competition catches up. Smarter companies look to exploit the inertia of competitors and do things that are harder to copy.[6] They also look for pathways that give them more options for the future.[7]

A firm's ability to build advantage will depend on the assets it has at its disposal and how it organizes these assets.[8] It may choose to invest in some activities and let third parties perform others. The objective is to configure to deliver the best returns.

The strategic business model documents the causal logic of the strategy, explaining the linkages between the drivers of advantage and the level of advantage expected. For instance, a doubling in plant scale might drive unit costs down by 15%. The logic also identifies the critical interdependencies between activities to reveal the effects of each activity on overall advantage. For example, for many years, Wal-Mart used to spend more on IT than its competitors, but the overall effect of this was to reduce costs because it brought the cost of many other activities down.

In addition to the logic, firms require strategic metrics[9] showing the size of their advantage relative to competitors, the rate at which this is changing to see who is changing faster, the goals the firm has set itself and milestones along the way. Metrics help to test the veracity of the model and to ensure that everything is on track.

Ideally, the logic of a strategic business model should incorporate positive feedback loops or ''virtuous circles'', driving ever-greater advantage.[10] For instance, a firm might cut prices to increase volume. The extra volume helps to reduce cost per unit. This allows the firm to cut prices further, which drives further volume and more price cuts. This is the virtuous circle that has sustained Wal-Mart's strategy for 50 years. It is critical to Wal-Mart's business model. The more virtuous circles in the system, the more effective the strategy. Conversely, firms should avoid negative feedback loops or ''vicious cycles''. For instance, cutting quality to improve profits might have short-term benefits, but if it reduces volume and increases unit costs, then the benefit is short lived.

Finally, the model identifies the crucial assumptions on which the strategy is based. These are assumptions that drive strategic choices and require a change of strategy if they turn out to be wrong. Firms that know their crucial assumptions and are tracking them are more ready to change when circumstances demand it.

Chapter 1.3: What is Strategy? explains the principles behind strategic business models in more detail. **Chapter 1.4: Moderate Strategic Intelligence** shows, step by step, how to develop and implement one.

Moderate Strategic Intelligence

The first step on the road to moderate Strategic IQ is for a firm to make a real commitment to developing skills in strategy formulation and implementation as one of its core assets. The goal is a high level of competence. Hiring

consultants to develop a strategy does not suffice. This may provide a quick and very necessary fix, but it doesn't prepare the firm for the next time it needs to make a change, or put it on a path towards high Strategic IQ where it must constantly strive for better strategy.

Developing high strategic competence is a long and challenging journey for any firm. While individual journeys differ, firms pass through various stages of strategic enlightenment as they add strategic knowledge and skills. The earlier stages typically focus on building expertise in formulating strategy while the latter are more concerned with strategy execution. But making a commitment is the first step on the journey.

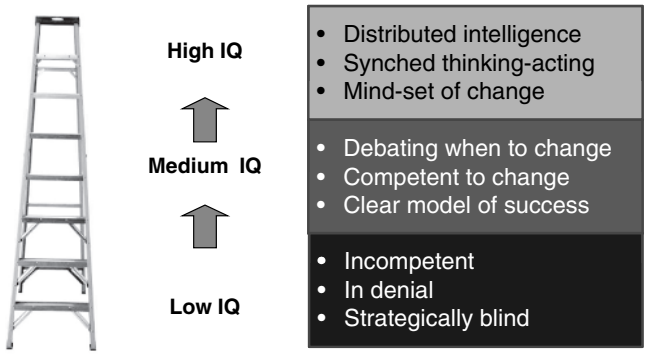
And what is the path to competence? Picture a ladder from moderate to high Strategic IQ. What state is a firm in as it stands on each rung and what skills does it take to climb to the next? At the bottom, firms recognize they need a strategy and are committed to building one, but don't know how; the ''**incompetent but committed**''. The first few steps for them focus on strategy formulation. They must learn to conduct a rigorous **external strategic review** to identify the range of opportunities offered by the competitive environment and an **internal strategic review** to test the firm's ability to exploit these opportunities. This helps build strategic awareness, but novice firms often become ''**lost in the maze**'' – overwhelmed by the detail and not knowing what to do. To climb to the next rung, they must learn how to synthesize all this information into viable ***strategic options***. A range of options is helpful, but it means the firm must now make a clear choice. Many firms get caught ''**dithering**'', not sure which path to take. They must build capacity to **make strategic decisions**.

Once the choice is made, the firm is ready to implement but some firms often forget to tell their people – the ''**secret strategy syndrome**''. The first implementation step requires **sharing and declaring**, communicating the strategy and explaining the logic behind it. This builds commitment to action and prepares everyone for change. But a **strategic change programme** is then required to redeploy assets and realign the organization, otherwise firms find themselves ''**waiting for change**''. The challenges of such programmes are discussed more fully in Part Two, but we focus on a few critical steps here. To avoid ''**flying blind**'' firms need a **strategic scorecard** with new metrics and milestones. And firms must also beware of ''**unintended consequences**'' that occur when the reward systems are not aligned with the new strategy. Once everything is working well, some firms become complacent, reluctant to

change; they get ''**fat and happy**''. Others become ''**convinced we're right**'' and refuse to change. Firms must commit to a **rigorous revision cycle**, repeating the whole formulation and execution process to keep their strategy fresh and their skills well-tuned. The firm has then reached the top of the moderate Strategic IQ scale.

A firm gets strategically smarter as it climbs the ladder (Figure 5) but the benefits grow exponentially as it rises. Good formulation is nothing without good implementation. And like all skills, firms get better with experience; the more revision cycles, the better, faster and more cost-effective they become. But there is no resting place at the top of the scale; the natural tendency is to decline. It is too easy to become complacent and slide back into incompetence, denial or even blindness. **Chapter 1.4: Moderate Strategic Intelligence** describes the climb to the top of the ladder and the challenges of staying there.

Figure 5: Climbing the Strategic IQ Ladder



High Strategic Intelligence

Many firms that reach the top end of the moderate band still view strategy as a one shot deal. The goal for them in developing a strategy is to spend a short time thinking intensely about what they should do, make the changes as quickly as possible and then switch off their strategic minds and focus on execution. If things don't turn out quite as planned, they take a quick time-out to make a correction and then get back to work. Strategy for them is a commitment to a particular course and any deviation is a

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distraction, an admission of their failure to develop a good strategy in the first place. Hence, they only change the strategy if they really need to.

But making steadfast commitments in a rapidly evolving environment is foolhardy. The environment is always changing, so firms must change too. Moderately strategically intelligent companies execute their strategy until they see the need to change it. For them, the critical question is *when* to change. For firms of superior strategic intelligence, this question is not relevant; they are always changing.

Firms in this **mind-set of change** see strategy as a dynamic, on-going process rather than a one shot deal. The distinction between formulation and implementation disappears, and everything is addressed strategically. The firm is always looking to increase advantage, thinking and acting at the same time.[11] The processes that drive better strategy are developed as a cherished asset and embedded in the architecture of the firm. Firms develop a fast, efficient and effective process for strategic change and work tirelessly to improve it. They allocate resources to the change process and are financially disciplined in their approach, always expecting a payback from their efforts. And they measure, reward and celebrate change and rate of change of key strategic metrics.

High IQ firms are never satisfied with their current model. Everyone in the organization is looking for strategic improvement. They are driven by lofty and inspiring goals to deliver higher performance, always seeking to improve their current model while setting aside time and resources to test radical new approaches. They generate many strategic options and superior decision-making processes for choosing between them. They seek to align their organizations continuously by focusing on measures correlated with strategic success and rewarding those who deliver it. And they operate on the edge, always prepared to change and learn from experience.

For a top management team that insists on driving all strategic changes from the top, the concept of a continuous search for better strategy is daunting. Even when reviewed every few years, strategy absorbs a lot of top management time; doing it more frequently can quickly overwhelm the top management team. However, this capacity constraint can be relieved by integrating everyone down to the front line in strategy, **distributing strategic intelligence** throughout the organization. This dramatically increases the number of people on the look-out for strategic threats and opportunities, shaping options, making choices, developing metrics, executing change.

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Properly organized, distributed intelligence provides more change capacity and leads to more timely, efficient and effective changes. But it requires a business model that distributes strategic decision rights, training and reward systems to make sure that decisions are made in the best long-term interests of the firm and information systems that support the distributed decisions and allow top management to track what is going on in order to reassure shareholders that everything is under control.

Chapter 1.5: High Strategic Intelligence describes in more detail how a firm that has developed strategic competence can break through into the upper echelons of the Strategic IQ scale.

Notes

1. Carroll (1865).
2. Magretta (2002) emphasizes the importance of a business model to success; once competition is included, it becomes a strategic business model.
3. Porter (1980) provides a robust framework for identifying attractive battlefields.
4. Porter (2004) identifies lower cost and differentiation as the key sources of competitive advantage and describes how they are built.
5. Stalk and Hout (1990).
6. Yoffie and Kwak (2001).
7. Luehrman (1998).
8. The resource-based view of strategy specifically addresses the firm's assets and how they can provide competitive advantage (Hamel and Prahalad, 1989; Montgomery and Collis, 1998).
9. Kaplan and Norton (2000).
10. Casadesus-Masanell and Ricart (2007).
11. Paparone and Crupi (2002).