THE STRATEGY PARADOX

WHY COMMITTING TO SUCCESS LEADS TO FAILURE [AND WHAT TO DO ABOUT IT]

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CHAPTER ONE

WHAT STRATEGY PARADOX?

Most strategies are built on specific beliefs about the future. Unfortunately, the future is deeply unpredictable. Worse, the requirements of breakthrough success demand implementing strategy in ways that make it impossible to adapt should the future not turn out as expected. The result is the Strategy Paradox*: strategies with the greatest possibility of success also have the greatest possibility of failure. Resolving this paradox requires a new way of thinking about strategy and uncertainty.*

Here is a puzzling fact: the best performing firms often have more in common with humiliated bankrupts than with companies that have managed merely to survive. In fact, the very traits we have come to identify as determinants of high achievement are also the ingredients of total collapse. And so it turns out that, behaviorally at least, the opposite of success is not failure, but mediocrity.

There is more at stake here than simply observing that accomplishing anything worthwhile requires making the attempt, while those who attempt nothing bold never fail. Theodore Roosevelt, the twenty-sixth president of the United States, explained this much to us when he argued that the credit belongs to those actually "in the arena," whose faces are marred by "dust and sweat and blood."[1] His point was that victory demands valiant action, and that valiant action necessarily brings with it the risk of defeat.

In business, the kinship between these antipodes runs far deeper, to the nature of the actions one must take in order to prevail, and therein lies the strategy paradox: the same behaviors and characteristics that maximize a firm's probability of notable success also maximize its probability of total failure.

THE SIMILARITY OF OPPOSITES

Many opposites are not nearly as different as they first appear. For example, as Nobel Peace Prize winner Elie Weisel observed, the opposite of love is not hate, but indifference; for at a minimum, to love or hate someone is to have intense emotions toward them.[2] We see how the similarities between love and hate often outweigh the differences when one is transformed into the other, a phenomenon that literature—from Gilgamesh to Shakespeare to Harlequin Romances—has exploited and explored for millennia.

In fact, the psychological proximity of love and hate is part of the hard-wiring of the human psyche. Dan Gilbert explains, in his book *Stumbling on Happiness*, that the same neurocircuitry and neurochemistry triggered in response to stressful events ("flight or fight") are also triggered in response to sexual arousal.[3] As a result, when we are stressed in the presence of a person we find sexually attractive, we have a tough time telling what we are responding to: are our passions inflamed (hate) because of a stressor, or are we aroused (love) because of the attractive person?

In the 1994 movie *Speed* starring Keanu Reeves and Sandra Bullock, Bullock's character, Annie Porter, appeals to this possible confusion when she notes, upon finding herself in the hero's arms after several near-death experiences, that "relationships that start under intense circumstances, they never last."

Call it an "emotional paradox": two very different dispositions—loving and hating—can have far more in common with each other than a seemingly intermediate state.

The strategy paradox is visible only when we can put under the microscope strategies whose only flaw was that they flopped. Chapter 2 explores two such strategies: Sony's Betamax VCR and its Minidisc music player. In both cases, the company never set a foot wrong by the lights of how one is supposed to build a successful strategy: it understood its customers, identified viable market segments, developed cutting-edge products, executed flawlessly, and monitored and responded to its competitors' countermoves. Yet, in both cases, Sony came up short because the commitments the company had to make in the pursuit of greatness were undermined when the perfectly reasonable assumptions behind those commitments turned out to be wrong. Sony's failures were not a consequence of *bad* strategy, but of *great* strategy coupled with bad *luck*. Sony did everything necessary to maximize its chances of success, yet those same actions exposed it to the possibility of near-total defeat. When key uncertainties broke against it, Sony became a victim of the Strategy Paradox.

The purpose of this book is to describe how the strategy paradox can be

resolved. In what follows, a new principle I call *Requisite Uncertainty* and a new management tool I call *Strategic Flexibility* provide a way for managers to implement the kinds of strategies that can deliver outstanding results without exposing themselves to the vagaries of fate.

1.1 HIDDEN IN PLAIN SIGHT

Why is this the first you have heard of the strategy paradox? After all, there is no shortage of well-designed and well-executed studies that have offered useful insights into the defining characteristics of successful firms. Similarities with failed firms and the importance of luck have not featured prominently.

The reason most business research misses the strategy paradox is that, understandably enough, few studies ever examine failure. Instead, most investigators tend to study success; after all, who wants to learn how to fail? In some cases, this is because pursuing the secrets of success seems more rewarding than picking through the wreckage of failure. In other cases, it is simply a flawed method: researchers embrace the idea that by studying winners they can discern the secrets of success, forgetting that the factors differentiating winners from losers can be identified only by analyzing both. Finally, there is the reality that failures are often harder to document because failed companies are typically no longer available for study.

In light of these difficulties, researchers often compromise, comparing companies that have been very successful over ten or fifteen years (focal companies) with companies that have been less successful over that same time period (comparison companies). Some studies look for firms that have done very poorly over that time, and others look for comparison companies that have actually done pretty well—just not nearly as well as their focal companies. Either way, however, comparison companies have at least *survived* for the period in question, and over a ten-year period, mere survival is actually a pretty high bar.[4]

What this means is that most studies of the determinants of success have based their conclusions upon comparisons of the exceptional with the mediocre. A review of more than thirty empirical studies published in academic journals over the past twenty years exploring the relationship between strategy and performance found none that had accounted for survivor bias. Because these studies systematically seek out successful companies, each will necessarily find those that in the past made the right commitments. And because the comparison companies are always firms that have performed less well, but not failed completely, they will invariably be firms that have avoided high-risk, high-return strategies.

By examining primarily those companies that have guessed right and

comparing them with those that have avoided guessing, what has been largely missed is the critical importance of managing uncertainty. The gallant charge and the cowardly retreat are not the only alternatives to catastrophe. There is a way to mitigate risk without compromising performance, and describing that solution is the promise of this book.

Accepting the strategy paradox forces us to accept mediocrity, giving up a chance at greatness as the price of our continued corporate existence. Resolving it will free us from a debilitating trade-off between risk and return and allow us to strive to be first without giving up the hope that we will last.

1.2 MUST COMMIT

The cause of the strategy paradox is as obvious as it is overlooked. A successful strategy allows an organization to create and capture value. To create value, a firm must connect with customers. For a firm to capture value, its strategy must be resistant to imitation by competitors. Satisfying customers in ways competitors cannot copy requires significant commitment to a particular strategy, that is, *strategic* commitments, to unique assets or to particular capabilities.

Not just any commitment will do, however. Success stems from committing to what enough customers want but few competitors have. Commitments are a powerful determinant of success because they make a strategy difficult to imitate. To reduce their strategic risk, many firms imitate only what has been shown to work. Since these late-comers wait while some firms—the lucky ones—make what happens to be the right commitments, lucky firms enjoy a period of relatively little competition: it takes time to replicate capabilities so painstakingly created. For example, new products snapped together from off-the-shelf components are usually easily imitated by competitors, while those based on proprietary technologies developed over years are far likelier to be the foundation of a durable franchise. The downside of commitment is that if you make what happen to be the wrong commitments, it can take a long time to undo them and make new ones.

The strategy paradox, then, arises from the collision of commitment and uncertainty. The most successful strategies are those based on commitments made today that are best aligned with tomorrow's circumstances. But no one knows what those circumstances will be, because the future is unpredictable. Should one have guessed wrong and committed to the wrong capabilities, it will be impossible to adapt—after all, a commitment that can be changed was not much of a commitment. As a result, success is very often a result of having made what *turned out to be* the right commitments (good luck), while failed strategies, which can be similar in many ways to

successful ones, are based on what *turned out to be* the wrong commitments (bad luck). In other words, the strategy paradox is a consequence of the need to commit to a strategy despite the deep uncertainty surrounding which strategy to commit to. Call this *strategic* uncertainty.

New research detailed in Chapter 3 suggests that often the main factor separating success and failure is indeed luck. Mediocre firms—those that survive but do not prosper—avoid commitments that expose themselves to the vagaries of luck. The price of avoiding that risk is the opportunity for greatness; the reward is an increased chance of survival. For now, these seem to be the only alternatives to failure, and firms are forced to choose. There is no intrinsic merit in opting for greater returns over survival or vice versa; the problem is that firms must choose at all.

Sony's case, referred to earlier, is not unique. The strategy paradox is more than a theoretical possibility or a curiosity; it is a general condition. As recounted in Chapter 3, an analysis of the competitive strategies of several thousand operating companies reveals that organizations pursuing the most commitment-intensive strategies generate the highest returns, but they also suffer the highest mortality rates. Seen in this light, Sony's failures were not a consequence of avoidable mistakes but were instead an inevitable result of making commitments—the defining element of successful strategy—despite inescapable uncertainty. And when those uncertainties were resolved to Sony's detriment, it paid the price.

The strategy paradox rests on two premises: commitments cannot be adapted should predictions prove incorrect; and predictions are never reliably or verifiably correct. Are these premises true?

1.3 CAN'T ADAPT

For all we might think we know about how to make organizations agile, flexible, and adaptive, the data suggest strongly that, if anything, competitive advantage is eroding faster than ever. This acceleration is interpreted by some to mean that there is a greater need than ever for adaptable enterprises. Such an observation is entirely correct. Unfortunately, the acuteness of the need does not mean it can be satisfied.

Some degree of adaptability is visible in most organizations. However, as explained in Chapter 4, adaptability is far less useful than we might like. Specifically, adaptability is viable only when the pace of organizational change matches the pace of environmental change. When the environment changes either faster or slower than the organization, it can no longer effectively adapt. The bad news is that every organization will at some point face one or both of two types of mismatch between the two rates of change, and

each can prove debilitating.

Fast change leaves an organization's capabilities optimized for an environment that suddenly no longer exists. For example, when the price of oil rose 400 percent in a matter of weeks in the early 1970s, North American automakers found that the mainstay of their product lines—full-sized cars—were singularly inappropriate to the new competitive conditions. Unfortunately, it took those same automakers years to design, manufacture, and market more fuel-efficient models, and they lost valuable market share to better-positioned competitors. (Ironically, the tide turned in their favor in the mid-1990s when cheap gas made SUVs all the rage; their good fortune began to evaporate once again in the face of high-priced petrol in the mid-2000s.)

Slow change prompts an organization to adapt to incremental changes in the environment around it, and because of these incremental adaptations, the company often fails to see the need for a more fundamental transformation. The auto sector's response to the current oil crisis may be subject to this slow change pathology. As oil prices have crept up, automakers have responded by extending the life of the internal combustion engine by dramatically increasing fuel economy and creating hybrid electric engines, among other technological advances. But the day may well come when, due either to the need to limit carbon emissions for environmental reasons or the inability of the general economy to absorb still further increases in oil prices, the internal combustion engine must be abandoned. Should that day arrive, companies that have been exploiting their adaptive capacity could well be overtaken by firms that are already aggressively pursuing alternative technologies intended to replace, rather than merely extend, this century-old technology.

Compounding the difficulties of responding to fast and slow changes is the fact that most competitive environments are characterized by multiple rates of change, creating the impossible organizational task of changing at different rates at the same time.

As a result, adaptability cannot expect to resolve or even mitigate the strategy paradox.

1.4 CAN'T PREDICT

The first half of the paradox is commitment: companies cannot adapt their commitments should they turn out to be the wrong ones. Might they instead predict the future accurately enough to make consistently the right commitments in the first place? Futurists make such predictions, believing that by analyzing the past and present they can identify and interpret the trends that will ultimately define the future. Since there always seems to be someone with a track record of successful predictions, we might be tempted

to write off the paradox as an illusion.

We would be wrong for three reasons, which are explored in Chapter 5. First, no one can legitimately claim to have a meaningful ability to foresee the future in anything like the level of detail required to make consistently successful strategic commitments. Any such claims can always be explained by the law of large numbers: with so many people predicting so many things, it is inevitable that someone is going to get something right occasionally. Since we cannot know who that someone is going to be, or what they are going to get right, the fact that some predictions turn out to be accurate is useless.

Second, predictions in the form of point estimates betray a fundamental misunderstanding of what the future actually is. The future is a range of possible outcomes, not a specific set of circumstances that will inevitably come to pass. A prediction of the future *as seen from the perspective of today* would have to describe each of the events that could happen and their associated probabilities. Unfortunately, there is no way to compare our probability-based description of the future with the true probabilities as they are today. For instance, if I say that there is a 10 percent chance of rain tomorrow, whether it rains tomorrow or not tells you nothing about the accuracy of my prediction, for either outcome is consistent with a 10 percent chance of rain.

One could, of course, note all those occasions when I predicted a 10 percent chance of rain and then see if it rained on 10 percent of those days for which I predicted a 10 percent chance of rain. When it comes to weather forecasting, this is reasonable, but when it comes to strategic forecasting, the outcomes of interest are rarely repeated events. As a result, this kind of track record is impossible to establish. Consequently, we have no way of determining if someone can provide accurate, probability-based descriptions of the range of possible future events.

The third reason accurate prediction is impossible is the ubiquity of randomness. Randomness generally can be thought of as the absence of the kind of order that allows us to predict what comes next in a series. That is, we might be able to identify a pattern, but unless that pattern repeats in ways that allow us to foresee what follows, the series is ultimately random. It turns out that the systems we hope to understand and predict for the purposes of making strategic commitments are subject to two main sources of randomness.

First, competitive systems are subject to exogenous shocks such as new technologies or regulatory regimes that create new competitors and upset long-standing equilibria. It is tempting to believe that we can overcome this problem by simply expanding the boundaries of our analysis, but it is the

nature of this source of randomness that as soon as we begin expanding our scope we do not know when to stop. Before long we find ourselves compelled to build a "theory of everything" in order to predict anything at all.

Second, even if the dynamics of a particular system are predictable, competitive dynamics are highly sensitive to past commitments—what systems dynamics theorists call "initial conditions." What constitutes the initial conditions of a system is a judgment call, and getting it wrong makes any subsequent predictions highly suspect.

We can see these first two sources of randomness at work in the evolution of Toyota from its humble beginnings to a world-class auto manufacturer. The oil crisis of the mid-1970s was an exogenous shock that created a surge in demand in North America for smaller, fuel-efficient automobiles. Toyota made precisely these kinds of cars, and many customers who would not otherwise have purchased a Toyota were motivated to purchase one for the first time. Many were pleasantly surprised at the value Toyota offered, and stuck with the brand as the pressure on gas prices receded. The oil shock was, in a sense, the lucky break Toyota needed to gain access to the mainstream of the U.S. auto market.

For General Motors to have predicted this shift in competitive fortunes, it would have had to focus not on its would-be competitor but on the geopolitics of the Middle East. GM would also have had to predict accurately the impact of that shock on consumer buying behavior, and that the "temporary" interest in Toyota would prove to have long-term implications.

Why was Toyota better positioned than other car companies such as Ford or Chrysler to steal a march on GM? Was Toyota blessed with a prescience or adaptability that allowed it to exploit events that others were blind to? Hardly: in Toyota's home market of Japan, gasoline had long been more expensive than in the United States, while economizing on space had long been a priority. These "initial conditions" are features of the Japanese market that can be attributed to geographic, political, and cultural traits that are centuries old. It is not as though Toyota had a "copy GM" strategy in the 1950s but changed course when it foresaw the oil crunch; neither did Toyota adapt to the embargo when it occurred. Rather, as a consequence of home market pressures, the company since its birth had been committed to a strategy (small, fuel-efficient, inexpensive cars) that was eventually appropriate for the North American market for reasons few had foreseen. This takes nothing away from Toyota's success; as Louis Pasteur put it, "Fortune favors the prepared mind." But the corollary of this insight is that preparation without fortune—or worse, coupled with bad fortune—amounts to the wrong preparation.

In sum, prediction cannot resolve the paradox any more than adaptability can.

1.5 MANAGING STRATEGIC UNCERTAINTY

The strategy paradox is a consequence of the conflict between commitment and strategic uncertainty. The answer to the paradox lies in separating the management of each, charging some with the responsibility of delivering on the commitments the organization has already made, and others with the task of mitigating risk and providing exposure to promising opportunities.

The foundation for this division of labor is the traditional organizational hierarchy. As explained in Chapter 6, well-functioning hierarchies are defined by clear separation between levels according to the time it takes for those at each level to know whether or not they have made the right decisions today. Most who work in large organizations have an intuition that this basis of organization is right. The CEO should be thinking about the long term, while divisional management (typically an operating division) is worried about the medium term, and in-the-trenches line management has to deliver the goods.

In the short run, there is very little strategic uncertainty. We typically know (even if we cannot implement) the best way to create and capture value in the present. We cannot know how best to create and capture value ten or twenty years from now. The range of strategies that might be optimal in the future only expands as we lengthen the time horizon under consideration. Consequently, there is a great deal of strategic uncertainty when considering the long run.

Senior management, because it is responsible for longer time horizons, should therefore focus its efforts on managing strategic uncertainty. Those lower down in the hierarchy, because they are responsible for shorter time horizons, should focus on delivering on the commitments already in place. This new organizing principle is called *Requisite Uncertainty,* because each level of the hierarchy is defined by its relationship to managing strategic uncertainty.

The implications of separating the management of uncertainty from the management of commitments are more far-reaching than it might seem. In the first place, Requisite Uncertainty provides a foundation for the widely held yet often violated belief that senior management should not be concerned with short-term results. There is very little that pulling on the strategy lever can do to improve this quarter's cash flow, and any CEO that is compelled to intervene frequently on issues that can affect current financial results is likely not able to pay enough attention to strategy.

Explicitly identifying strategic uncertainties and requiring that senior management attend to them might well be quite different from the more bottom-up risk-management processes many organizations have in place.

Focused on important but shorter-term uncertainties such as the supply chain, the company's reputation, and so on, much of established risk-management practice overlooks the risk that the company has committed to the wrong strategy, and what to do about that.

Perhaps more controversially, applying the principles of Requisite Uncertainty implies that CEOs should not see their role in terms of making strategic choices—that is, commitments. Rather, they should focus on building "strategic options," that is, creating the ability to pursue alternative strategies that *could* be useful, depending on how key uncertainties are resolved. It implies also that the board should not concern itself as much with engaging the substance of a firm's strategy as with determining the most appropriate exposure to strategic risk and opportunity. Only by shifting the emphasis at the top of the hierarchy from making and executing strategy to managing strategic uncertainty can corporations hope to mitigate strategic risk while simultaneously creating strategic opportunities.

In Chapter 7 a case study of Vivendi Universal, a French media conglomerate, illustrates what happens when a CEO succumbs to the temptation of top-level, hands-on strategy making. Examinations of the diversified Canadian telecommunications company BCE Inc. and U.S. software company Microsoft highlight the benefits of an option-creating top management. In particular, the BCE and Microsoft cases show how corporations can manage strategic uncertainty in ways that investors cannot replicate.

However, it will be apparent from these examples that the success of an options-based corporate strategy has depended largely on the charisma, influence, and power of the CEO—it has required people such as Bill Gates and Rupert Murdoch to do this successfully. Not every company is led by such titans. Consequently, we need an explicit, process-based description of how managers at all levels can contribute to managing strategic uncertainty in ways that mitigate risk and position a firm to capture emerging opportunities. This is the subject of Chapter 8, a case study of how Johnson & Johnson (J&J), the diversified U.S. pharmaceutical, medical devices, and consumer products company, has tackled this challenge.

J&J is breaking new ground in the management of strategic uncertainty. The company's operating divisions are not exclusively responsible for managing long-term strategic uncertainty. Rather, divisional leadership's primary role is to commit to a specific strategy, because making a commitment is the only way to create and capture value. But the range of strategies available to the operating divisions is a function of the opportunities created by the corporate office. That is, operating divisions enjoy a level of *strategic flexibility*—a deliberate oxymoron that qualifies the irreversibility of strategic commitments without undermining their competitive power.

Operating divisions that manage their own long-term strategic uncertainty will most likely end up mediocre performers, avoiding high-risk bets to increase their odds of survival. In addition, since great performance demands relentless focus on a particular strategy, devoting resources—especially management time and attention—to creating options is typically beyond the capacity of an operating division. Consequently, Strategic Flexibility is not something a successful operating division can typically create for itself. Only by focusing the corporate office on the management of uncertainty can the overall corporation achieve high results (thanks to commitment-focused divisions) at lower risk (thanks to the uncertainty-focused corporate office).

Highlighted here is the profound difference between "growth" options and true *strategic* options. Often, companies will make a small investment in a new venture and see it as an "option" on future growth: if the venture takes off, then invest more in it; if it falters, let it wither, or perhaps even expedite its demise. Strategic options, however, enable established divisions to pursue fundamentally different strategies. A strategic option is an option on an element of an alternative strategy that might or might not be implemented, not simply an option on further investment in a new business that might or might not succeed.

Making the corporate office responsible for managing uncertainty is a significant break from much current thinking about the role of the corporate office. Most prescriptions on what a corporate office should do start with the premise that all competition takes place at the product market level—that is, in the domain of operating divisions.[7] This is true, but the conclusion that all corporate office activity must, therefore, be directed at improving the current competitiveness of operating divisions—by, for example, facilitating the capture of synergies between operating divisions—does not necessarily follow.

Drawing too direct a line between the actions of the corporate office and the performance of the operating divisions is an unhealthy side effect of our collective obsession with generating returns. The frameworks for developing competitive strategy that have emerged over the last thirty years have given us unparalleled insight into how companies can succeed. And competitive strategy remains enormously important, but it should be the preserve of divisional management. But just as there can be no left without a right, there is no return unaccompanied by uncertainty: operating divisions worry about competitive strategy to create and capture value; corporate strategy should be focused on the management of strategic uncertainty. Requisite Uncertainty delegates to corporate management responsibility for managing strategic risk and opportunity leaving operating division to create and capture

value, and Strategic Flexibility is the corporate level framework for managing strategic uncertainty through the creation of strategic options.

It would be a mistake to think that the distinction between corporate and competitive strategy, and hence Requisite Uncertainty, applies only to Fortune 500 corporations. Any organization with greater size and complexity than a sole-proprietor corner store—or even just the ambition to achieve said size and complexity—can benefit from thinking carefully about separating how to generate returns from how to manage uncertainty. If your organization has operating managers who report to still more senior managers, there is not simply the chance but the likelihood that there is an unhealthy overlap between the jobs each level thinks it is doing. In fact, the smaller the organization, the greater the temptation of senior management to involve itself in operating decisions, with the unfortunate consequence of leaving the management of uncertainty largely to . . . chance.

1.6 THE TOOLKIT

J&J teaches us that strong results arise from driving individual operating divisions to pursue the kind of high-risk, high-return strategies that stand-alone divisions tend to avoid. Pushing divisions in this direction is done using a set of *constraints* defined by the corporate office. Resource constraints limit the time horizon a division can consider and the investment level it can support. Structural constraints restrict the operating scope of a division and enforce specific size parameters. And strategic constraints ensure that relentless attention is paid to particular customer groups and that the risk profile of a division remains within well-understood boundaries.

Fighting the drift toward mediocrity is only half the battle: if J&J's corporate office did nothing more than drive its divisions to high-risk, high-reward strategic positions, the overall corporate returns would likely show high variability and an average no better than any other portfolio of investments. What makes J&J special is that they move beyond simply driving performance to actively managing risk *without undermining the operating divisions' focus on results*.

With divisions focused on generating returns, J&J manages uncertainty through a highly specialized organ of the corporate office that identifies the relevant strategic uncertainties and devotes resources to creating the options needed to manage them. Going far beyond simply "facilitating communication" or "investing in blue-sky opportunities," J&J Development Corporation (JJDC) is pioneering a new role for the corporate office, giving structure and repeatability to the insights and intuition that have

traditionally been the preserve of a "heroic" CEO. The tool for creating strategic flexibility, called Strategic Flexibility, has four phases:

Anticipate: build scenarios of the future
Formulate: create optimal strategies for each of those futures
Accumulate: determine what strategic options are required
Operate: manage the portfolio of options

You might recognize the silhouette of one or more established management tools—scenario-based planning, strategic planning, or real options, to name three of the more obvious ones. But Strategic Flexibility is not a pastiche of existing approaches. Integrating these tools and grounding them in a validated theory of organizational hierarchy creates something that is quite different from any of these tools on its own, or in mere combination with the others.

Chapter 9 illustrates the first two phases using the case of Alliant Energy's mooted entry into the unregulated electricity-generating business. Alliant Energy is a $3.3 billion Wisconsin-based energy-utility holding company, and in 2002 the firm was considering whether to invest in nonregulated ("merchant") generating assets. Rather than commit heavily to a particular merchant generating strategy, the company considered just a series of scenarios designed to capture the full range of possible futures over the relevant time horizon—about ten years. There is, of course, a well-developed body of work describing how to build scenarios; this case study describes which threads of that work are most relevant to the *Anticipate* phase of Strategic Flexibility.

With scenarios in place, the next step is to *formulate* optimal strategies for each scenario. Again, there is an established discipline of strategy formulation that can be relied upon to provide guidance for building a successful strategy given a set of competitive conditions.

In the context of Requisite Uncertainty, however, strategy formulation has very different objectives depending on one's relative focus on managing uncertainty or delivering on commitments. As illustrated in the Alliant Energy case study, the objective at the board and corporate level is to create strategic options. At the divisional level, where commitments to specific strategies have to be made, the key is to hedge the downside attendant to the chosen strategy. How this can be done effectively is demonstrated by SBC (now AT&T) in its response to increasing competition in consumer voice and data services also explored in Chapter 9. Finally, at the line management level, where the emphasis is exclusively on delivering on commitments, the key is to learn as efficiently as possible how to make the most of

the commitments already in place. We see this kind of approach to strategy formulation in Chapter 9's fluid case study, Bell Canada's integration of the wireline and wireless telephony divisions.

With scenarios and strategies developed, the challenge now is to translate that analytical work into concrete action. The *accumulate* and *operate* phases are explored in the context of the M&A, joint venture, and partial equity stake investments that have been made in the financial services sector of the last ten years. Reinforcing the difference between simple growth options and true strategic options, examples from the investment banking and international finance sectors illustrate how the corporate office can create the ability for existing divisions to move in ways they could not if left to their own devices.

Accumulating the right portfolio of real options creates an investment strategy that mirrors the uncertain nature of the need for a particular asset. The key to realizing option value is to ensure that the investing company has the control required to *preserve* and *exercise* the option it has created. This is a very delicate balancing act. If an option-generating investment is granted too much freedom, it can evolve in ways that make the ultimate exercise of the option impossible. Too little autonomy, on the other hand, could undermine the viability of the option as a stand-alone investment, making it prohibitively costly to maintain or *abandon*.

Whether exercising or abandoning an option, there is a need for a healthy tension between divisional management and corporate management when determining a course of action. Simple prescriptions of "top down" or "bottom up" belie the inevitable subtlety and nuance of corporate decision-making. Guiding principles for managing this tension are described in detail in Chapter 10, along with some observations on how to value a strategic option and how to ensure that the entire process is self-renewing.

This book is not the first to observe that the future is unpredictable and that strategy making must take uncertainty into account. What is new is that here uncertainty is not an afterthought, not something one considers after commitments have been made. Instead, uncertainty is placed at the core of decision-makjng at the highest levels of the organization, and a broad range of strategic and organizational thinking has been marshaled to address the paradox created by uncertainty.

In the context of Strategic Flexibility, scenarios are transformed from an adjunct to strategic planning into its foundation, for scenarios serve to define the key strategic uncertainties that a company faces (the Anticipate phase). Strategy development is no longer a determination of what commitments to make and is instead a process for identifying which risks a company will accept, hedge, or avoid (the Formulate phase). The Accumulate and

Operate phases rely on the principles of Requisite Uncertainty, and make it possible for concrete investment decisions and ongoing strategic action at every level of the hierarchy to reflect the appropriate emphasis on commitment and uncertainty. The result is an integrated approach to creating greater value at lower risk. That is about as close as we can hope to come to getting something for nothing.

1.7 A NEW STRATEGIC CONVERSATION

I collaborated with Clayton Christensen on a book called *The Innovator's Solution*.[8] That book described how organizations can create and sustain profitable growth. But there are no returns without risk, and I have come to think of the ideas in this book as the other side of the risk/return equation. As we seek value, what risks do we run, and how can we reduce those risks without abandoning our quest?

The strategy paradox is that the prerequisites of success are often the antecedents of failure. Faced with this painful trade-off between the returns to bold commitment and the risk of making the wrong commitment, most organizations forgo the possibility of glory for a timid existence bereft of greatness.

Not all business failures are a result of traits typically associated with success: Incompetence, hubris, denial, and many other causes of catastrophe are decidedly not the stuff of victory.[5] But at least *some* failures *are* caused by a good strategy and solid execution. Until we accept this fact, we will continue to be blind to the disturbing similarities between success and failure. Only by understanding the paradox's root cause can we build strategies that succeed deliberately, rather than only when fortune smiles on us.

To break this trade-off and mitigate the role of luck in success, we must expand our strategic conversation to include not merely the commitments required for success but also the uncertainties that will determine which commitments will succeed. We know a great deal about how to make and manage commitments; our understanding of how to identify and manage uncertainties is far less well developed. As a result, expanding our strategic conversation in this way will require a new language and a new set of tools.

Requisite Uncertainty provides the foundation for separating the management of uncertainty from the management of commitment. The connection between hierarchical level, time horizon, and the degree of strategic uncertainty faced is the basis upon which responsibility for managing uncertainty is delegated primarily to the corporate office, while making and delivering on commitments falls mainly to the operating divisions.

This is only the first step: a better allocation of decision-making responsibilities is a necessary but not sufficient condition for resolving the paradox.

The rest of the answer lies in a new toolkit, Strategic Flexibility, which provides a step-by-step process for each level to address the uncertainties it faces and to deliver on its commitments. Combining these two concepts will further any organization's attempts to achieve the results it desires at a level of risk it can tolerate.

The strategy paradox has been largely ignored for too long, despite its ubiquity and its influence over the choices managers make. The goal of this book is to fuel the hope that although the future is uncertain, your fate does not have to be.

The strategy paradox arises from the need to commit in the face of unavoidable uncertainty. The solution to the paradox is to separate the management of commitments from the management of uncertainty. Since uncertainty increases with the time horizon under consideration, the basis for the allocation of decision making is the time horizon for which different levels of the hierarchy are responsible: the corporate office, responsible for the longest time horizon, must focus on managing uncertainty, while operating managers must focus on delivering on commitments. This is known as the principle of Requisite Uncertainty. A critically important tool in applying the principle of Requisite Uncertainty is Strategic Flexibility, a framework for identifying uncertainties and developing the options needed to mitigate risk or exploit opportunity.

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1. Roosevelt made these points in a speech titled "Citizenship in a Republic," more commonly known as "The Man in the Arena." It was delivered at the Sorbonne in Paris on April 23, 1910. See http://www.theodore-roosevelt.com/trsorbonnespeech.html, accessed July 17, 2006.
2. See http://en.thinkexist.com/quotes/elie_wiesel/, accessed July 17, 2006.
3. Gilbert, Dan (2006), *Stumbling on Happiness,* New York: Alfred A. Knopf.
4. Four studies worth reading that make these kinds of comparisons are, in alphabetical order by first author's last name, Collins, James C., and Jerry I. Porras (1994), *Built to Last: Successful Habits of Visionary Companies,* New York: HarperBusiness; Collins, Jim (2001), *Good to Great: Why Some Companies Make the Leap . . . and Others Don't,* New York: HarperBusiness; Joyce, William, Nitin Nohria, and Bruce Roberson (2003), *What (Really) Works: The 4+2 Formula for Sustained Business Success,* New York: HarperBusiness; Marcus, Alfred A. (2006), *Big Winners and Big Losers: The 4 Secrets of Long-Term Business Success and Failure,* Upper Saddle River, New Jersey: Wharton School Publishing.
5. See Porter, M. E. (1987) "From Corporate Strategy to Competitive Advantage,"

Harvard Business Review, Vol. 65, Iss. 3; and Goold, Michael, A. Campbell, and M. Alexander (1994), *Corporate Level Strategy,* New York: Wiley.

6. Christensen, Clayton M., and Michael E. Raynor (2003), *The Innovator's Solution: Creating and Sustaining Successful Growth,* Boston: Harvard Business School Press.

7. A number of books have examined failure, among them Tuchman, Barbara (1985), *The March of Folly: From Troy to Vietnam,* New York: Ballantine Books; Schnaars, Stephen P. (1989), *Megamistakes: Forecasting and the Myth of Rapid Technological Change,* New York: Free Press; Bazerman, Max H., and Michael D. Watkins (2004), *Predictable Surprises: The Disasters You Should Have Seen Coming and How to Prevent Them,* Boston: Harvard Business School Press; Mittelstaedt, Robert E. (2005), *Will Your Next Mistake Be Fatal? Avoiding the Chain of Mistakes That Can Destroy Your Organization*, Upper Saddle River, New Jersey: Wharton School Publishing.

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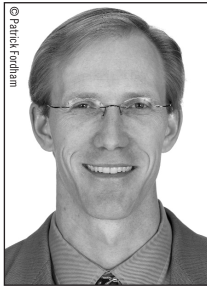
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"This is one of the most important, realistic and useful books on strategy ever written. With consummate clarity and withering logic, Raynor confronts and resolves the paradox that while strategy requires commitment, much about the future is simply unknowable. It is an absolutely brilliant, lucidly written piece of scholarship."

—CLAYTON CHRISTENSEN, Professor, Harvard Business School, and author of the bestselling *The Innovator's Dilemma* and *The Innovator's Solution*

A compelling vision. Bold leadership. Decisive action. Unfortunately, these prerequisites of success are almost always the ingredients of failure, too. In fact, most managers seeking to maximize their chances for glory are often unwittingly setting themselves up for ruin. The sad truth is that most companies have left their futures almost entirely to chance, and don't even realize it. The reason? Managers feel they must make choices with far-reaching consequences today, but must base those choices on assumptions about a future they cannot predict. It is this collision between commitment and uncertainty that creates THE STRATEGY PARADOX.

This paradox sets up a ubiquitous but little-understood tradeoff. Because managers feel they must base their strategies on assumptions about an unknown future, the more ambitious of them hope their guesses will be right — or that they can somehow adapt to the turbulence that will arise. In fact, only a small number of lucky daredevils prosper, while many more unfortunate, but no less capable managers find themselves at the helms of sinking ships. Realizing this, even if only intuitively, most managers shy away from the bold commitments that success seems to demand, choosing instead timid, unremarkable strategies, sacrificing any chance at greatness for a better chance at mere survival.

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Price: $27.50/$34.00 in Canada • ISBN: 978-0-385-51622-8 (0-385-51622-3)

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