Strategic Management: Overview

The two most important things in strategic management are thinking, preferably in a comprehensive, critical manner with a fair amount of rigor, and your ability to articulate and express that thinking. As a result, basically everything in this “book” is about modeling and analyzing[1] the business world to answer the question, "Why does firm[2] performance differ?"

The title of this course is strategic management. Management is getting work done through others.[3] Strategy is unfortunately a little more complicated. What is strategy? Strategy comes from the Greek root stratos - army, and ag - to lead, hence "Art of the General." From this it is no great jump to: " the science or art of planning and directing large-scale military movements or operations".[4] That is a little too specific for our purposes, so let's define strategy as the overall plan for deploying resources to establish a favorable position. This can include military operations, but can apply equally well to business firms. In a business context, strategy can be defined as developing and deploying resources to gain a sustained competitive advantage over others. A sustained competitive advantage (SCA) is exactly what it sounds like, it’s some performance advantage over rivals that persists.

The idea of a general manager can help facilitate thinking strategically. A general manager understands how all the basic functions of the firm come together to influence the performance of that organization. A function is any specific action or activity, so accounting, finance, marketing, production are all examples of basic business functions. A good general manager recognizes the value all functions of an organization contribute to its success. An illustration may help clarify this idea:

> Imagine you are in charge of the budget for a firm. You have called together all the heads of the various functional departments for a meeting to discuss their requirements for the coming year. Each reports to you all the additional wonderful things that they can accomplish if you provide them with additional resources. Accounting can improve their internal controls, providing you with additional cost information on your production. Your management information systems people say they can link all the information systems in your firm together to help improve order tracking and customer service. Finance wants to hire an investment advisor to consider the capital structure of the firm. The human resources officer is rolling her eyes and saying people are the difference, we need to invest in them, with training and better benefits. The production engineer is trying to hang himself with his tie because he needs new machinery. Meanwhile the research department claims that with just a little more support a revolutionary product can be developed. Your marketing officer wants to do a new media buy to improve the image of the company.

Whose claims are most important? What should you do?

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[1] Analysis refers to breaking up something into its component parts to discover their characteristics, their relationship to each other, and to the whole. Basically, this class is about ways to do analysis to firms and their surroundings.

[2] An organization is any formally arranged group of people, a firm is an organization that is engaged in commerce, i.e. profit seeking activity. Organizations are more common than firms, but all firms are organizations.

[3] This classic definition of management is usually attributed to Peter Drucker.

[4] Webster's Dictionary

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As an area of study, strategic management was developed in an effort to help address these types of difficult questions. Each department head has good and strong reasons for advocating the position they do. But in the absence of clear financial returns (and any estimates you have are probably little more than guesswork) how can you pick between so many good choices? Strategic management is about these attempts to balance the competing functional demands of a business. It is NOT about the answers to these problems, but it is about the best questions to ask to make the best decisions possible in addressing these problems.

As a result of this approach, strategic management is general and integrative in its approach. It is necessary to have some understanding of each of the functional areas of the firm in order to appreciate it, because as we've already stated, each of these areas comes together to explain why firm performance differs.

Why does firm performance differ? This is not an easy question and interestingly under neoclassical economics all firms should earn "normal" rents, the same returns given their risk adjusted cost of capital. There is just one minor problem with this model, it is demonstrably untrue. Firm performance (there are many measures for this, accounting returns, stock value, etc.) clearly varies tremendously, Why? Because of the decisions human managers make about private resource allocation. The outcome of these decisions are contingent on the abilities of the firm and its external environment. Therefore, the fundamental question is: How can you quickly understand your firm, what your environment is, and make good decisions given this information?

In summary, business strategy is a plan or pattern of resource development and allocation that enables firms to maintain or improve performance. Strategic management is the process through which business strategies are chosen and implemented. The outcomes of strategic decisions are almost always contingent in nature: there is no one right answer, because the outcome is dependent on the independent actions of others.[5] Therefore, we'll stress ways to think quickly and comprehensively in order to understand your environment, your firm, and what you should do.

Strategic Planning. Strategic planning was the first effort to attempt to systematically examine the internal abilities of an organization and its external environment. This gave us the anacronym SWOT, for strengths, weaknesses, opportunities, and threats. SWOT analysis tries to take the strengths of the firm and use them in exploiting opportunities and minimizing external threats and internal weaknesses. Strategic planning became wildly popular and extensively used in the 1960s and 1970s.

Unfortunately, strategic planning was not as successful as everyone hoped. "No battle plan survives contact with the enemy," was a famous quote by Moltke that turns out to be just as true in the business environment. The rise and problems of strategic planning were carefully investigated by Henry Mintzberg. His critique established three basic problems of strategic planning which he termed fallacies; the fallacy of prediction - it's hard to know the future; the fallacy of detachment - if the people who make the plans don't coordinate well with the people who are going to implement them it often goes poorly; and, the fallacy of formalization - too often planning is separated from action.[6]

[5] This is why when we discuss decision making, we will claim that outcomes are a poor way to judge the quality of a decision.
[6] Mintzberg, H. (1994) The Fall and Rise of Strategic Planning, Harvard Business Review, January-February.

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Despite these problems, strategic planning is the most common management tool used by firms today.[7] There are things that can be done to help strategic plans be more meaningful. The problem of predicting the future can be partially addressed through the use of scenario planning. Scenario planning is developing a range of different situations that might present themselves. In addition, the simple fact that things are not "going according to plan" can be an important consideration for managers of an organization. The last two problems can be addressed by giving those who are responsible for implementing the plans a large role in developing them. While this sounds easy and obvious it is rarely done in practice.

Tasks of Strategic Planning

The tasks of strategic planning are very simple and boil down to four key questions:
a. What do you want? Which we will cover as missions and goals.
b. What's going on? Which we will cover as external analysis.
c. What do you have? Which we will cover as internal analysis.
d. What are you going to do? Which of course is the plan!

Therefore, these tasks - external analysis, internal analysis, and strategic choice - basically serve as an outline for most strategic management courses. You may remember Strengths/Weaknesses/Opportunities/Threats (SWOT) analysis from another class, which was a popular (but by no means the only -- my favorite one was WHAT'S UP) starting point for strategic planning. It is a useful starting point and what we'll do is basically go through and talk about how to do SWOT analysis better using more rigorous frameworks. We'll cover each of the following topics in more depth. Many people refer to this as the strategic management process.

Missions and goals are simply what is the organization trying to accomplish and what specific and measurable targets does it have to help make sure it gets there?

External analysis (enhancing the OT of SWOT) consists of examining things that fall beyond the borders of the firm. While there are numerous potential frameworks for this I suggest two, one dealing with the broad macro environment and another, the well known five forces framework for the industry environment. Recall**,** an industry can be defined as a group of producers of close substitutes.

For **Internal Analysis,** what goes on inside the organization, (enhancing the SW of SWOT) we'll use VRIO analysis. Given that almost anything a firm possesses can be considered a resource or capability how should you attempt to narrow down the ones that explain why firm performance differs? VIRO stands for valuable, rare, inimitable (including non-substitutable), and organized resources and is the foundation for internal analysis. An example of a VRIO advantage may be Southwest Airlines corporate culture.

Once internal and external analysis is completed the question becomes how should the firm compete in its markets. Again, there are multiple extant frameworks[8] but there are basically three strategic choices for a firm in any one industry it is involved in. We'll term these **business level strategies** and they are low cost, differentiation, or focus.

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[7] Rigby, D. 2001. "Management Tools and Techniques: A Survey", California Management Review, 43(2): 139-160.

[8] Probably the most colorful one was developed by Miles and Snow who modeled firms as Defenders, Prospectors, and Analyzers.

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Finally, while a firm uses business level strategies for how to compete in any one industry, it uses **corporate strategy** to determine which markets or industries it should compete in. Corporate strategy is frequently described in terms of diversification, what percentage of sales comes from what industries, and vertical integration, does the firm own some of its customers or suppliers. However, our focus is not to describe corporate strategy but to explain how it relates to why some firms do well and others do not. Therefore, the main issues we'll discuss are opportunities to share resources, transfer competencies or create specific assets.

The layers of organizations. Strategy can be done at any level of the organization. Functional strategy revolves around the actions of a single function or aspect of a firm. Examples from functional areas include marketing campaigns or production schedules. Business level strategy discusses the actions of a firm in a single industry. Corporate strategy deals with the scope of the firm, what industries and markets should it be involved in. Global strategy includes the ideas and plans for operations in foreign markets.

The problems of performance. While this class is about the question "why does firm performance differ," it will skirt the issue of what exactly *is* performance. However, this does not suggest you shouldn't be familiar with possible metrics and their issues. There are many possible measures of firm performance (and even MORE for organizational performance) but no definitive measure. Some of the most common include conventional financial accounting measures such as profit, revenue, return on assets, and return on equity. These are mostly focused on the past performance of the firm, so called backwards looking measures. There are also marketing measures such as market share. Recently, measures that include an aspect of stock market performance, e.g. market capitalization, have gained considerable attention. Theoretically, the price of a stock represents the discounted future value of a proportionate share of the future income stream from the firm. This is a more forward looking measure of performance. However, stock values fluctuate a great deal. All of these measures are subject to manipulation, including, accounting notes, channel stuffing, and CEO commentary, respectively. Therefore, while the precise performance metric can be left to managerial discretion please be mindful of these issues.

Two Ways to Answer the Question of How a Firm Should Compete. So you have a big pile of capital and want to make more, how should you think about this? You have two basic approaches. The first is the industrial organization (I/O) model that is based on neoclassical economics.[9] Under this model you should identify a good industry and get what you need in order to enter it successfully. The second model is the resource-based model. Under this model, the idea is to use what you have in the best places. What you have consists of two things: a. resources - anything possessed by the firm including intangibles; and b. Capabilities - what the firm can do with those things. A good example may help clarify this distinction between resources and capabilities: My PC (a resource) is more advanced than the computer used to land the space shuttle, however, I do not have that capability. The important thing to remember is that the I/O model underlies our external analysis frameworks, while the resource based model underlies our internal analysis frameworks. Both come together to more fully answer the question of why firm performance differs than either one can do in isolation.

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[9] This is obviously a simplification, the real framework is called Structure, Conduct, Performance, the idea being that industry structure dictates firm conduct which in turn influences firm performance.

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The Strategic Management Process. The hard part is that all of this analysis and strategy comes together. This is referred to by some as the strategic management process.

Mission/Goals - What do you want?
Analysis: SWOT (Internal AND External) - What's going on and what do you have?
Strategic Alternatives and Choice - What are you going to do?
Strategy Implementation - How are you going to do it?
Monitoring and Feedback - How are things going?

Each of these topics, plus ethics and corporate governance, will be examined in detail in the following chapters.

A Detour to Decision-Making.[10] Obviously, at every stage of the strategic management process decision making is important. Rational decision making is generally viewed as the preferred way to distinguish between alternatives. (An assumption of rationality underlies all economic work. Economic work underlies a lot, but not all, of our thinking about why firm performance differs.) Unfortunately, evidence strongly indicates that people are NOT rational. We are emotional creatures as much, if not more, than rational ones.

In addition to human nature, rationality is undermined by five cognitive biases based on problems we have as humans perceiving the world around us and needing to "make sense" of it. Grounded in psychology, they are:
a. <u>prior hypothesis</u> - Based on the perceptual problem of selectivity, prior hypothesis bias is ignoring new information that is not consistent with your current beliefs. Frequently seen in social situations when someone you don't like does something nice for you, yet you still don't like them.
b. <u>escalation of commitment</u> - Escalation of commitment is committing additional resources even though the initial commitment resulted in failure. This bias is tied to the important idea of sunk (non-recoverable) costs from economics. Therefore, sunk costs do not matter when evaluating a decision rationally but humans have a hard time remembering this. Escalation of commitment is seen all the time in casinos when losing gamblers decide to increase the amount they are betting to "catch up."
c. <u>analogy</u> - using simple parallels from the past to make sense of complex problems. We all do this to some extent, but if this is the ONLY method used for decision making problems can arise because the context of decisions frequently changes.
d. <u>representativeness</u> - Based on the perceptual problem of closure, people often over generalize from very little information. I hear this all the time in Harrisonburg when people talk about "JMU students being _______."
e. <u>illusion of control</u> - An especially big issue for *successful* Americans, who generally believe they have a lot of control over what happens to them, is the risk of overestimating our ability to control or manage events.

In addition to these biases, as humans we tend to evaluate decisions based only on their outcomes. If things "don't work out" we assume we made a bad decision. This is NOT a good way to evaluate decisions, but it is a good starting point to evaluate our decision making processes. This relates to an important tactic of setting the criteria first when making decisions.

[10] Generally, strategy is concerned with ideas about the organization (so called, macro level) but sometimes ideas that relate to an individual become important.

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Decision-making can be improved by using a couple of techniques. The first and easiest is called Devil's Advocacy. This is the process of designating someone to argue against whatever is being considered. It comes from the Catholic Church's practice of designating someone to argue against a person's sainthood. (Would you want to say that Mother Theresa was not a good person and worthy of sainthood? Probably not, but that side of the discussion needs to be considered.) The second, more complicated process is didactic process. This is simply assigning two teams to a problem. Even if the two teams arrive at a similar conclusion, their approach is likely to uncover additional aspects of the issue that would otherwise go unnoticed.

Diversity can also play an important role in decision making. Generally, diverse groups make better decisions than homogenous groups. However, they also take longer to arrive at those better decisions.[11] We will talk more about diversity as a firm resource and its role on how performance differs when we discuss internal analysis.

Conclusion

Therefore, at its core strategic management is about theoretical models that can be applied to the world around you. We will discuss each of them in turn. However, the hard part will be seeing how they all fit together. This integration is a very challenging issue. It is different from how most subjects are taught, applied, and understood. Most explanations of subjects start at the general and move to the specific. Here, we're going to start with the specific reasons why firm performance differs, and move them all into a relatively simple general model.[12]

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[11] Richard, O. C. (2000). Racial diversity, business strategy, and firm performance: A resource-based view. *Academy of Management Journal*, *43*(2), 164-177.
[12] I believe that a broadly applicable general model that you have some chance of retaining and using once you are finished is much more valuable that a more accurate and detailed model that you will quickly forget.

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