Strategizing Realistically in Competitive Environments

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Abstract: Statistical evidence indicates that formal strategizing makes insignificant contributions to profits. First, formalization undercuts the value of strategizing. Second, nearly all managers hold very inaccurate perceptions of both their firms and their market environments. Third, no one can forecast accurately over the long term. Fourth, fundamental barriers make it very difficult to attain high profits through strategic actions. However, strategists can make strategizing more realistic and can use it to build healthier, more alert and responsive firms. They can try to develop and exploit distinctive competencies, entry barriers, and proprietary information; they can use forecasts to foster alertness; they can help managers to develop more realistic perceptions; and they can strategize in ways that make it easier to change strategies later.

‘Let me make one thing perfectly clear . . . ‘

This article advances an iconoclastic argument — that formal strategizing generally makes no important contributions to profits. This argument has four bases: One is the formality with which most firms strategize; formalization undercuts formal strategizing’s potential value. A second basis is the existence of fundamental barriers to achieving measurable gains through forecasting and strategizing; these barriers mean that strategizing usually cannot have visible, intended effects on profits. A third basis is the high frequency of large errors in managers’ perceptions of their own firms and their market environments; when managers strategize, most of them are trying to run imaginary firms in imaginary markets. A fourth basis is the impossibility of making accurate long-range forecasts and thus of anticipating the consequences of strategies.

It is possible for formal strategizing to help firms to operate more effectively. To do so, however, the strategizing must preserve uncertainty and allow for contingencies. This, in turn, implies that strategists should not take their activities too seriously, and they should advocate common sense in a world that often shuns it.

What does research evidence say about the effectiveness of formal strategizing?

‘The war in Vietnam is going well and will succeed.’

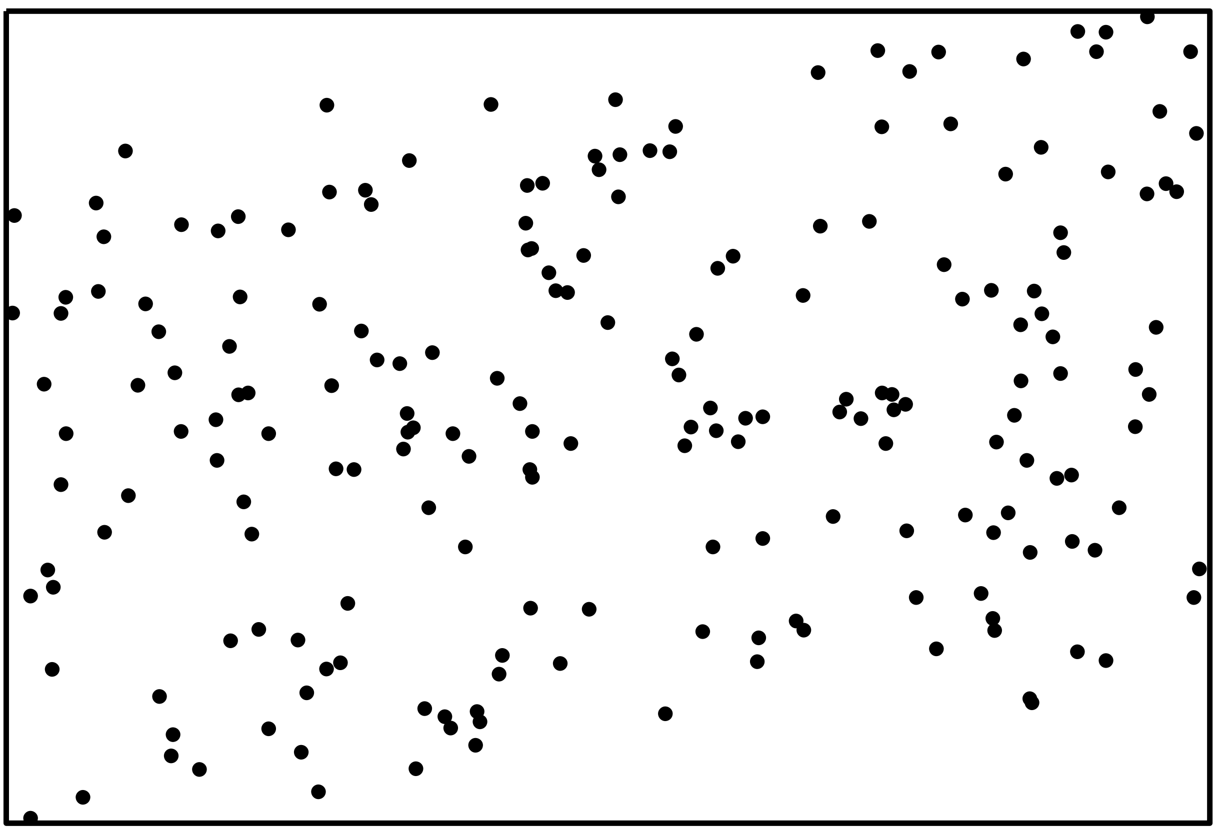
— Robert McNamara, U. S. Secretary of Defense, 1963

Everyone does some strategizing informally and strategies are often beneficial. The practical issue is: How much better is it to strategize *formally*?

Formal strategizing is a social process as well as an intellectual one. It involves meetings, discussions, negotiations, and commitments. It builds consensus about perceptions, goals, and roles and it creates rationalizations to support strategic actions.A few years ago, I ran into a surprise when I surveyed the research evidence about the benefits of formal strategizing. Many studies had examined the relationships between formal strategizing and profitability. A few of the earliest studies had found strong correlations between profitability and the degrees to which firms used formal methods of strategizing. However, these early studies had used quite poor methodology, so researchers responded by making more studies that used better methodology. As the research methods improved, the observed correlations between profitability and formal strategizing declined toward zero. The best research shows that, on the average, formal strategizing does not increase profits enough to be practically useful.

Probably the best study of this topic is one by Grinyer and Norburn (1975). They studied only 21 firms, but they chose these very carefully and gathered valid and extensive information from several executives in each firm. They made four key findings, two of which relate to the profitability of formal planning.

First, profitable firms are about as likely to strategize informally as formally, and so are unprofitable firms. Firms' profitability correlates only very weakly with the formality of formal strategizing (r = 0.22). Figure 15.1 graphs such a correlation to give a sense of its practical value.



Second, profitability correlates inconsistently and meaninglessly with the degrees to which senior executives agree about their firms' objectives or their personal responsibilities. The correlations ranged from 0.40 to -0.40.

When one first sees Grinyer and Norburn's findings, they are difficult to accept — especially if one teaches or practices formal methods of strategizing! Yet, reflection discloses that the findings do make sense: There is no reason strategizing should generally produce high profits. Consensus can be as harmful as beneficial when there is no way to assure that the objects of consensus are good.

Formal strategizing is a two-edged sword that is as likely to reduce profits as to raise them. One sees the beneficial edge when strategies reflect accurate forecasts of future events and accurate assessments of capabilities and everyone works together to achieve difficult, but possible, goals, while ignoring irrelevant distractions. This is the best of all worlds. But formal strategizing also can produce the worst of all worlds. One sees the harmful edge when strategies reflect inaccurate forecasts and assessments and everyone works intensely to achieve the wrong goals, while overlooking unexpected opportunities. The research studies imply that negative outcomes happen about as often as positive outcomes, and that formal strategizing has negligible effects on the average.

Chakravarthy and Lorange (1991) used the adjective 'integrative' to denote formal strategizing. They observed that 'integrative' strategizing works *only* when two conditions hold: (1) the business faces a predictable environment, and (2) the business has several distinctive competencies. When these conditions do not hold, they said, integrative strategizing is not only ineffective, it is counter-productive. Few businesses have several distinctive competencies that are large enough to yield significantly higher profits, and a later section of this article explains why no business can predict its environment beyond the short term.

Grinyer and Norburn made four noteworthy findings, only two of which were discussed above. The other two findings concerned strong correlates of profitability, and they imply that informal strategizing is usually more effective than formal strategizing.

- Managers in more profitable firms make greater use of informal communication, whereas managers in less profitable firms communicate primarily through formal reports ($r = 0.40$).
- Managers in more profitable firms use diverse information when evaluating their firms' performances, whereas managers in less profitable firms get their information mainly from formal reports ($r = 0.68$).

Few firms will ever be able to gain high profits from formal strategizing

'I think there is a world market for about five computers.'

— Thomas J. Watson, CEO of IBM, 1948

Four difficulties confront any firm that attempts to increase its profits significantly through formal strategizing.

First, most firms compete against skilled competitors that have access to very similar information. These competitors can either anticipate strategic moves or react to them promptly, so it is very difficult to gain meaningful competitive advantages through strategic moves.

Second, the strategies that can produce significant profits are illegal, immoral, or impractical; most businesses will not pursue them. High-profit strategies are all variations on monopoly power. Although these strategies have proven themselves very effective, U. S. laws bar nearly all monopolistic strategies, so American firms risk anti-trust actions if they adopt them. Microsoft provides an example. The legal forms of monopoly — such as patents, first moves, and geographic locations — give either small advantages or transient ones. Patents and first moves also tend to be quite expensive, so the benefit-to-cost ratios are often poor and firms do not use these strategies repeatedly for long periods.

Third, formal strategizing often emphasizes big issues involving large sums and many people. These are nearly always long-term issues, yet the long term never unfolds as expected.

Thus, strategists expend their resources on threats that never turn into actual problems and on dreams that never become real opportunities.

Fourth and most importantly, most firms use formal strategizing to build strong consensuses and to establish strong commitments. However, this use of formal strategizing makes unrealistic assumptions about people's knowledge and about their abilities to forecast accurately. Consensus is dangerous unless the strategies are very likely to produce wanted outcomes. For strategizing to produce wanted outcomes, the strategists need to have realistic perceptions of their firms' capabilities and their market environments. However, the evidence is that most managers do not have realistic perceptions of their firms or their market environments.

Nearly all managers misperceive both their firms and their market environments

'Gaiety is the most outstanding feature of the Soviet Union.'

— Joseph Stalin, 1935

Managers' subjective perceptions often diverge widely from objective observations. Of course, some managers see some aspects of their worlds accurately. However, most managers misperceive so greatly that, averaged across many managers, their perceptions correlate hardly at all with objective data.

Payne and Pugh (1976) compiled data that suggest that most people (including managers) see their own firms inaccurately. Payne and Pugh reviewed roughly 100 studies in which researchers had asked firms' members to characterize their firms' structures and cultures. They surmised:

Different members of a firm disagree so strongly with each other that it makes no sense to talk about an average perception.

Members' perceptions of their firms correlate very weakly with measurable characteristics of their firms.

I was reassured to learn, as you may be, that people *do* know whether they are working in large firms or small ones!

John Mezias and I (2003) observed senior managers' perceptions of quality performance in four divisions of a very large company that had made quality improvement a top priority. The company had trained nearly all managerial personnel in quality, and each business unit had a quality improvement department. The company distributed quality measures to all managers frequently, and managers met regularly to discuss quality performance in their divisions. Yet, when we asked them about current levels of quality performance in their divisions, 49 to 91 percent of the managers reported 'I don't know'. Although the managers who thought they knew the current levels of quality performance were often fairly accurate, the managers who specialized in quality were no more accurate than the non-specialists.

Two studies have inadvertently produced disquieting evidence about the accuracy of managers' perceptions of their market environments. Both studies asked middle and top managers to describe the stabilities of their markets. They then compared these perceptions with stability indices calculated from the firms' financial reports and industry statistics. The correlations between managers' perceptions and objective measures were all near zero and were as likely to be negative as positive.

Tosi, Aldag and Storey (1973) analyzed data from 102 middle and top managers from diverse firms: correlations of managers' perceptions with stability indices ranged from -0.29 to +0.04.

Downey, Hellriegel and Slocum (1975) got data from 51 heads of the divisions of a large conglomerate: correlations of managers' perceptions with stability indices ranged from -0.17 to +0.11.

Mezias and I (1996) found large perception errors in data collected from 70 managers in several companies. In the best case, 39% of managers' perceptions of a given variable were within 50% of the objective measure. In the worst case, 31% of managers' perceptions exceeded 200% of the objective value. Most surprising was that managers' perceptions of variables specifically related to their areas of specialization were no more accurate than other managers' perceptions of those same variables. That is, managers with sales experience were as inaccurate in their estimates of sales-related variables as managers without sales experience.

In principle, by playing one person's error off against another's, firms might compensate for the biases of individual people. However, firms often amplify biases. First, misperceptions are often shared. Some get their unrealistic perceptions by talking with their colleagues. Second, organizations emphasize communication, and easily communicated ideas oversimplify. Third, formal strategizing encourages managers to construct rationalizations for their actions before the fact. These rationalizations then have to be reconciled with actual events, through processes that involve much distortion. Fourth, people's careers depend upon the evaluations of strategic actions, so managers strive to conceal bad outcomes. Fifth, social pressures induce managers to espouse positions dishonestly (Janis, 1972). Sixth, firms' formal reporting systems foster misperceptions by emphasizing financial and numerical data, by highlighting successes and rationalizing failures, and by crediting good results to superiors. Finally, top managers' perceptions get more weight than those of subordinates even though top managers have much less contact with current markets and technologies than do their subordinates. Top managers also get much of their information through channels that bias upward messages to de-emphasize bad news and to emphasize good news. Indeed, people in hierarchies listen to their superiors more than they do to their subordinates, and they talk to their superiors more than they do to their subordinates. Thus, top managers mostly hear echoes of their own voices (Porter and Roberts, 1976).

With even the most elegant methods, no one can make reliable long-range forecasts

'Prediction is very difficult, especially about the future.'

— Niels Bohr, renown physicist

Although almost everyone can make accurate short-range forecasts, no one can predict accurately beyond a few months ahead. When it comes to foretelling the future, there are no true experts. In his classic book on forecasting, Armstrong (1985: 91) advised:

> 'Expertise beyond a minimal level in the subject that is being forecast is of little value in forecasting change. This conclusion represents one of the most surprising and useful findings in this chapter. It is surprising because emotionally, we cannot accept it. It is useful because the implication is obvious and clear cut: *Do not hire the best expert you can — or even close to the best. Hire the cheapest expert.*'

Since the 1950s, the U. S. government has poured many millions of dollars into intricate, computer-based economic forecasting models. The teams that developed these models have spent hundreds of man-years. They have included some of the world's most respected economists. They have used elegant statistical methods. They have not lacked financial or computation resources. Large industrial firms pay large sums for the predictions generated by these models. Thus, these models represent the very best in economic or social forecasting.

Elliott (1973) compared the four most famous of these economic forecasting models with two naive forecasts. One naive forecast, the no-change one, says that GNP in three months will be the same as GNP today. This no-change forecast was as accurate as three of the four computer models. The more accurate naive forecast, a linear trend, says that the GNP trend over the last three months will continue for the next three months. This linear-trend forecast was as accurate as the best computer model, which was the simplest one.

Surely, if these elaborate economic forecasting models say so little, one would be very foolish to expect more of any forecasting method.

Makridakis and various colleagues (1982) compared 24 statistical forecasting methods by forecasting 1001 series. They found that simple techniques generally work well. Complex methods tend to mistake random noise for meaningful events so they issue many false alarms. Complex methods forecast most poorly where situations are changing rapidly or where random noise is large. Complex methods work best for stable situations that contain little random noise — where any method would be accurate.

Makridakis and colleagues found that no-change forecasts beat others 38-64% of the time. Also, no-change forecasts were less likely to make large errors than any other method. Yet, the most accurate forecasts came from exponential smoothing with de-seasonalized data. This method beat each of the others at least 50% of the time. Exponential smoothing is a straight-line projection that assumes data include random noise and that filters the noise by averaging. The averaging usually gives more weight to newer data.

Thus, the findings of Makridakis and colleagues resemble those of Elliott.

Getting realistic: What can formal strategizing achieve?

'I cannot imagine any condition which could cause this ship to flounder. I cannot conceive of any vital disaster happening to this vessel.'

— E. J. Smith, Captain of the Titanic, 1912

As the foregoing observations show, real-life formal strategizing takes place in treacherous contexts quite unlike those assumed in management textbooks. So, what can strategists realistically expect to accomplish?

Strategizing can sometimes exploit distinctive competencies, entry barriers, proprietary information, and first moves

Economic theory says that almost the only ways to benefit from strategizing involve using resources that other firms lack. Thus, firms should try to identify or develop competencies that make them distinctive, and then to turn these into competitive advantages. Some firms possess or can create entry barriers that protect them from competitors. Proprietary information can also give a firm an edge; firms can generate proprietary information and try to keep it proprietary long enough to extract benefit from it. A few firms can make profitable first moves.

These tactics are much easier to advocate than to execute successfully, however. It may be very expensive or technically impossible to create distinctive competencies or entry barriers. When a firm begins to put its strategy into effect, competitors can react to the actual behavior rather than to their theories about it. Proprietary information and proprietary information-processing techniques are rare. For example, even if firms do not know their competitors' costs exactly they can likely estimate those costs accurately enough. Similarly, all sensible methods of data analysis yield similar inferences. Thus, these tactics are unlikely to prove highly profitable and their profitability is short-lived.

Strategizing can use forecasts to motivate alertness

Forecasts can be partly self-fulfilling prophecies. Because conservative forecasts may lead firms to achieve less than they could, accurate forecasting can be a mistake. Some managers use forecasts to motivate exceptional efforts. But strategists must keep balance. Consistently biased forecasts not only lose their motivation value, people learn to distrust them. Accurate forecasts, on the other hand, may help firms to identify important threats and opportunities.

Narayan Pant and Starbuck (1990) reviewed the literature about forecasting and proposed several recommendations for making accurate forecasts. Four of these recommendations are: (1) to allow for seasonality, (2) to consider 'no change' and 'no change in the trend,' (3) to average several forecasts, and (4) to assume that today is not a turning point. The studies of forecasting show that it is very difficult to identify turning points while they are occurring. Every analytic framework that has the potential to say 'something quite different has begun to happen' also has the strong propensity to say this when nothing is actually happening.

To avoid some of the game playing that renders forecasts ineffective, strategists can forecast both the best that can happen and the worst and then generate strategies to suit these extreme possibilities. This approach makes people aware of the diversity of what might happen; it reduces the tendency to assume that forecasts will come true; and it motivates alertness for information about how events are actually developing. Firms often overlook important opportunities or threats simply because these were not forecast, so firms need to be alert for surprises and not just confirm their expectations.

Strategizing can inject realism into managers' perceptions

Because most managers misperceive their firms and their market environments, there is opportunity for formal strategizing to educate managers about the actual properties of firms and market environments, by gathering and analyzing objective data. However, such education requires persuasion as well as evidence. Objective data become more valuable as managers' current perceptions become more unrealistic, yet people grow less willing to accept new information as it deviates more from their expectations. In fact, people tend to interpret nearly all information as confirming their perceptions. Because perceptions are widely shared in firms, social support often rigidifies perceptions (Nystrom and Starbuck, 1984).

Formal strategizing also creates diverse opportunities to improve the flows of information upward. Porter and Roberts (1976) reviewed literature showing that top managers do not listen carefully to their subordinates. People in hierarchies talk upward and listen upward: They send more messages upward than downward, and they pay more attention to superiors than to subordinates. They also overestimate how much accurate information they do transmit upward, and they tend to tell the boss what the boss wants to hear. Formal strategizing can expose senior managers to inputs from lower levels.

In a demonstration of the usefulness of realism, Donald Regan, the U. S. Secretary of the Treasury in 1981, observed of President Reagan's economic program: ' . . . the President's program will begin to bear fruit even before it is enacted.'

Strategizing can keep strategies flexible

Because managers do misperceive their firms and environments, and because firms tend to exaggerate these errors, explicit strategies often make actions less realistic and less responsive to unexpected events. Thus, formal strategizing should provide for changing strategies in response to new information.

1. *Strategists can avoid building strong rationales.* Strong rationalizations make behaviors inflexible and make it difficult to evaluate outcomes.
2. *Strategists can de-emphasize the long term.* Long-range forecasts incorporate much larger errors than do short-range forecasts.
3. *Strategists can avoid generalizations.* Generalizations suppress alertness, and Boland and colleagues (2001) found that managers make better decisions when they focus on particulars.
4. *Strategists can minimize formalization.* Formalized strategies incorporate larger errors than do informal strategies, and managers revise formalized strategies much less often than informal strategies.
5. *Strategists can emphasize informal communication.* Perhaps profitability correlates positively with informal communication because informal communication produces better understanding.
6. *Strategists can foster trust and good feelings.* Because strategies are so faulty and yield such vague benefits, only foolish managers would stake their careers on strategies or turn formal strategizing meetings into battlefields. Indeed, consensus may itself be a liability, insofar as it induces managers to focus too narrowly and to underestimate the actual uncertainty of future events.

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