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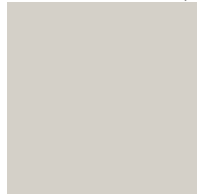
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BRINGING DISCIPLINE TO STRATEGY

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Strategy today is an extraordinarily demanding, complex, and subtle *discipline*. But you'd never know that from reading the management journals and business bestsellers of the past five years. Each season brings a new crop of experts proclaiming that their framework -- core competences, customer retention, management ecosystems, strategic intent, time-based competition, TQM, "white spaces," managing chaos, value migration -is the definitive way to think about *strategy*.

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Applied to specific cases, these solutions sometimes prove an exquisite fit, but just as often they offer only a mediocre approximation.

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Nonetheless, managers have reached out to these new theories because the classical microeconomics-based model of *strategy* is inadequate in a growing number of situations. Consider some recent examples:

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- A telco executive needs to make a \$1 billion "yes or no" decision as to whether to invest in a new network technology to provide new service to customers. One

best-practice market research survey predicts a return on investment of 25 percent; a second, equally valid, forecasts minus 25 percent. What should that executive do?

- How should executives at a software firm deal with a large customer that is also their chief competitor -- and one of their biggest suppliers?
- How should the CEO of a credit card company think strategically about positioning, when segments and value propositions come and go every six months?
- A large regional bank recognizes that to achieve its aspirations in retail banking, it must shape the nature of competition by discovering huge but as yet unrecognized customer needs, and stimulating other players to follow its bold lead. How can it embark on such a *strategy*?

All these cases lie outside the conditions for which the traditional model of *strategy* was designed. In fact, our work suggests that up to 50 percent of the *strategy* situations faced by large companies lie outside of those conditions. Equally, no single one of the new frameworks can address them all.

Therefore, it is time for a new approach to *strategy*. The past twenty years have seen a wider range of business situations emerge than ever before. No single *strategy* prescription can be appropriate in each one of them. What's needed is a more robust model of business that can handle a much broader set of circumstances and suggest when and how we should use specific theories.

The shortcomings of the traditional approach

At the heart of the traditional *strategy* framework lies a microeconomic model of industry. Exhibit 1 illustrates its popularized form, the Porter model. This model combines exogenous forces acting on an industry (such as technology and regulation) with endogenous ones. More importantly, it makes three tacit but crucial assumptions. First, that an industry consists of a set of unrelated buyers, sellers, substitutes, and competitors that interact at arm's length. Second, that wealth will accrue to players that are able to erect barriers against competitors and potential entrants; in other words, that the source of value is structural advantage. Third, that uncertainty is sufficiently low that you can accurately predict participants' behavior and choose a *strategy* accordingly. Even if the odds of each assumption being individually correct is moderate, the combined chances of at least one of these being wrong is high. So, let's examine the validity of these assumptions.

Industry structure

The traditional microeconomic model is based on a "rational" industrial structure where each player competes at arm's length not only with its rivals, but also with customers and suppliers for control of the economic rents. However, at least two other industry structures are commonly found today. In both these structures, conduct differs from that prescribed by the traditional model -- and anyone blindly applying the standard microeconomic rules will get into trouble.

Co-dependent systems are cross-industry structures such as alliances, networks, and economic webs. The most novel and increasingly widespread of these is the economic web. Webs are sets of companies that use a common architecture to deliver independent elements of an overall value proposition that grows stronger as more companies join the set (for example, the "Wintel" and Apple webs in the computer industry).[*] The fortunes of any player in a web depend both on the success of the web as a whole, and on how well that player uses its own position of influence within the web. The strategic challenge is to strike the right balance between the prosperity of the web and that of individual participants: greedy players can harm themselves as well as wreck the web. Thus, an arm's length fight to grab economic rents could be highly counterproductive.

High-tech industries such as computers, telecommunications, software, and multimedia are migrating toward web structures, but evidence of webs can also be seen in older sectors such as automobiles, healthcare, forest products, and financial services.

Privileged relationships are structures within which firms single out other firms in the same market for special treatment because of financial interest (Korean chaebols, Mexican grupos, Japanese keiretsus), friendship, trust, or ethnic loyalty. Governments create similar business relationships in the name of national defence or pride.

Consider also the Indians and overseas Chinese, who have networks of family-owned corporations where relationships between members are clearly privileged. In such situations, network members' actions need to be understood in the light of not just their firms' *strategies*, but also the *strategy* of the whole network, and the individual members' positions in the family hierarchy.

Source of advantage

The traditional microeconomic model assumes that wealth will accrue to businesses that possess structural advantages over competitors and potential industry entrants. In major sectors of the economy --telecommunications, basic materials, transportation -- this is still true. But competitive advantage can also be built on two other foundations:

Frontline execution. Companies in some industries win by consistently outperforming competitors in the execution of day-to-day tasks. In commercial lines property/casualty insurance, for instance, a few players have demonstrated that superior underwriting and claims handling can overwhelm any structural advantage.

Insight/foresight. Some firms create wealth by possessing knowledge or having insights that others lack. The knowledge may lie in scientific or technical expertise (Hewlett-Packard's continuing superiority in printers), pattern recognition (the ability of some banks to make consistent profits by taking short-term positions in foreign exchange), or sheer creativity (Disney's unmatched success in animated films).

If the three (that is, one old and two new) sources of competitive advantage are brought together with the three (again, one old and two new) industry structures mentioned earlier, the result is a new model that better reflects the rich strategic possibilities of today's industrial landscape (Exhibit 2).

Level of uncertainty

The traditional model assumes that uncertainty is sufficiently low in an industry that you can make reasonably accurate predictions on which to base your *strategy*. In reality, however, the future is usually much harder to foretell. When faced with uncertainty, executives tend to leap to extremes. Some simply pretend the uncertainty does not exist; others see it, but it paralyzes them.

What should strategists do when the true results (at least in part) of their situation analysis is "I don't know, and no amount of good analysis will tell me?" Certainly,

they should not just apply scenario planning and recommend options. Rather, the secret of devising successful *strategies* under high uncertainty lies in ascertaining just how uncertain the environment really is, and tailoring *strategy* to that degree of uncertainty. Four levels of uncertainty can be identified:

At level 1, the traditional microeconomic model still holds, and strategists are able to develop a single useful prediction of the future. This does not mean that there is no uncertainty, but rather that analysis will be sufficiently robust to allow a clear strategic direction to emerge. Appropriate sensitivity analysis can be performed after a course of action has been determined. Consider the fast-food industry, where change over the past decade has been evolutionary, allowing companies to base their *strategy* on a prediction.

At level 2, analysis shows that the future will follow one of a few discrete scenarios, though it cannot predict which one. In late 1995, for example, the outline of the pending telecom legislation in the United States was clear; what was not clear was whether it would pass Congress. In this case, *strategy* could be built around two possible scenarios. Generally speaking, since the number of scenarios is usually small at this level of uncertainty, *strategy* can be determined analytically.

At level 3, continuous uncertainty prevails. Though there are only a few dimensions of uncertainty, analysis is unable to reduce the future to a limited number of discrete scenarios. Instead, the reality might lie anywhere along a continuum for each dimension. Many new technologies, for instance, face uncertainty over the rate of market acceptance. It is not just a matter of fast or slow acceptance; it could be anything in between.

At level 4, there is true ambiguity: multiple dimensions of continuous uncertainty. Consider the case of a multinational deciding whether to invest in Russia in 1992. In addition to an unusual degree of uncertainty over demand, the company would have faced uncertainty about the laws that would govern contracts, about who would have the power to enter contracts, and even about whether current suppliers and distributors would remain in business.

These graduated levels of uncertainty govern the type of situation analysis a strategist should perform. At level 1, traditional frameworks are entirely appropriate. At level 2, scenario planning, quantitative game theory, and options pricing frameworks will be needed to help determine *strategy*. At levels 3 and 4, qualitative game theory, latent demand analysis, and evolutionary models will be required.

When this concept of uncertainty is combined with the new industry model illustrated in Exhibit 2, the result is a new approach to situation analysis (Exhibit 3). It takes account of the varying levels of uncertainty about the external forces acting on an industry, the effect of these forces on that industry, and the industry's interactions with itself. It also shows that the level of uncertainty can rise and fall over time.

A new definition of strategy

Traditionally, **strategy** was defined as an integrated set of actions that leads to a sustainable competitive advantage. This definition continues to work well in traditional industry structures characterized by low uncertainty. Beyond this limited context, however, we believe a broader definition is needed. For example, in high uncertainty situations **strategy** is likely to call for more than a single integrated set of actions. It will probably require investment in a variety of options, small bets, and so on. The new definition is that **strategy** is the handful of decisions that:

- drive or shape most of a company's subsequent actions,
- are not easily changed once made, and
- have the greatest impact on whether the company's strategic objectives are met.

To be specific, the handful of decisions are:

- selecting the company's strategic posture
- identifying the source(s) of competitive advantage
- developing the business concept
- constructing tailored value delivery systems.

Let's look at each of these decisions in detail.

Strategic posture

Depending on the extent of its ambition, a company can adopt one of three strategic postures: adapting, shaping, or reserving the right to play.

Adapting is the most common choice. A company analyzes its environment, then commits to a set of actions that conform to that environment. Though different levels of uncertainty might require different actions, the mindset is always one of accepting the world as it is -- seizing known opportunities and responding to known threats.

Shaping consists of attempting to change the environment in a direction that would benefit the firm. Shapers invent entirely new products for which demand is only latent, or alter the basic structure of their industry, or develop entirely new ways to compete. They believe they can influence the world to such an extent that a detailed analysis of their current environment is scarcely relevant. This belief may rest on the power of an idea or on consistently superior capabilities. Either way, shapers depend on their own ability to change their external circumstances.

Shaping turns out to be attractive in some pretty counter intuitive cases. In highly uncertain environments, for instance, one would normally be tempted to hedge and avoid commitment. Yet for some strong players, this might actually be the best time for a bold move. Imagine a group of frightened children, lost in a forest. The best

strategy might be for the biggest kid to shout, "I know the way. Follow me!" Even if that kid didn't really know the way, and it took hours to get out of the forest, the group would still stay together. Similarly, if there is uncertainty over industry direction, a bold shaping posture may be the best option.

That said, shaping isn't always advisable. It offers the highest reward, but also the highest risk, of the three postures. It is difficult to create massive wealth without being a shaper; think of the steel and railroad barons of the nineteenth century, Thomas Edison, Microsoft, and Netscape. But at the opposite end of the spectrum, think too of Zap Mail, Microsoft Network, Betamax, and the English Channel Tunnel.

Reserving the right to play is a noncommittal posture. It consists of doing the minimum required to keep open the possibility to become a strong player later. It is not the same as taking no action at all; rather, it is an investment in learning.[*]

Underlying these three postures are fundamental differences in mindset. However, it would be wrong to oversimplify; companies like Microsoft seem to be able to blend elements of all three, and a company's choice of posture may change as conditions alter. In general, though, most companies should aim to develop a single dominant posture.

Competitive advantage

Earlier, we noted three different bases of competitive advantage: structural advantage, frontline execution, and insight/foresight. There are, of course, many subvariants of each, such as core competences, time-based competition, and hustle. And new sources of competitive advantage may well emerge in the future. Though companies have many tools for selecting a source of advantage, they seldom realize how this choice can "lock them in" in unexpected ways.

Structural advantage results from a tight congruence between a company's value proposition and a structural reason why competitors cannot copy it. This necessarily locks the company into a particular set of customers or needs. If these change, the *strategy* may become obsolete.

Frontline execution *strategies* are usually even more locked in, committing an entire organization to adhere to a set pattern of performance. One company's program to build execution skills incorporated 65 separate subprograms to change organization structure and hiring and pay practices, and introduce new information systems, policies, and procedures. Not surprisingly, the company had little flexibility to adjust its *strategy* if conditions changed.

Insight/foresight might appear to be a more flexible basis for competitive advantage, as it does not entail locking into a single value proposition in terms of product or market. However, there is often lock-in at the input level. When a company is

dependent on one source of insight, it can be vulnerable if that source becomes less valuable. Moreover, companies can only create wealth if enough customers buy their goods or services. Therefore, insight/ foresight usually has to be combined with structural advantage or frontline execution if it is to create value.

Business concept

There is more to translating postures and sources of advantage into specific strategic decisions than simply choosing your positioning. Any complex business concept will probably be constructed from four types of building blocks: "big bets," "real and financial options," "no regrets moves," and "safety nets."

Big bets are major commitments to a course of action that may pay off handsomely in some situations, but produce dismal results in others. Real and financial options give a company flexibility, either financially or operationally.

Financial options are well understood. Real options are investments in tangible capital goods or operating expenses that are made in order to learn or create flexibility (for instance, installing machinery that can work on a variety of raw materials). No regrets moves are actions that make sense no matter what eventually happens. And safety nets are options that are specifically designed to protect against a big bet going bad.

Consider the case of a large specialty chemical company that faced uncertainty over which of two new technologies its industry would accept. If it had decided to make a major investment in one of the two, it might have been able to convince other players that its choice was superior, and so shape the industry's technology base. This constituted a big bet: if the company failed to convince others, its plant would be stranded. It could have complemented the bet with no regrets initiatives, such as cost reduction and sales improvement programs, and added a safety net provision by planning to retrofit the second technology if its bet proved wrong.

In practice, management at this company chose a *strategy* consisting of several real options. The company formed an alliance with a new entrant using one of the new technologies, while retrofitting several of its own small plants with the other technology. In addition, it took several no regrets measures, but it did not need a safety net.

Tailored value delivery system

Big bets, real options, and so on are the building blocks from which new *strategies* are assembled. For each of these building blocks, companies need to construct a separate value delivery system. Imagine that a company faced with a choice between two technologies elects to buy real options to cover both of them. Real options, unlike financial options, are investments in organizations and people. When these options turn out not to be valuable there is a significant human and organizational

cost attached to unwinding them. (Do you fire the R&D team whose solution you do not use?) Thus, *strategies* capable of dealing with the complexities of today's business environment are likely to call for the ability to create, grow, and manage multiple value delivery systems simultaneously.

Evolving *strategy*

As well as making the four strategic decisions outlined above, managers must also learn to recognize the dynamics inherent in every situation and manage the building blocks of *strategy* effectively over time.

Traditionally, strategic management has meant little more than staying the course. Today, however, it means actively managing the way in which *strategy* unfolds, month after month, year after year. That might entail drawing up contingent road maps in which reaching specific milestones will clarify the right *strategy*; it might equally mean recognizing that *strategy* will have to evolve as industry conditions alter.

Just as the new framework changes what is required of *strategy*, so it changes the *strategy* development process especially in terms of who actually develops *strategy*, and when they do it. In situations where there is little uncertainty and structural advantage is critical (for instance, capacity decisions in the chemical industry), a traditional *strategy* development process, led by senior line management and conducted annually, could continue to work well. In industries with low uncertainty where frontline execution is the source of differentiation, bottom-up processes could be the right choice.

On the other hand, where uncertainty is high, where web-like structures are in the ascendant, or where a company aspires to be a shaper, the *strategy* development process will probably need to be totally revamped. In fact, it might not be a separate process at all. Instead, direction setting by the CEO or business leader would be combined with extremely short communication lines to the workers in the marketplace, and real-time rather than periodic adjustment of the *strategy*.

The broader picture

How does this new approach to *strategy* relate to concepts that have been proposed by others? We believe that, like the traditional model, most of these concepts are appropriate only in specific situations within the broader picture (Exhibit 4). The customer retention framework, for example, is really only valid in frontline execution industries with limited uncertainty. If companies base their *strategy* on it anywhere else, they will be focusing on minute improvements to a value proposition that could be blown away by competitors if the environment were to change.

We have examined over 25 separate *strategy* concepts proposed over the past few years. Close examination of any of these reveals how their underlying assumptions

limit the circumstances in which they can be used. Consequently, strategists should be familiar with all of these concepts, but not biased toward any of them. They should narrow their focus to a specific submodel only after they have determined which one is most appropriate to their situation. In today's diverse business world, they must take into account a wider range of industry structures and bases of competitive advantage, and a higher degree of uncertainty. Admittedly, this is more complex than looking for keys under a guru's lamppost. But if any area of business deserves the extra effort, surely it is *strategy*.

* For a detailed examination of web industry structures, see John Hagel III, "Spider versus spider," The *McKinsey Quarterly*, 1996 Number 1, pp. 4-18.

* See Mehrdad Baghai, Stephen C. Coley, and David White with Charles Corm and Robert J. McLean, "Staircases to growth," pp. 38-61.

DIAGRAM: The Porter model of industry

DIAGRAM: A new industry model

DIAGRAM: Situation analysis

ABOUT THE RESEARCH

This article is based on the findings of the *McKinsey Strategy* Forum/*Strategy* Theory Initiative (STI) that involved more than 60 consultants on four continents. Beginning with a review of the traditional *strategy* model, the project included a survey of academic literature, an examination of practitioners' theories of *strategy*, and discussions and applications with over 70 companies.

So far, the STI has developed perspectives on economic webs, winning under uncertainty, alternate *strategy* concepts, a reassessment of core competences, and a framework for developing breakthrough ideas. Research is continuing, and project members are also collaborating with leading academics to develop new approaches

The authors would like to thank all of STI's contributors and supporters, but particularly the handful of people who have truly driven the effort: Patrick Viguerie, Jane Kirkland, Hugh Courtney, Bill Barnett, David Benello, John Hagel, and Eric Beinhocker.

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