Strategy: The end of the endgame?


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[Headnote]

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The first phase was the era of "Business Policy," as developed at the Harvard Business School in the late 'fifties and 'sixties. It was an attempt to render the process of decision making more formal and more abstract in order to equip senior managers to make critical decisions over a wider span of business activities than they could comprehend directly. Though generally agnostic on the content of the strategy, this approach rested on implicit assumptions: that problems were sufficiently similar for formalization to be workable; that the essence of the problem could be captured in such an abstraction; and that senior managers, by dint of their experience or unique ability to marshal resources, could add value via such a process. In the stable, corporatist world of that era, such premises seemed obvious.

The second phase, that of "Competitive Analysis," was initiated by Bruce Henderson and codified by Michael Porter. Borrowing liberally from the economics of industrial structure, the discipline of strategy making plunged into content. Strategy became the pursuit of sustainable advantage within an industrial, technological, and competitive context.
Although Henderson introduced radically dynamic elements (such as the experience curve, now enjoying a renaissance as Moore's Law), the discipline quickly settled into a static, marginalist approach: the application of standard tools of microeconomic optimization to the control variables of a business. But again there were implicit premises: that the business, industry competitors, and customers were all well-defined; that returns were diminishing (and therefore micro-optimization actually meant macro-optimization); and that the control variables recognized by microeconomics were indeed the control variables that mattered.

It was this last assumption that was challenged so trenchantly in the early 'eighties, implicitly by the mania fest competitive success of the Japanese, and explicitly in the writings of Henry Mintzberg, Tom Peters, Robert Waterman, and others. Attention shifted to operational excellence and the affective side of management, to the alliterative quintet of quality, kanban, customer care, and culture.

Despite all the humanistic rhetoric, it was processes that finally won out over people in the purgation we now call re-engineering. But for strategic planning, the dispute between the humanists and the engineers hardly mattered. Either way, the Big Picture had ceased to matter: God had descended into the details. "Strategic planning" fell into disrepute.

The third phase of strategic thought was a revival of sorts, centered on the "resource-based theory of the firm." Pioneered by Gary Hamel and C.K. Prahalad, this new view reinstated the top-down perspective via the concept of "core competencies." Since (dirty secret) a core competence was anything you wanted it to be, the theory could resonate with any chief executive's agenda without running the risks of refutability.

Yet even this body of tautology presumed something about the firm: that core competencies were better nurtured and transferred within the warm womb of the firm than across the and nexus of the market, and that the firm should therefore take its shape from the competencies that define it. Although nobody could define competencies, competencies defined the firm. And strategists, once again, had something new and knotty to talk about.

The Internet Challenge

The Internet turns all this upside down. First, it destroys the stable, mature environment the Business Policy school assumed it could create. Indeed the whole idea of an Internet business having a "policy" on anything is rather quaint. The Business Policy School believed that all those reviews, controls, and formalities would minimize the probability of getting things wrong.

But now the goal is to maximize the probability of getting things right, which is not the same thing at all. Risk has to embraced, not avoided; speed matters more than accuracy; innovation matters more than control. In the Internet Age, father does not know best: Indeed, it is quite likely that Father does not have a clue what is going on. And discounted cash flow projections or abstracted planning templates will not help him.

Second, the Internet undermines the premises of competitive analysis. Porter's "five forces" framework presumed that the definitions of the firm, industry, suppliers, customers, and new entrants were given and obvious. But the Internet destroys these neat categories. The definition of the business, competitors, suppliers, etc. is now the essence
of the question, not a premise of the answer. Compound this with the well-known prevalence of increasing returns when businesses are defined by information systems, intellectual assets, or networks, and the whole logic of microeconomic optimization crumbles. In this environment, fine tuning gives way to big bets. Resources become chips to be shuffled and deployed; planning becomes gambling; winner takes all. Poker replaces Pareto as the paradigm of competition.

Third, the New Economy liberated competencies from the core. The technologies of Silicon Valley (to take one of the purest examples) belong largely to the community, not to any individual firm. Personal networks, fluid labor markets, and sophisticated venture capital communities transplant much of that know-how from one firm to another, despite the efforts of every constituent firm to prevent it. But in the New Economy everyone gains from everyone else's leaky competencies. And it turns out that the gains from all that promiscuity outweigh the dilution of individual paternity.

So now Silicon Valley has become the model everyone must emulate. Open business models, open standards, technology sharing, strategic partnering, and a massive fluidity of money, people, and ideas render the boundaries of the firm porous to the point of indeterminacy. Try to draw the boundaries around firms like Amazon or Microsoft, for instance. Their alliances, minority investments, exclusives, partnerships, and even the personal investments by their principals render the exercise totally futile. Competencies rule more than ever, but no longer are they the definers of corporate shape.

The Crisis in Strategic Planning

After such knowledge, what forgiveness? How can one pick up the pieces of the discipline called strategic planning in a world where there are no longer any round, solid bodies to obey the Newtonian laws of business motion, where we have reverted to the Big Bang and the universe is a formless plasma of indeterminacy?

The most ambitious response, of course, is chaos theory: the theory of complex, adaptive systems. Simple principles of micro-behavior, replicated recursively, yield emergent structures in the macrocosm. Such is the form of biological evolution, of turbulence, of fractals. Chaos theorists suggest that perhaps firms and brands and technologies and business cultures can be understood as emergent structures.

The problem with this approach is that while chaos theory offers a wonderful heuristic that illuminates the nature of complexity, it offers precious little help in shaping it. The notorious sensitivity of complex systems to miniscule changes in specification renders simulation a useless tool for understanding any particular complex interaction: All we can do is try to understand complex behavior in general, which is fascinating but as a practical tool, useless. Perhaps someone at Santa Fe will make a breakthrough, but I see no real signs of it.

But the honest truth is the business world is not really that chaotic. "Atoms" in general are not really being replaced by "bits." Successful New Economy companies have hierarchy, reports, budgets, even profits. They do a lot of very old-fashioned things, and they do them quite well. So the real challenge in practice may be less that of understanding from first principles some post-industrial, neo-biological paradigm of business, and more the simpler task of steering a course through a period of rapidly and continuously changing information technology.

Bill Gates, arguably the most successful practitioner of strategy in the New Economy, has never articulated anything particularly original or convincing about where all this leads, but he clearly grasped some simple principles for putting his competitors out of business, and did so without any known reliance on theories of complex adaptive systems.

So perhaps a lot of traditional insights can still be exploited if we are willing simply to abandon the idea of a solution, an endgame. Not because it does not exist or does not matter, but simply because it is unknowable, at least for now. Perhaps we need to redefine strategy as the art of surviving rapid transition, something like log-rolling or surfing. Strategy as direction rather than strategy as solution. And if this sounds tactical, so be it: There have been many eras in military history when tactics mattered more than generals drawing arrows on maps.

From Paradigms to Rules of Thumb

This premise diverts our attention away from the asymptote to the transition, away from principles of advantage toward rules of thumb for surviving. At the technology level, Moore's Law is such a rule of thumb. It tells us nothing about where-all-this-will-lead (on which technologists are actually quite divided), but tells us a lot about the direction in which we are heading. Propositions about connectivity, bandwidth, etc. are easily and safely formulated as directions, but are almost invariably wrong when formulated at predictions.

We can use the same principle to redefine the goal of strategy: Success is survival into the next round of the game. Successful strategies generate options. This does not imply the irrelevance of cash flow (as many thought until recently), but it does diminish the value of cash versus that of the right to play in an uncertain future. Indeed, finance theory tells us that the greater the uncertainty, the lower is the value of expected cash flows (because we discount them more aggressively) but the greater is the value of an option.

Directional rules of thumb can similarly describe how the economics of business are shifting. There are quite a few, but let
me mention just three.

First, information flows are tending to separate from physical flows. This raises efficiency because so often they are mutually compromising. But far more important, it allows relatively pure “information” businesses to evolve away from their physically bounded antecedents, and these information businesses are often the inheritors of the data, information asymmetries, switching costs, etc. that define competitive advantage.

When SABRE is worth more than American Airlines, if Covisint proves more valuable than Ford, GM, and DaimlerChrysler, we see a compelling logic for creating new businesses out of the information flows embedded in current business definitions. And each advance in technology (for example, mobile connectivity and broadband) opens a new family of opportunities.

Second, connectivity and information standards are driving progressive reductions in transaction costs. Since organizations exist to economize on the cost of transactions, markets are therefore substituting for organizations. The value chains that define a business, the supply chains that define an industry, the customer relationships and brands that define a franchise, and the organization charts that define hierarchy, power, and the boundaries of the corporation are all premised on the “glue” of information.

That glue is progressively melting. The edifices of value chain, supply chain, customers, organization, etc. (all of which are taken as givens in conventional strategy) are progressively deconstructed, breaking up into separate entities busily conducting arms-length transactions. Just think of the evolution of the computer industry over the past 25 years, and imagine that process being replicated at Internet speeds through swaths of the economy. The key controlling factor is the promulgation of standards, which is why fundamental architectures such as extensible markup language (XML) and domain-specific data dictionaries such as OFX or RosettaNet are becoming so pivotal.

Third, navigation is progressively emerging as an independent function, and often as a business in its own right. Navigators marshal the data that enable decision making in the context of infinite connectivity and choice. They create standards. They may be party to the transaction (e-tailers), they may be switches (business-to-business hubs), or they may be advisors (Morningstar, CarPoint). They inherit many traditional functions of the marketer or salesperson, but they do not necessarily represent the interests of the seller. Indeed, competition among navigators will drive them to tilt their affiliation toward the buyer. That promises to destroy many of the traditional asymmetries between buyers and sellers (especially in retail contexts), and therefore will shift bargaining power down supply chains.

These and other rules of thumb are merely directional. They leave unanswered (and often unanswerable) the questions of where and when. And they are continual shifts, not once-for-all events. But, like Moore's Law, they are pervasive and powerful. Strategy becomes a matter of positioning one’s business to exploit them, of placing repeated bets on an outcome whose logic is a mere tendency.

This is a less satisfying process than the closed-form solutions presented in the traditional texts, but if it makes the strategist of the future a little less smug, that may be a good thing. After all, the greatest writer on military strategy, Clausewitz, repeatedly reminds us how the most meticulous of preparations, the grandest of strategies, can pale into irrelevance when we face the “fog of war.”

[Footnote]
1A reasonable possibility since, apart from their cash holdings and the value of their finance companies (another information business), the three are nearly worthless today.
2 Tom Wurster and I have argued that information technologies are progressively displacing tradeoffs between “richness” and “reach” in patterns of information flows. This captures the point that a "transaction" is not a discrete and pre-defined thing, but can vary in the intensity (richness) and extent (reach) of the information that is exchanged. But this perspective still centers on transaction cost economics. See Evans and Wurster, Blown to Bits: How the New Economics of Information Transform Strategy (Harvard Business School Press, 1999) Chapter 3.

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