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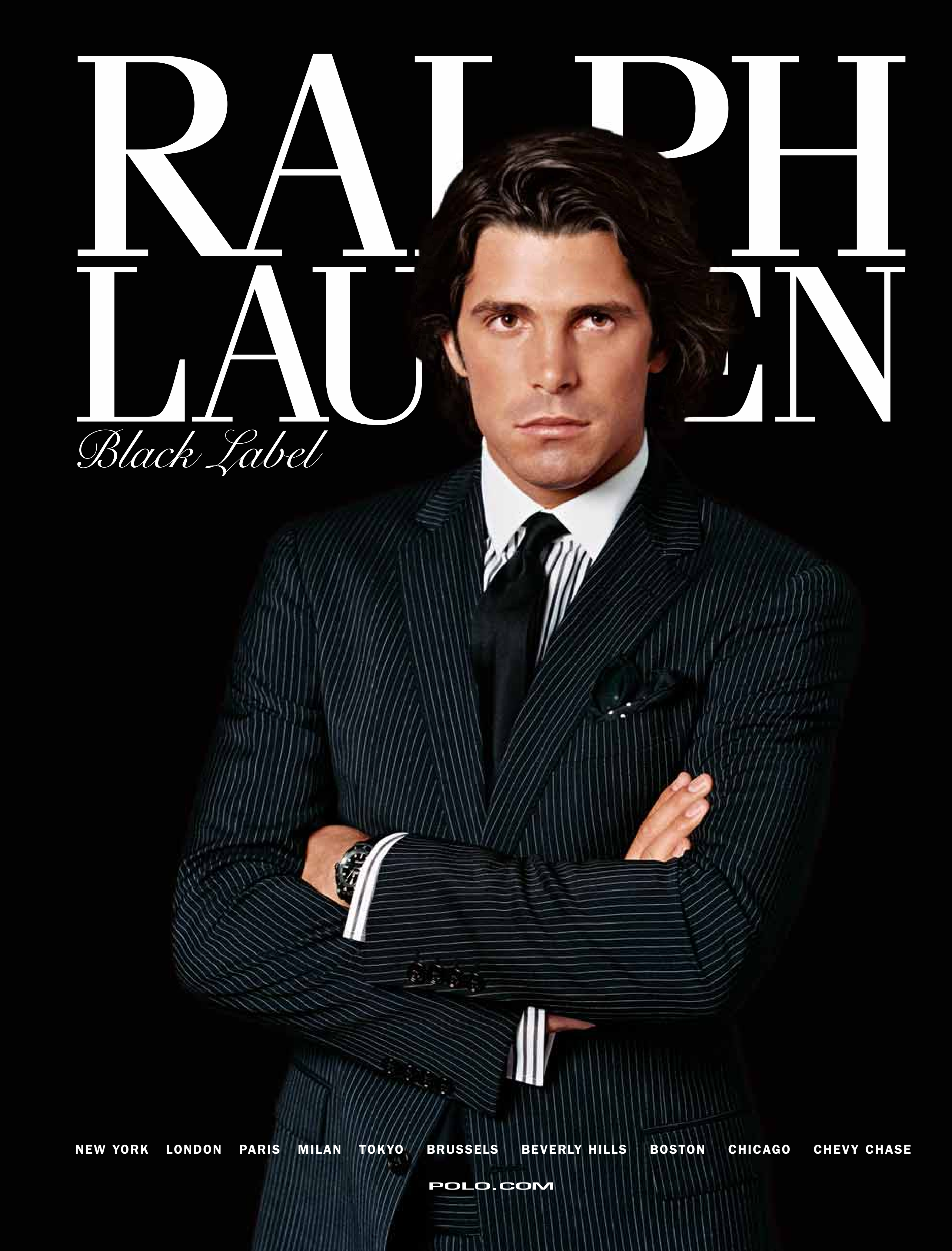
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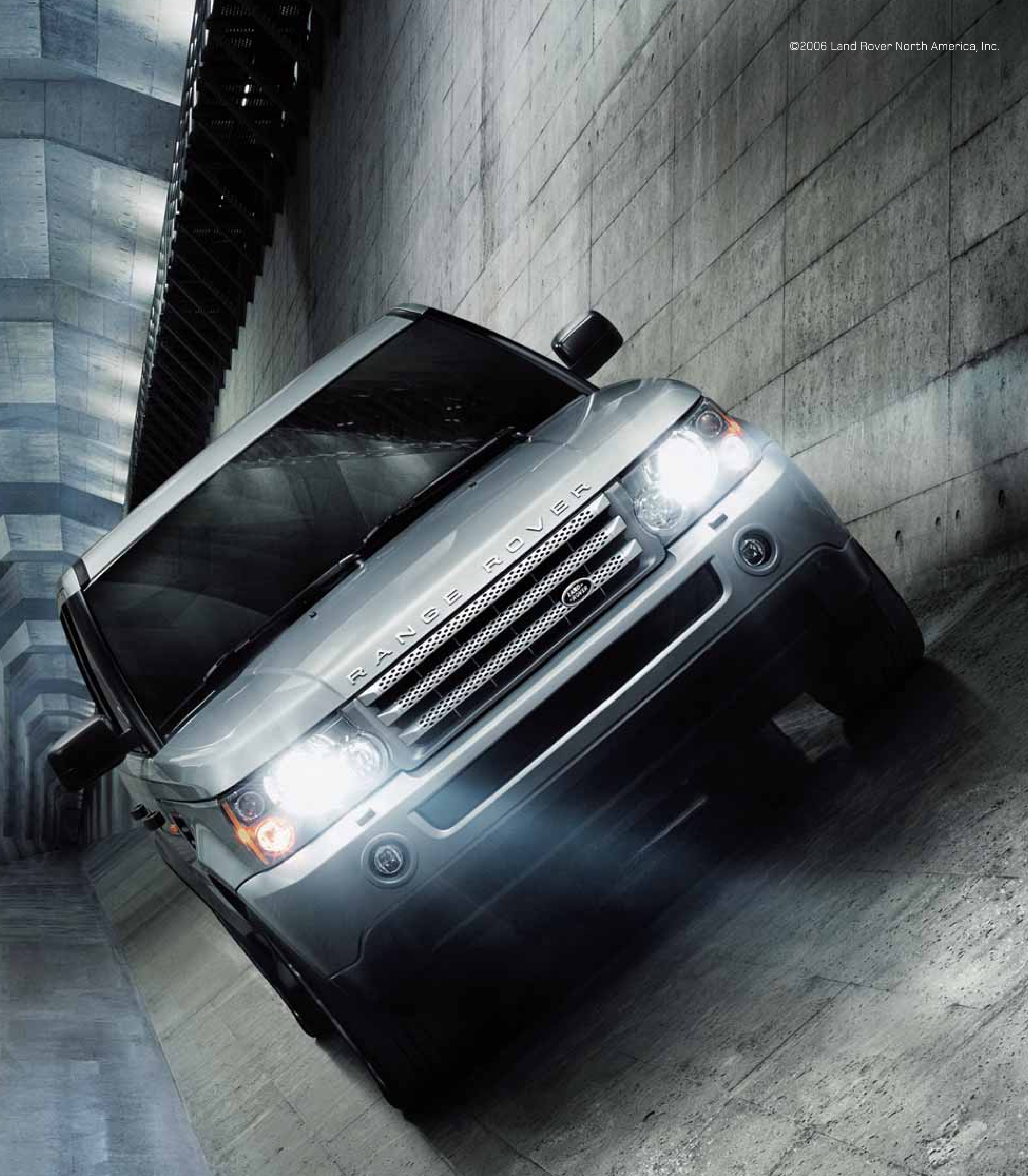
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88 **With Friends Like These: The Art of Managing Complementors**
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104 **How to Keep A Players Productive**
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114 **Curveball: Strategies to Fool the Competition**
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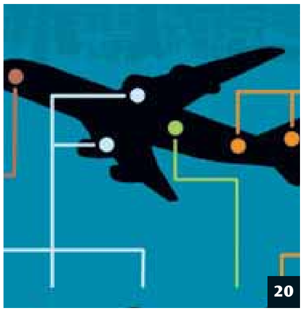

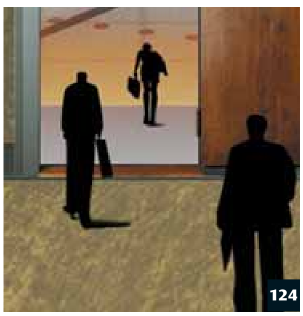

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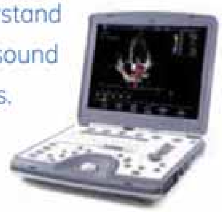

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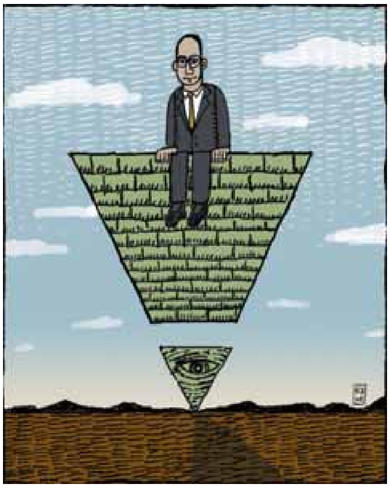
Are You Wealthy, or Are You Rich?



During proxy season last spring, a debate about executive compensation erupted that was notable for its ardor and its vacuity. Clearly something is rotten in the state of executive pay. Amid growing worry about the competitiveness of corporations in the developed world, an increasing number of top executives bring home eight- and nine-figure paychecks. There is a growing gap between the remuneration of senior managers and that of ordinary workers. At the same time, bankers and traders on Wall Street earn fortunes compared with the pay of the men and women who run companies in nonfinancial industries. A handful of top dogs receive lavish treats even when their companies' stock prices roll over and play dead.

Much of what passes for debate about this topic has been the intellectual equivalent of rounding up the usual suspects: cozy CEO–director relationships, inattentive institutional investors, short-termism, and stock options. All of these are partly guilty. Anyone who has followed my writing with a stalker's avidity knows that I have a particular bone to pick with stock options, whose purpose is to align managers' thinking with that of owners but whose effect is to align their interests with those of traders. Stock-option-accounting sophistry aside, if the goal is to make managers shareholders, why not just pay 'em half their comp in company stock itself, bought in the market at the opening every payday?

This debate can't get anywhere until it shifts its ground from the mechanisms of who gets what to a more profound and meaningful topic: understanding the difference between getting rich and creating wealth. That is the real lesson to be drawn from Al Rappaport's article in this issue, "Ten Ways to Create Shareholder Value." Rappaport, a professor emeritus from the Kellogg School at Northwestern University, literally wrote the book on this subject (*Creating Shareholder Value,* first published in 1986). His new article does three necessary things brilliantly: It dissects the rhetoric of those whose claim of creating wealth for shareholders is really a cover for behavior that makes them rich; it exposes as false some charges leveled against the creation of shareholder value (for example, that it's a short-term strategy); and it unambiguously lays out ten practices that companies should follow if they are serious about building wealth. Few companies reach "level 10" performance by Rappaport's standards – in a sidebar by Michael Mauboussin you'll read Warren Buffett's comments about how Berkshire Hathaway stacks up. For boards of directors, these practices should be ten commandments. For investors, they're a checklist that reveals whether "your company" has your interest at heart. For managers, they are a framework for strategy and business modeling. The link between management and markets is central to a well-functioning company – and to the success of capitalism. That link is too often weak.

• • •

Walter Kiechel's name is missing from HBR's masthead, where it has been for over nine years. Walter, who most recently served as editor-at-large for our parent, Harvard Business School Publishing, will be consulting to the company and is completing a book, under contract to HBS Press, that chronicles the rise of the study of strategy. Walter's contributions to our work are innumerable. He brought us deep experience in the magazine profession. He brought extraordinary intellectual gifts and literary flair. Most of all, Walter brought us, whether we wanted it or not, the outside world. He helped to increase HBR's clock speed during the *Review*'s transformation from a bimonthly to a monthly publication. He founded HBSP's newsletter business, which likewise pressed us to keep step with a fast-moving world. HBSP's conference business, which puts our readers, authors, and editors in the same room, would not exist without Walter. He had a significant role in recruiting many of HBR's senior editors, especially the two who came to us from outside the United States. The counsel he has given me during my time as HBR's editor has been bracing, smart, tough-minded, and invaluable. Though he disappears from our masthead, we won't let him out of our sight – and his influence suffuses every issue of the magazine.

Thomas A. Stewart

ROBERT MEGANCK

Harvard Business Review

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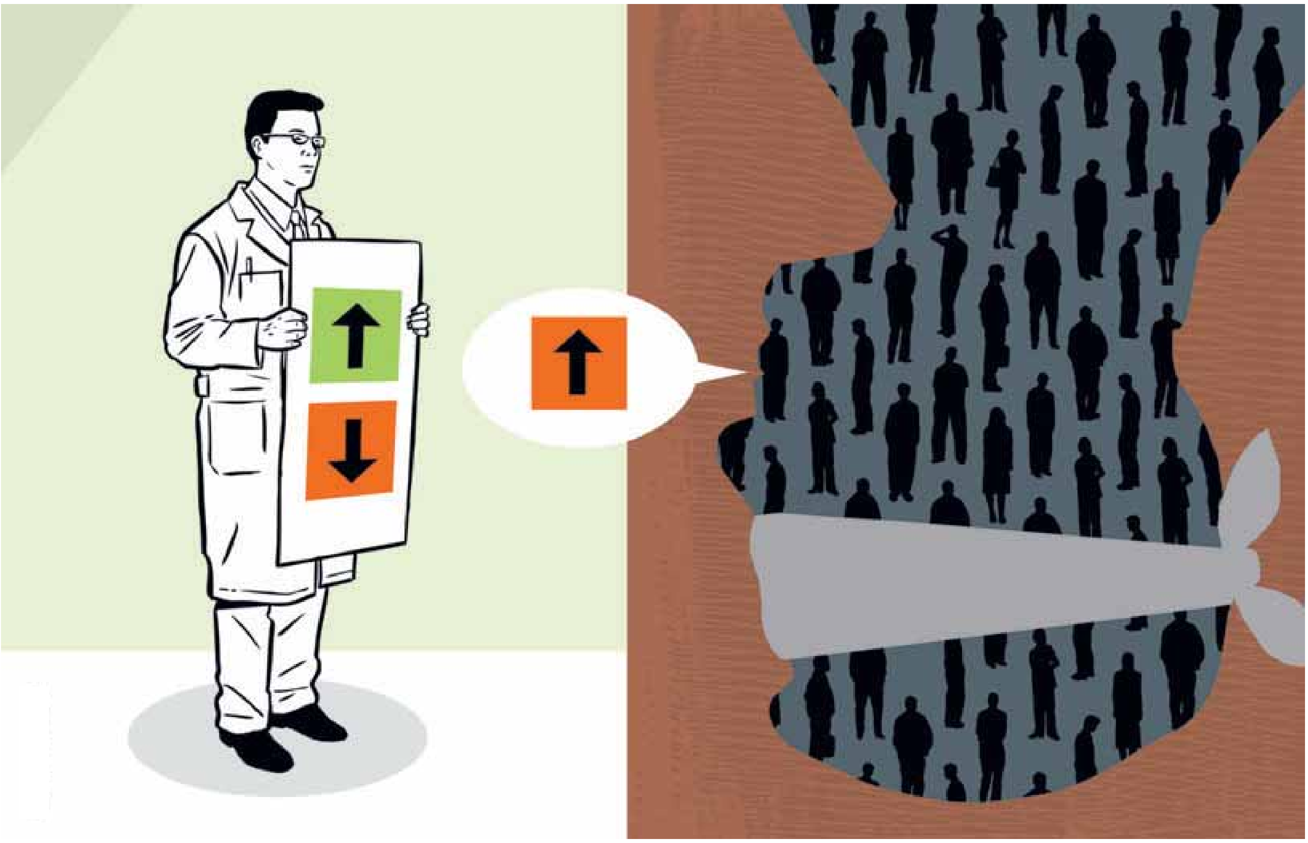

MATT WOOD

GRIST

When Crowds Aren't Wise

by CASS R. SUNSTEIN

Suppose that an executive wants to make a prediction that bears on his company. Will a particular product sell? How will a particular job applicant perform? When will a new office be ready to open?

Under certain conditions, the best way to answer such questions is to ask a large number of people and go with the majority's opinion. As emphasized by James Surowiecki in *The Wisdom of Crowds*, the conclusions of large groups can, in a sense, be better than those of experts, simply because such groups can aggregate a large amount of dispersed wisdom. Often the average judgment, which we might describe as the group's "statistical judgment," will be uncannily good.

What remains widely unappreciated is why, and when, statistical judgments will prove to be accurate or inaccurate. The best explanations come from the Marquis de Condorcet, a Frenchman who offered, in 1785, some simple arithmetic, captured in what is now known as the Condorcet jury theorem. The theorem has enduring lessons for those who want to know when to rely on the views of groups, and it offers a warning to those who think that crowds will consistently outperform experts.

To see how the theorem works, suppose that a number of people are answering the same question and that there are two possible answers, one correct and one incorrect. Assume, too, that the probability that each individual will answer correctly exceeds 50%. With a few calculations, the theorem shows that the probability that a majority of the group will answer correctly increases toward 100% as the size of the group increases.

Groups will do better than individuals in choosing a correct answer, and big groups better than little ones, as long as two conditions are met: the majority response "wins," and each person is more likely than not to be correct. Social scientists have extended Condorcet's theorem to questions having more than two possible answers. If people – workers, managers, customers – are more likely to choose the right answer than any of the wrong ones, then the plurality's answer is highly likely to be right if the group is large enough.

The theorem helps explain the amazing growth and accuracy of prediction markets, in which people bet on future events. The most famous example is the Iowa Electronic Markets, which consistently outperform polls in forecasting the outcomes of presidential elections. Or consider the Hollywood Stock Exchange, which does stunningly well in predicting box office success – and which has taken some of the fun out of Oscar night, accurately predicting 15 of the last 16 major Academy Awards.

Not surprisingly, many companies, including Microsoft, Google, and Eli Lilly, have been asking their employees to participate in prediction markets, "betting" on whether products will sell, when new offices will open, and whether profits will be high in the next quarter. (The markets are structured to comply with bans on gambling.) The early predictions have been exceedingly accurate. At Google, for example, events that are forecast as 80% likely to occur tend to happen 80% of the time; those forecast as 60% likely tend to happen 60% of the time; and so on.

But for those who embrace crowd wisdom and prediction markets, there's an important qualification. As Condorcet himself warned, his theorem reveals the downside of group decisions. Suppose that each individual in a group is more likely to be wrong than right because relatively few people in the group have access to accurate information. In that case, the likelihood that the group's majority will decide correctly falls toward zero as the size of the group increases.

Some prediction markets fail for just this reason. They have done really badly in predicting President Bush's appointments to the Supreme Court, for example. Until roughly two hours before the official announcement, the markets were essentially ignorant of the existence of John Roberts, now the chief justice of the United States. At the close of a prominent market just one day before his nomination, "shares" in Judge Roberts were trading at $0.19 – representing an estimate that Roberts had a 1.9% chance of being nominated. Why was the crowd so unwise? Because it had little accurate information to go on; these investors, even en masse, knew almost nothing about the internal deliberations in the Bush administration. For similar reasons, prediction markets were quite wrong in forecasting that weapons of mass destruction would be found in Iraq and that special prosecutor Patrick Fitzgerald would indict Deputy Chief of Staff Karl Rove in late 2005.

Businesses and governments take heed: When there isn't a lot of dispersed information within an organization, it's ill-advised to rely on what its members think. A computer company executive could sensibly rely on an internal prediction market if she is asking about completion dates for the company's own products in development. But should the manager ask employees about completion dates for competitors' products? That wouldn't be a good bet. When most people are not likely to be right because the group has little relevant information, it's best to ignore their judgments – and to try to find an expert instead.

CASS R. SUNSTEIN *(csunstei@uchicago.edu) is the Karl N. Llewellyn Distinguished Service Professor of Jurisprudence at the law school and the department of political science at the University of Chicago. He is the author, most recently, of* Infotopia: How Many Minds Produce Knowledge *(Oxford University Press, 2006).*

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RISK MANAGEMENT

Cutting the Cost of HIV *by* MERGEN REDDY AND BOETIE SWANEPOEL

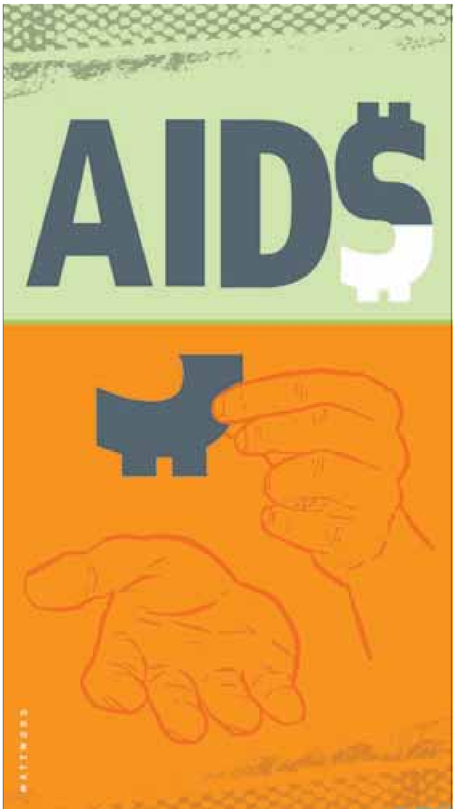
Companies doing business in the developing world have to contend with the staggering human and financial costs of HIV infection – and most would agree that conventional approaches to controlling the epidemic aren't working. In our experience in the labor-intensive mining industries of Russia, South Africa, and Botswana, we've seen infection rates among workers exceeding 90% in extreme cases and productivity losses as high as 30%. Efforts to prevent the spread of HIV infection have been only modestly effective, and so treatment is vitally important. But antiretroviral therapies and their associated health maintenance programs are extremely expensive. In our work with the largest mining companies in the world, we've found few that can afford to fund the total lifetime cost of treating workers – which can range from $400,000 to $900,000 per person.

Indeed, the root constraint for companies trying to manage HIV, we believe, is not the inadequacy of therapies or education, but cost. Therefore, we have approached the epidemic purely as a financial problem rather than a medical one. In pilot programs in Russian and Botswanan mines, we have lowered costs, reduced absenteeism, increased treatment, and improved productivity by applying the principles of capital-asset portfolio modeling to treatment programs and then creating contracts that allow companies to trade away (or insure against) the remaining financial costs of HIV on their business.

Here's how we did it: In step one, we created financial models of thousands of possible HIV management programs, each with different permutations of the elements constituting a complete program, from medications and treatment delivery to health facilities and ongoing wellness plans. Each such program is a possible treatment portfolio. Thus, portfolio A might consist of importing 2,000 capsules of drug A from India at a fixed contract price; importing 1,000 capsules of drug B from Belgium at market price; building five HIV/AIDS clinics owned and managed by the mining company; employing all nurses from company X; and giving each patient one of each pill once a day. Treatment portfolio B might be similar but require building fewer clinics while outsourcing for the remainder. Portfolio C might consist of outsourcing all treatment to managed health care company Y for a total fee of $10 million – and so on. (The actual portfolios we modeled have many more variables than described here and make forward projections.)

By running computer simulations of myriad different combinations of drugs and services, treatment locations, costs, and many other factors over time, we estimated the total costs and benefits (in terms of productivity and revenue) for the different portfolios. We then plotted the standard deviation of costs (the risk) versus the mean costs of treating employees (the "return") for each portfolio by averaging the outcomes of thousands of possible simulations run on each of them. The optimal portfolio for a given company, then, is the one that generates the highest likely return at an acceptable risk level. (This work required formidable computing power; a single portfolio would call for at least eight hours of processing on a laptop.)

While our method was initially greeted with skepticism, the technique generated significant positive financial and health results in both pilot locations. Over a two-year period, the companies' total treatment costs fell by approximately 30% to 40% – more than the simulations had predicted. In both of the pilots, the combined treatment costs fell from $1.2 billion to $800 million. At the same time, absenteeism rates fell by 7% and 15%, the



number of employees enrolled in treatment programs increased by 24% and 36%, and CD4 T-cell count among HIV-infected workers (an indicator of immune-system health) rose by 25% and 34%. Although location and type of mining does play a role in overall costs in our models (because labor costs vary), the single most important variables in our cost models are the source and price of drugs.

In step two of our program, we created instruments for trading risk. We devised a health derivative – in a sense, a sort of insurance contract – that an investment firm could sell to mining companies to buffer them against the potential productivity losses due to HIV. The contract states that if HIV-related absenteeism and injury were to affect productivity in specific ways, the investment firm – which receives a premium from the covered company – would pay the mining company a predetermined amount. If productivity is not affected, the investment firm would retain the premium as income. In essence, the contract allows the mining companies to shift the cost risk of HIV from themselves to a speculator (the investment firm). This investor is betting that a given portfolio will keep the cost of HIV-related productivity losses below the amount of the premium. Companies like Harmony Gold are taking this concept further, investigating the feasibility of contracts tied to individual mine shafts.

The positive results described here are based on trials in one industry. However, these pilot programs should offer hope to corporate leaders in other industries who are seeking ways to affordably – and effectively – care for their HIV-infected employees and limit the negative impact of HIV on their businesses.

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SUPPLY MANAGEMENT

Procurement as Strategy

by CARLOS NIEZEN AND WULF WELLER

In 2004, just days after Greece unexpectedly won the European Soccer Championship, Adidas delivered more than 145,000 Greece team jerseys across markets in Europe. Smart marketing, right? Without a doubt. But perhaps even more impressive were Adidas's global procurement efforts: Thanks to a centralized supply chain coordinated with its country-based sales subsidiaries, the company created just-in-time product not only for the championship team but also for the other national teams as they advanced through the series. To round out the success, Adidas's flexible supply chain strategy delivered these sales at very low risk, avoiding any significant investment in materials or finished product.

Procurement coups like this are helping to elevate supply management from an operational function to an integral part of company strategy. In fact, in a recent survey of 156 procurement executives

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Conversation

DAN WILLIAMS ON ICONS AND OPEN-SOURCE INNOVATION

Smart Product Design

Even more than technical expertise, it's the ability to connect the dots that drives innovative product design, says Dan Williams, who is widely known for the work he did on mobile phones when he was Motorola's design director. Now, as the creative director for the design and innovation firm TZ Limited, Williams has turned his attention to self-assembling fasteners, self-monitoring buildings, wearable medical sensors, and a host of other "intelligent" products at the Cambridge Innovation Center in Massachusetts. He spoke with HBR's Lisa Burrell about the view from design's leading edge.

What's the design lesson that companies should take from Motorola's success with the superthin Razr phone?

Razr is a great example of knowing when to stick with what you're doing well. It's actually an iterative design that evolved from another innovative icon: the StarTAC, one of the first clam-style mobile phones from the mid-1990s to challenge thickness. During development, many novel variations were considered, but management remembered what was good about the original concept and remained loyal to it. Motorola also realized that if you keep an archetype elegant as it evolves, you can keep it iconic.

The market was looking for something new to define the next level of cool. Motorola felt a lot of pressure to follow suit when other brands came out with concepts like sliding phones, for instance, but the decision makers respected heritage, and that paid off. Even though lots of companies are making clam-style phones now, in the minds of consumers Motorola still owns the concept.

There's much talk these days about "cocreating" with customers. Will product design become more collaborative, or will it always be done best by a small group of professionals?

There's room for all sorts of design models – expert creative groups, fab labs, and everything in between. Young upstarts are designing apparel on the Web, and we're seeing not just a little ding in the market but a significant impression. Some industries, like biotechnology and medicine, do require expert design. But even there, we're getting closer to a time when smaller private labs and individual scientists will be able to work on things in their garages and basements the way electronics pioneers did decades ago.

Neil Gershenfeld at MIT, the guy who wrote *Fab*, has a lab in one of Boston's inner-city neighborhoods where he just lets kids play around with technologies. You should see some of the things they're coming up with – electronic toys, robotic devices, new musical instruments. Neil sees a day when individuals will be able to strike out on their own and create products that were once considered too sophisticated or technical to be made outside a factory. Access to intellect, software, materials, and resources is really opening up. You'll be able to imagine something and then have some kid at a local 7-Eleven-type fab lab make it for you. It'll be design in quantities of one.

When do you think design efforts miss the mark?

When they overspecialize and focus too much on the technical side. Technology changes rapidly, but people don't. For instance, while kids today have a different way of communicating, their basic needs and desires aren't new. The best design groups understand why people want products and what gets them excited about certain designs. They also know how to aggregate dissimilar pieces of information and can work across disciplines. It's about being able to take something from one place and apply it in another. A friend of mine who was designing a pneumatic ice axe for climbers studied the physiology of woodpeckers to determine why they were so efficient at boring holes without hurting themselves. He discovered that it was balance, their spongy skulls, and the muscles around their beaks that cushioned the effect of the rapid hammering. He transferred that knowledge to his design. The valuable thing here is the ability to observe, listen, and communicate effectively in many areas. Big corporations should be careful not to lose that skill. As they specialize into functional or divisional operations, they need to have a few people who know how to fly across the field and make connections.

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that we conducted with our colleague Heidi Deringer, more than 90% said that their job responsibilities had expanded in the past three years. These new duties included shortening cycle times, taking the lead in product innovation, enhancing the quality of products or business outcomes, and even, as in the case of Adidas, generating incremental revenue via close collaboration with sales.

Consider how supply management has become strategic at Boeing. In developing its 787 Dreamliner, Boeing has expanded the role of procurement from outsourcing parts to outsourcing entire subsections. Nearly all of the new jet's design and fabrication, along with some 40% of the estimated $8 billion in development costs, is being outsourced to subcontractors. Mitsubishi is making the 787's wings, Messier-Dowty is making the landing gear, and Latecoere is creating the doors. Says James Renaud, Boeing's director of development operations, "The subcontractors are responsible for end-to-end design, and what we provide is integration [in project management and assembly]." As little as five years ago, such a pivotal role for procurement seemed remote.

At the Clorox Company, many new products are developed in conjunction with supply partners. When the company wanted to develop a line of surface-protecting cleaning products, it partnered with specialty chemical companies to develop products that could protect surfaces as sensitive as Teflon.

Clorox is a leader in a movement by manufacturers to expand their supplier universe in search of innovation. They are asking savvy procurement organizations to identify suppliers with new or different capabilities, which in turn can spur initiatives for innovation in a variety of forms. For example, when the division of one health-product maker sought a different way to market a new sweetener, the procurement organization went out and found the right marketing agencies to help expand the product's reach beyond an initial target of diabetics to include an expanding market of food and beverage makers and even fast-food restaurants.

Henkel Group is another supplier acting as an innovation agent for its manufacturer customers. Henkel runs units that provide adhesives, gaskets, and other bonding materials to auto and appliance manufacturers. Procurement teams from the appliance manufacturers frequently call on Henkel engineers to tear down new appliances in search of ways to save costs in assembly. In one such session, Henkel found 14 ways to save time and money in manufacturing a refrigerator by, among other things, using adhesives to replace screwed-on gaskets and taped-on shipping foam.

Beyond innovating processes and products, supply management is helping the balance sheet by shifting not just material and packaging inventories but even noncore R&D to capable suppliers, thereby freeing up resources to invest in sales, marketing, distribution, and higher margin products. For example, in the electronics industry, where supply management has long served strategy, Hewlett-Packard today uses supply partners to codesign items ranging from servers to printers and speed product out the door.

As more and more companies discover the scarcity and growing importance of supply management talent, the demand for such supply skills will only increase.

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ENVIRONMENT

Energy-Credit Buyers Beware

by AUDEN SCHENDLER

Companies are increasingly touting their green side, hoping that their show of conscience will appeal to customers and maybe even help the planet. One way they're doing this is by buying renewable energy credits (RECs), instruments that, in theory, offset the environmental impact of the purchaser's "dirty" energy use by subsidizing clean energy from renewable sources such as wind. Companies like Starbucks, Johnson & Johnson, Staples, and FedEx Kinko's are all prominent energy-credit buyers, and, last January, Whole Foods Market stunned even these giants by buying enough RECs to offset 100% of the company's annual electricity use – the largest wind-energy credit purchase in U.S. history.

Buying RECs may generate good press – "Whole Foods Goes with the Wind," announced a recent headline in *USA Today* – but these purchases don't always help the environment as advertised.

Utilities that generate renewable power through wind, solar, small hydro, or other means sell two things: actual electricity, and, separately, credits that represent the environmental benefits, as measured by reduced carbon emissions, of their cleanly produced product. Thus, one purchaser may buy a kilowatt-hour of clean electricity but a separate purchaser may buy "rights" to the environmental benefit of that same unit of electricity.

On paper, anyway, a purchaser whose use of electricity from a coal-fired plant generates, say, a ton of CO_2 may offset that pollution by buying RECs that represent an equivalent amount of nonpolluting electricity. The money paid to purchase those RECs, in theory, subsidizes the higher cost of producing clean electricity, making this alternative competitive, or creates a market mechanism that will cause more renewables to be produced.

There's a problem with this calculus, though: The clean electricity that a wind farm produces, for example, is fed into the utility grid for distribution regardless of what becomes of its associated RECs. Those RECs are handled independently; they may be sold for a lot or a little, immediately or sometime in the future. Right now, huge surpluses of low-priced RECs are flooding the market, and the cost of an REC represents just a fraction of the added expense of making green power. Therefore, the purchase of a kilowatt-hour worth of RECs does not necessarily displace a kilowatt-hour of dirty electricity; nor, by extension, does it reduce the amount of CO_2 entering the atmosphere.

In short, it's doubtful that most RECs are delivering the environmental benefits ascribed to them. So where does this leave companies that genuinely want to reduce the environmental impact of the electricity they use?

Happily, RECs do provide some environmental and social value – even if they don't directly reduce carbon emissions. In some cases, REC brokers have an ancillary mission to foster renewable energy production. Instead of just pocketing all the profits, REC sellers like Community Energy and the Bonneville Environmental Foundation earmark a portion of their profits for new renewable energy development. Another group, NativeEnergy, uses RECs to support wind on Native American reservations, which has social as well as environmental benefits. REC sales themselves sometimes subsidize otherwise untenable renewable energy projects. For example, a solar installation may not have an acceptable payback until the RECs from that project are sold. And REC purchases, such as that made by Whole Foods, get national press and so increase public awareness of the need for climate protection.

But buyer beware: Not all RECs are created equal. Companies purchasing RECs should, at a minimum, be sure that these are certified to meet environmental and consumer protection standards by a third party called Green-e. Buyers should determine how the revenues from the RECs they plan to purchase are used by the brokers that sell them. And buyers should also look to the reputation and mission of the REC seller.

If your goal is to *claim* that your company offsets the carbon produced by 100% of its electricity usage, buy RECs and leave it at that. But if your goal is to directly reduce carbon emissions, there are better ways to do that, such as investing in a new wind farm.

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NETWORK THEORY

Marketing in an Unpredictable World

by DUNCAN J. WATTS AND STEVE HASKER

It's time for producers of entertainment – movie studios, broadcast and cable TV networks, video game makers, publishers, music labels – to change the way they launch and market their products. In entertainment markets, a sizable portion of revenue is typically generated by a small number of blockbuster movies, best-selling books, and hit songs. But even talented, experienced executives acknowledge that predicting these hits is effectively a crapshoot. How else to explain why Miramax paid ten times as much for *Happy, Texas* – which grossed $2 million at the box office – as Warner Independent paid for *March of the Penguins*, which grossed close to $80 million?

What should entertainment companies do to improve their odds of success? The key is to understand that the outsize performance of hits is not driven solely, or perhaps even primarily, by intrinsic attributes such as sound, plot, style, or even star power. Rather, new research shows, much of the success of entertainment products derives from social influence – the effect that consumers have on one another's decisions. So in addition to anticipating which features individual consumers might find desirable, executives should adopt strategies that take social influence into account.

A study conducted at Columbia University by Matthew Salganik, Peter Sheridan Dodds, and Duncan J. Watts, and published in the February 10, 2006, issue of *Science*, sheds light on the role that social influence plays in driving aggregate consumer demand. More than 14,000 participants were recruited through the teen networking site Bolt, and the impact of social influence on their choice of songs to download was tested. After seeing a selection of 48 digital songs by unknown bands displayed on a Web page, participants were asked to choose songs to listen to and then allowed to download the ones they liked. As they arrived at the site, they were randomly allocated to one of two experimental conditions: "independent," in which they saw only the names of the bands and songs; or "social influence," in which they were further divided into eight distinct "worlds," and could see, in addition to the bands and songs, how many times each song had been downloaded by previous participants in their respective worlds.

There were three main findings. First, social influence increased the inequality of outcomes in all eight worlds, meaning that popular songs were more popular and unpopular songs were less popular than when participants made decisions independently. Second, however, which particular songs would turn out to be successful in any given world was more difficult to predict. And third, both inequality and unpredictability increased as the strength of social influence was experimentally increased. Overall, the "best" songs rarely did very poorly, and the "worst" songs rarely did very well, but any other outcome was possible.

These results suggest that the success of a particular entertainment product cannot be explained by any measure of intrinsic quality or even by "appeal" – the fit between the product's attributes and consumers' preferences. Rather, when people are influenced by what others think or do or buy, their individual choices interact in complicated and inherently unpredictable ways. In other words, experts fail to predict hits not because they are uninformed or incompetent but because hits are driven by complex networks of social influences that render accurate prediction of specific outcomes impossible.

The implication for marketing executives is that they should de-emphasize designing, making, and selling would-be hits and focus instead on creating portfolios of products that can be marketed using real-time measurement of and rapid response to consumer feedback.

To move in this direction, we recommend five strategies:

1 **Increase the number of bets, and decrease their size.** Acknowledging that hits can't be predicted would lead movie studios, for example, to plan for several relatively modest films costing, say, $30 million each rather than a few big-budget ones costing $80 million or more apiece.

2 **Focus on detection, measurement, and feedback.** E-mail and chat rooms, search engines, blogs, and online communities can accurately measure individual and group reactions to new products in real time. By tracking demand and satisfaction indicators as they emerge, and combining them with separately available sales data, marketers can tailor their campaigns to a rapidly evolving and unpredictable market.

3 **Follow through with flexible marketing budgets**. Marketing resources should quickly be reallocated from unsuccessful to successful bets as consumer demand materializes. Initial outlays should continue to be guided by prelaunch market research, but marketers should aim at a broader target population than that suggested by their data and intuition. More important, they should direct postlaunch resources at consumers who are reacting positively to the product, whether or not they correspond to marketers' initial expectations. Instead of unlocking the door to consumer demand, marketers should focus on finding and then pushing on doors that are already ajar.

4 **Exploit naturally emerging social influence.** Once a product has gained a following, marketers can amplify the corresponding social influence signal by directing the attention of a much wider audience toward the individuals or groups who are already enthusiastic about it. This strategy differs subtly but importantly from word-of-mouth or viral marketing strategies that seek to identify so-called influentials in order to solicit their endorsements. Instead, we suggest that marketers can, in effect, create influentials by selectively modifying social influence patterns as they emerge.

5 **Build flexibility into supply chains and contracts.** Supply chains should be designed to respond rapidly to a growth in demand for some products, artists, or services and a drop in demand for others. Firms can also expend less on the majority of flops, but still capture a share of occasional hits, by building flexibility into contracts with creative artists. For example, more generous royalties and offers of support that are pegged to an artist's success could be exchanged for less up-front investment in production, promotion, and distribution along with an option on any derivative revenues of the kind that superstars typically generate – from endorsements, concerts, and follow-up products.

Rapid changes in the technology of media production, distribution, and consumption are driving a proliferation of choices for consumers – the so-called long tail. Some believe that this trend will reduce the importance of hit songs, blockbusters, and best sellers, as sophisticated search algorithms enable audiences to find and consume increasingly niche-oriented forms of entertainment.

We believe, however, that precisely this proliferation of choice will further challenge consumers' limited capacity to discover and digest content, thus strengthening their tendency to like – or at least preferentially consider – what they think other people like. Meanwhile, social networking sites such as MySpace.com and Facebook, tagging sites such as Flickr and Del.icio.us, and user-generated content sites such as YouTube are increasingly exposing ordinary individuals to one another's decisions about what they watch, listen to, and buy.

Together, these trends point to a world in which successes will be more dramatic – and also harder to predict – than ever. Marketers should therefore abandon the notion that they can either anticipate or determine specific outcomes and instead develop their ability

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GENDER

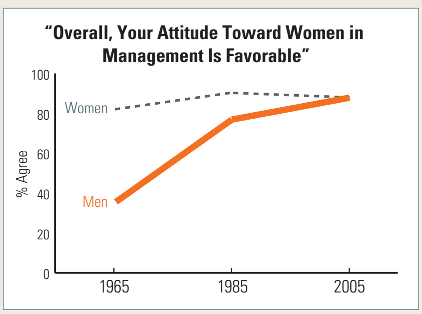
What Men Think They Know About Executive Women

by DAWN S. CARLSON, K. MICHELE KACMAR, AND DWAYNE WHITTEN

How do people in business feel about women in executive roles? The short answer is, attitudes have improved, but not as much as men seem to think.

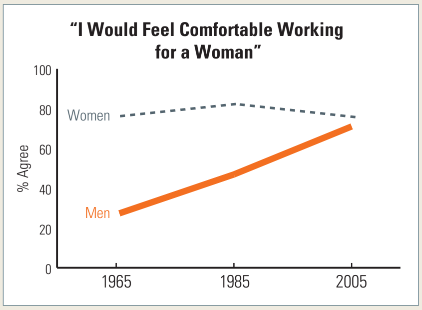
In the July–August 1965 issue of HBR, Garda W. Bowman, N. Beatrice Worthy, and Stephen A. Greyser examined the views of 2,000 U.S. executives (half were men, half were women) on that subject in "Are Women Executives People?" Charlotte Decker Sutton and Kris K. Moore followed up in the September–October 1985 issue with "Executive Women – 20 Years Later." Collaborating with Kris Moore, we've picked up where the second research project left off, using the same survey questions and a fresh sample of 286 executives randomly selected from leading public and private corporations. Although our sample is smaller than the 1965 and 1985 samples, it is representative of the executive population in the United States.

Over the past 40 years, female respondents have indicated steady support for the idea of women in senior management, and men have warmed up to it along the way. Since 1965, the percentage of male respondents who said they agree with the statement "Overall, your attitude toward women in management is favorable" has increased from 35% to 88%. Indeed, in our 2005 survey, men's answers were as positive as women's.



"Overall, Your Attitude Toward Women in Management Is Favorable"

Men and women are also responding similarly to the statement "I would feel comfortable working for a woman." Most female respondents continue to say they would, though there's been a slight drop since 1985. Of the men, 71% say they would. That figure is up significantly from 1965 (27%) and 1985 (47%).

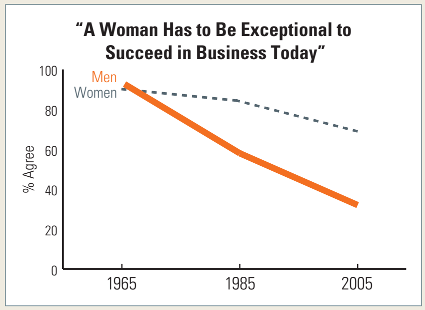


"I Would Feel Comfortable Working for a Woman"

We begin to see a parting of views with the statement "The business community will never wholly accept female executives." Although the downward trends demonstrate increased optimism among both men and women, the gap between the two groups is currently 18.3%, with women expressing notably less faith that complete acceptance is in the offing.

"The Business Community Will Never Wholly Accept Female Executives"

There's an even greater discrepancy in the responses to this statement: "A woman has to be exceptional to succeed in business today." Overall, the trend is down for both male and female respondents, but the gap between them is large. In our survey, only 31.7% of men thought women had to be exceptional to succeed, while 69.4% of women felt that way, even with laws in place to level the playing field.



"A Woman Has to Be Exceptional to Succeed in Business Today"

Both points of difference – on the likelihood of full acceptance and the necessity of exceptional performance – suggest that men's perceptions are overly rosy. Executive women still say they encounter barriers to success. Men tend not to see those barriers, or perhaps they have learned to offer politically correct responses to questions about their attitudes. But look at the numbers: Women hold fewer than 20% of corporate officer positions in *Fortune* 500 companies. Only eight of those companies have female CEOs. Executive men may be saying the right words, but if the gender composition of the typical boardroom is any indication, they're probably not behaving accordingly.

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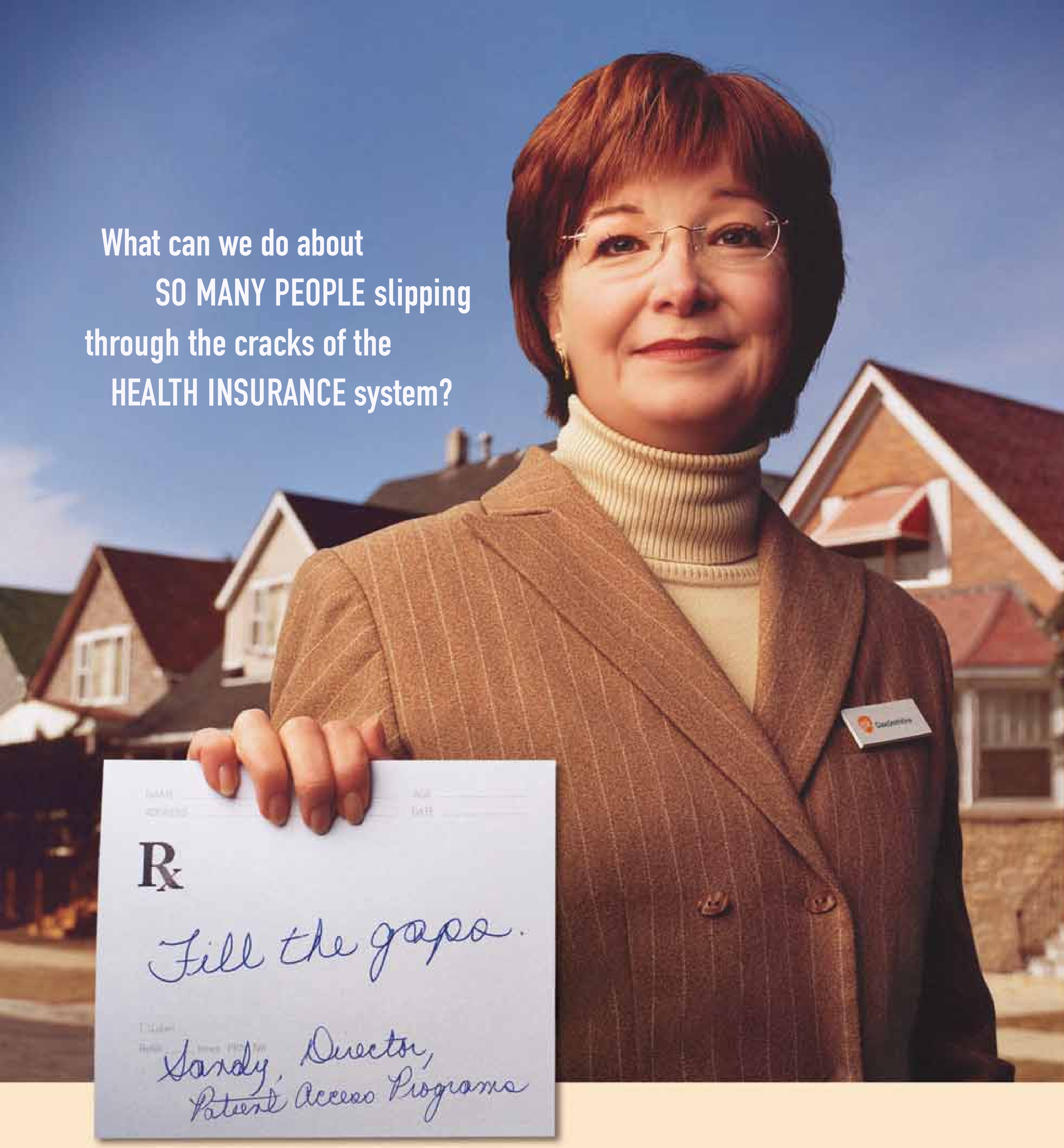
What can we do about
SO MANY PEOPLE slipping
through the cracks of the
HEALTH INSURANCE system?
℞
Fill the gaps.
Sandy, Director,
Patient Access Programs

to measure and exploit consumer demand as it arises.

DUNCAN J. WATTS *(djw24@columbia.edu) is a professor of sociology at Columbia University in New York. He is the author of* Six Degrees: The Science of a Connected Age *(Norton, 2003).* STEVE HASKER *(Steve_Hasker@mckinsey.com), a partner at McKinsey & Company in New York, serves clients in the media and entertainment industry.*

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PERSONNEL

How to Fix HR

by GARY KAUFMAN

In my 34 years working in and around human resources, I've found that most HR departments are mired in power struggles, bureaucratic programs, and miscellaneous special projects when they should be focused on one objective: maximizing organizational performance. It's tempting to blame this sorry state of affairs on HR alone. But the fundamental reason has to do with lack of leadership by companies' senior managers – the CEOs, COOs, and company presidents whose jobs are to focus the various departments on accomplishing the organization's goals.

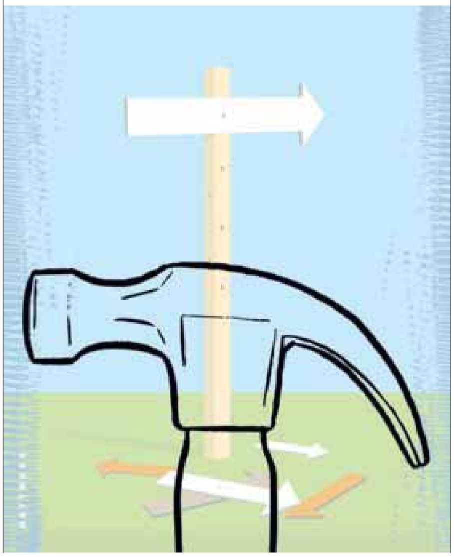
Consider HR mission statements. Here's a typical one: "To provide quality services and support in hiring, training, staff relations, benefits, compensation, and safety beyond the expectations of all employees, enabling them to better serve our external customers." Shame on the managers who approved this slop! Statements like this are painfully short on real deliverables and accountability. Why? I suspect that senior managers don't understand what HR can deliver. As a remedy, here are five steps to help direct and get more value from your HR department.

Step 1: Set a clear mission. The department's mission should put responsibility for business outcomes front and center: "HR's responsibility is to ensure that our human resources are more talented and motivated than those of our competitors. HR's performance will therefore be measured by comparing the company's sales, profits, and productivity with those of our top two competitors."

Saddled with this, your HR manager may have questions like, "Isn't the sales department supposed to be responsible for sales?" Answer by asking, "Where would the sales department be without sales*people*?" Respond this way as needed, whether the question relates to production, engineering, or customer service.

Step 2: Get rid of the distractions. Outsource costly, labor-intensive chores like benefits, payroll, and salary surveys so that HR can focus on attracting, motivating, and retaining superior employees. Suppress the urge to assign special projects to HR, things like implementing TQM or reengineering, or programs to imbue the "seven habits." Kill this stuff before it has a chance to grow in HR's fertile soil.

Step 3: Assess HR's technical knowledge. Check to see if your HR people have been keeping up with the literature in the field; if so, are they applying their knowledge to benefit your company? Can they defend HR's programs, citing research from reputable journals? Look at what the HR staff is reading. Do you see peer-reviewed journals like *Administrative Science Quarterly*, or books like *Personnel Selection in Organizations*? If the meatiest thing you can find is *HR Magazine*, you're in trouble. Ask questions of staff specialists like, "What is [competitor's name] doing to recruit management trainees?" "What's the latest research in gain-sharing plans?" or "What is the difference between test reliability and validity?" You don't need to know the answers to these questions, but HR certainly should.



Step 4: Find the right leader for HR. If you have a strong HR staff, promote a high-potential manager from a line organization. He or she will bring the credibility HR needs to make changes. If the staff is weak, you'll need to go outside to hire someone who has an advanced degree in business or industrial or organizational psychology and strong management experience. Don't be tightfisted here; there's a whole lot of money at stake. Don't make the mistake of transferring in a midlevel manager who is a "great people person" but has a marginal track record for achievement.

Step 5: Hold your HR manager accountable. You've set the goal. Now insist that it be met. Do not accept measures of *activity* – things like positions filled, training hours delivered, and appraisals completed on time. Require measures of *accomplishment* that reflect business success: sales or revenue, profits, productivity, customer retention, and so on.

If you implement these five steps, you'll see some dramatic changes. HR will abandon traditional programs that have no demonstrable impact on organizational performance, and it will create programs that boost results–such as compensation plans that tightly link pay with profits and aggressive recruitment approaches that lure the best people away from competitors. You'll also see your HR manager – under the spotlight and required to deliver – actually fire ineffective HR employees and replace them with more talented people who understand HR's true role. Ultimately, you'll see the real fruits of HR's new approach reflected in your bottom line.

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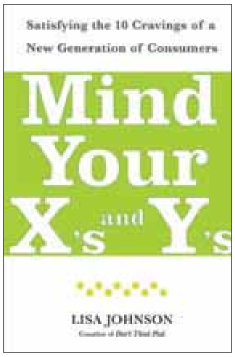
Ermenegildo Zegna

Reviews

Mind Your X's and Y's:
Satisfying the 10 Cravings of a New Generation of Consumers

Lisa Johnson
(Free Press, 2006)

Lisa Johnson's first book was *Don't Think Pink* – she's a marketing consultant largely focused on the buying habits of women. But the X's and Y's of her current title aren't chromosomes, they're generations. Here, Johnson addresses that evergreen topic: kids today. And like legions of others who've judged their collective progeny since time immemorial, she perceives attitudes, preferences, and values that represent a "colossal shift."



For Johnson, the differences show up in the form of ten new cravings. The people of Gen X and Gen Y lust for the spotlight, for adventure, and for "loose connections." They crave good design, being part of a subculture, and a filter they can trust to edit the morass of products and information out there. They live to pitch in on stone-soup-style initiatives like Wikipedia and to have every purchase elevated to an experience. They are hungrier than their parents for spirituality and for more satisfying forms of charity.

How should all this inform the means and ends of marketers? The case studies sprinkled through the text do a good job of highlighting new ventures that capitalize on (or perhaps create) the cravings. Social networking sites like MySpace.com are all about loose connections. A company called Imatoy.com puts buyers in the spotlight by personalizing action figures in their likeness. VocationVacations allows someone contemplating a new career to try it out first. The book is less successful in showing how existing marketers with more workaday product lines can respond to the generational shift. And it has nothing to say about whether these attitudes are U.S.-specific or international – surely a matter of interest to multinational companies.

Johnson presents a credible list of ten cravings, but most of us could sit down with a pinot grigio and its attendant napkin and come up with as many again. Where's the bit about multiculturalism and whether it's made these generations more or less tolerant? What about the fact that so many of these young people have been diagnosed with syndromes, deficits, and disorders? For that matter, aren't about a third of them obese? How does this, besides the obvious, affect their cravings? Perhaps Johnson explored these and other known trends and found they didn't yield attitudinal shifts, but she offers no evidence. This may mean that, among serious market researchers, Johnson will not be embraced as a trusted filter. But if she provokes them to think more deeply about their responses to generational differences, she will have done them a service.

– JULIA KIRBY

The Managerial Moment of Truth: The Essential Step in Helping People Improve Performance

Bruce Bodaken and Robert Fritz
(Free Press, 2006)

Like the *One Minute Manager*, this book tells managers to confront underperformers with the gap between what's expected of them and what they've delivered. But through hard-hitting, dialogue-rich vignettes, it also advises managers to help employees take responsibility for their work. What's missing is guidance about the stroking needed to repair relationships strained by this intervention. Bodaken, the CEO of Blue Shield of California, and Fritz, a consultant, tell managers instead to appeal to employees' professionalism – a strategy that could fall short in the passionate world of business.

Profit with Honor: The New Stage of Market Capitalism

Daniel Yankelovich
(Yale University Press, 2006)

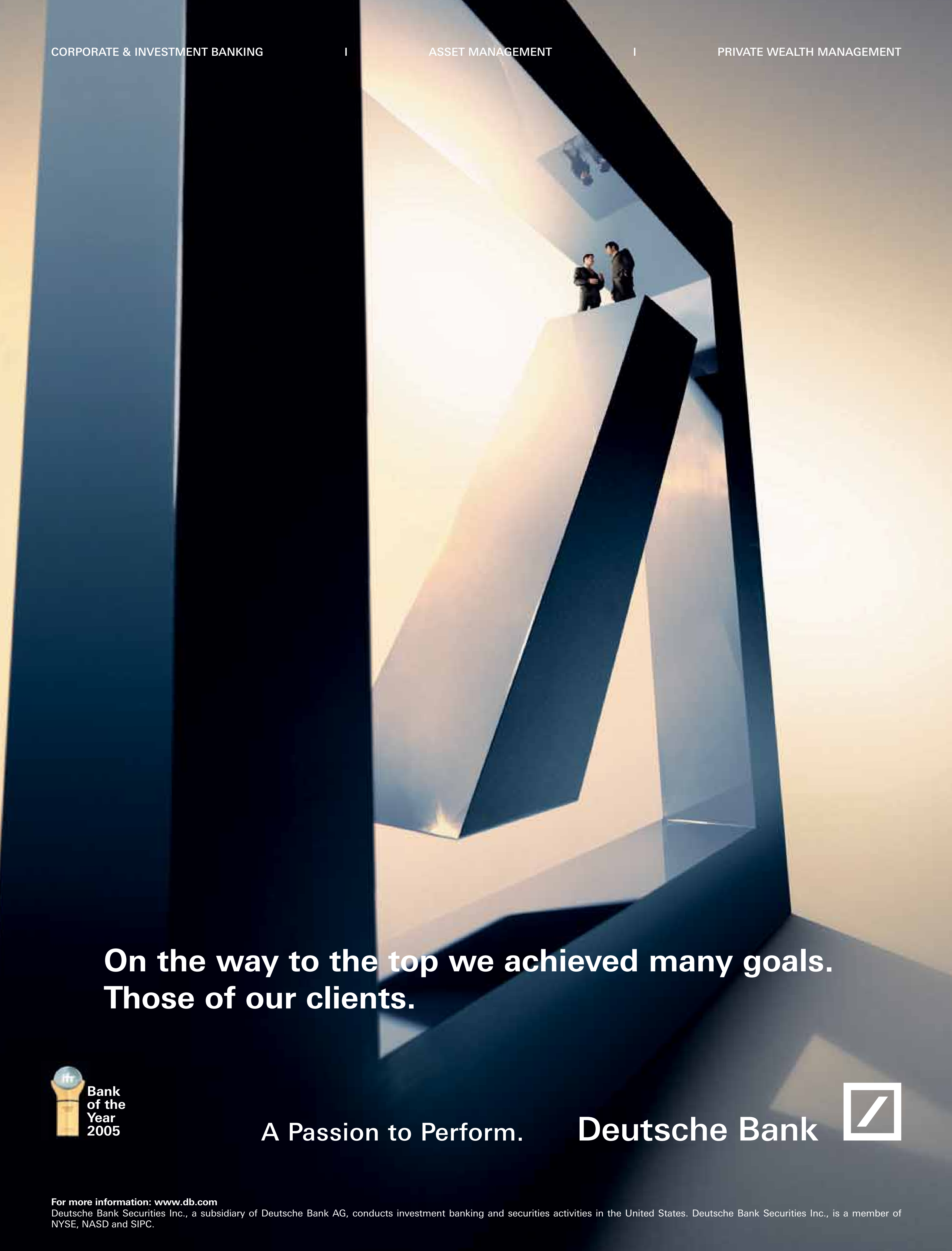
Despite a wave of corporate scandals and growing environmental concerns, the movement for corporate social responsibility has had little influence. Yankelovich, a marketing consultant, hopes to change that with two suggestions. First, he says, recast CSR as stewardship, which makes companies' obligation to thrive as profitable enterprises explicit. And second, figure out a visible ranking metric for stewardship that gives executives a personal incentive. Without the latter, he insists, they'll continue to put their energies into the only metric we have now: monetary compensation driven mainly by short-term results.

The Age of Oil: The Mythology, History, and Future of the World's Most Controversial Resource

Leonardo Maugeri
(Praeger, 2006)

Are we running low on oil? After a slew of books by pessimists, here is a convincing counterargument by an oil company analyst. Maugeri explains that the industry has been scarred by recurrent periods of overproduction. The major players' resulting cautiousness probably makes current estimates of reserves very conservative. If prices continue at today's levels, we can expect aggressive investments in exploration and technology to yield enormous extra supply.

– JOHN T. LANDRY


CORPORATE & INVESTMENT BANKING I ASSET MANAGEMENT I PRIVATE WEALTH MANAGEMENT
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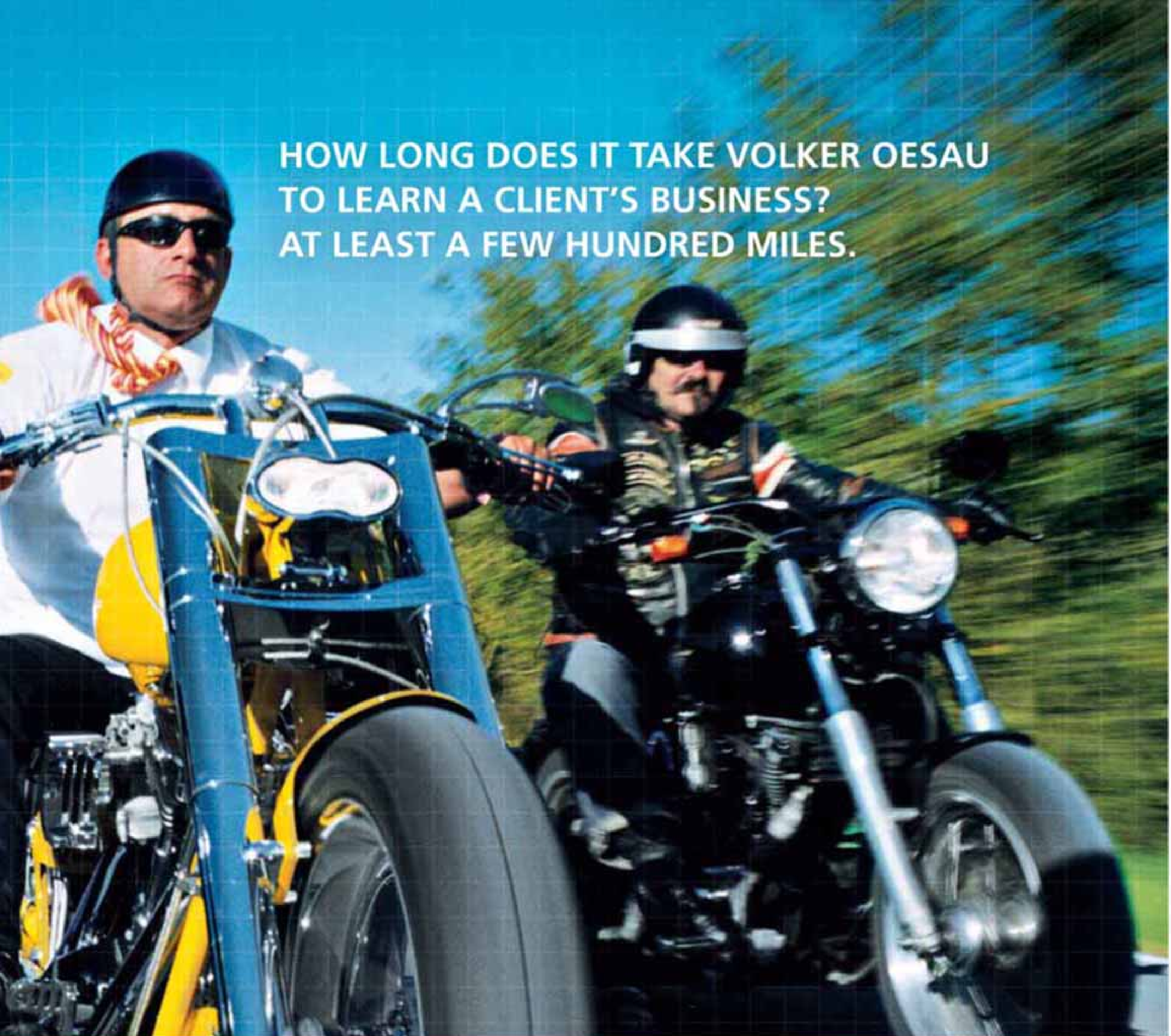
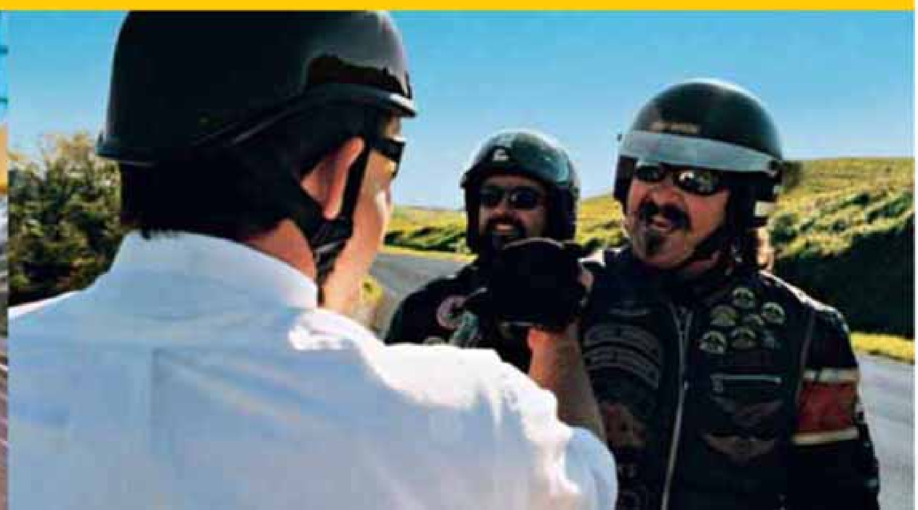
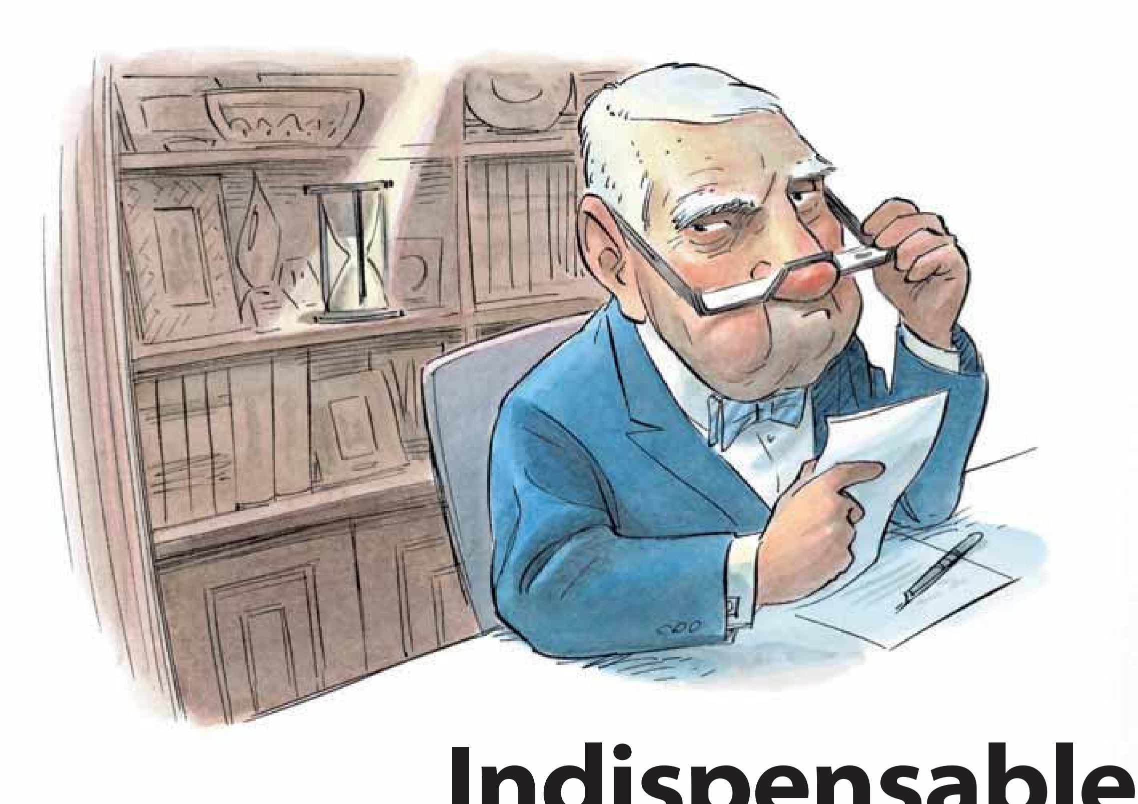
>> VOLKER OESAU
>> MANAGING DIRECTOR, CENTRAL AND EASTERN EUROPE
REGION: FRANKFURT, GERMANY
ASSIGNMENT: HIT THE ROAD.


HOW LONG DOES IT TAKE VOLKER OESAU
TO LEARN A CLIENT'S BUSINESS?
AT LEAST A FEW HUNDRED MILES.





Indispensable

by John Beeson

Edward Bennett is a talented CEO with a lot on his plate. But he's not getting any younger, and his board can't get him engaged in succession planning.

Tom Calloway, nonexecutive chairman of Astar Enterprises, put the phone back in its cradle as gently as he could, given the circumstances. He had just finished yet another difficult and unsatisfactory conversation with Edward Bennett, Astar's CEO, about succession planning. Calloway wheeled his chair around and looked out over the stunning view of Boston Harbor. His 25th-floor office at Pedigree Investment Partners was smaller than the one he'd had at Puritan Bancorp before retiring as CEO four years ago, but he'd brought his impressive mahogany desk with him, and the table in the corner displayed a career's worth of "tombstones" from major deals he'd done during his career at Puritan.

Calloway had joined the board of Astar, a highly profitable consumer products company, eight years ago and had taken over as chairman shortly after his retirement from Puritan. He enjoyed a strong working relationship with Bennett. Although they didn't always see eye to eye, they had always been able to work out their differences. Regarding Astar's strategy and financial matters, Bennett was invariably open and transparent. The CEO held the reins a little tighter on management and organizational issues, but as he continued to deliver results, the board was inclined to let Bennett follow his instincts. The topic of succession planning, though, was another matter.

"What does he think he is, immortal?" Calloway thought to himself. After 18 months and several conversations, Bennett had grudgingly agreed to prepare

HBR's cases, which are fictional, present common managerial dilemmas and offer concrete solutions from experts.

DANIEL VASCONCELLOS

a presentation and lead a discussion on succession planning at the upcoming board meeting. But in today's conversation, like several that had preceded it, the CEO had still been reluctant, if not downright resistant to the whole idea.

Until now, Bennett had strongly (and effectively) argued that the board should be focusing on more immediate priorities. Astar had recently initiated a major global expansion, and as the public face of the company and a dynamic speaker, Bennett had been centrally involved in the road shows required to secure equity funding from the investment banks. The effort had been successful, the company had now reached the level of funding required to support the expansion, and yet Bennett continued to maintain that his attention was better focused on implementing the new strategy than on succession planning.

It was true, Calloway thought, that this was a critical moment for Astar. It was just beginning to draw the attention of the industry's two dominant multinational players, and the company had taken on significant financial commitments. Several board members had suggested they begin succession-planning discussions among themselves if Bennett continued to beg off. However, Calloway understood that Bennett knew more about Astar and its employees than anyone else, and he still hoped to entice the CEO to participate.

Calloway's longtime assistant interrupted his thoughts by knocking softly at the door to alert him to a scheduled conference call on another matter. As he turned, she saw him nervously spinning the embossed "brass rat" on his MIT class ring round and round his finger. Normally, Calloway was composed in virtually any situation, but his assistant knew from their years of working together that something was deeply troubling him.

John Beeson (jbeeson100@aol.com) is the principal of Beeson Consulting, Incorporated, a firm specializing in succession planning, executive development, and organization design. He is based in Kansas City, Missouri.

Who's on Deck?

Selections from the Astar Enterprises Board Succession Planning Packet

Astar Rising

For decades, Astar Enterprises, headquartered in northern New Jersey, had been a relatively small but respected niche player in the consumer products industry, distributing a few well-known brands regionally in New England and the mid-Atlantic states. Under Bennett's leadership during the past 15 years, the company had more than tripled in size and begun nationwide distribution. This growth had been accomplished through product line extension as well as a disciplined acquisition strategy. Astar's current-year revenue forecast was $3 billion, and the company boasted a strong product portfolio encompassing home-cleaning and laundry care goods (notably Nature Pure detergent), as well as personal hygiene and skin care products (such as the Canterbury line of toiletries). The bulk of its products were distributed through major retailers, especially those in the supermarket, discount, and chain pharmacy channels. Astar also did private label manufacturing and had a line of professional products targeted primarily at the health care and hospitality industries.

Edward Bennett, now 64, had joined Astar 25 years ago, after a few years with a well-regarded consumer products company and a stint with an advertising agency. Since taking over as CEO, Bennett had become known as a charismatic and entrepreneurial leader. His background allowed him to develop strong personal relationships with advertising firms and key customers – relationships that were said to be hugely beneficial to Astar. In the words of an investment

READY NOW

Tom Terrell

Vice Chairman, Age 62

Background:

- Joined Astar in 1982 after 12 years in a succession of sales and sales management/administrative positions at Nabisco.
- Rapidly progressed through a series of sales management positions.
- Created and led Chain Drug Sales/Marketing Team, 1990–1995.
- Head of National Operations,1995–2001.
- Head of Acquisition Integration, 2001–2004.
- Vice Chairman from 2004 to present.

Accomplishments:

- Created the sales/marketing team organizational model that has increased business with and satisfaction of major customers.
- Led margin improvement project in 2000 and 2001 that increased pretax margins by 20%.
- Successfully integrated three niche acquisitions into Astar.
- Created acquisition integration model that is now the corporate standard.

Profile:

- Seasoned general manager; deep knowledge of products, customers, channels, profit drivers.
- Strong financial skills and business acumen.
- Excellent project management skills.
- A strong people developer.
- Can rally people and lead complex initiatives.
- Deeply committed to company goals.
- Needs to increase visibility within the industry by taking on additional leadership positions in industry associations.
- Just beginning to take a more active role in community relations.

Education:

- B.S., Business Management, Fairleigh Dickinson University, 1966.
- Advanced Management Program, Harvard Business School, 2002

NEAR-TERM (1–2 YEARS)

Robert Glenn

President, Astar Consumer Products Group, North America, Age 48

Background:
- Joined Astar in 1998 as Vice President of Marketing, Consumer Products Group.
- Quickly assumed responsibility for sales and customer relations.
- Named Group President in 2002.
- After military service and business school, joined General Distribution Industries in its Marketing Career Development Program.
- Progressed rapidly through a series of marketing, market research, and sales management jobs.
- Led GDI's acquisition and integration of Phyllo Foods.

Accomplishments:
- Largely responsible for double-digit growth in sales and operating profit in the Consumer Products Group since 2000.
- Personally led contract renewals with top five customers over the last two years.
- Instituted a series of metrics to focus and unify the Consumer Products management team.
- Key contributor to Astar's acquisition strategy.

Profile:
- Results-oriented; strong leadership skills.
- Broad knowledge of the industry.
- Strong strategic, customer, and communication skills; excellent executive polish.
- Sets high performance standards.
- Needs to increase collaboration with peers.
- Extremely competitive but can be "reined in."
- Needs to better understand how to influence not just customers but other external constituents.
- Currently working to ensure the success of newly hired executives in his organization.

Education:
- B.S., Business Administration, Pennsylvania State University, 1980
- M.B.A., Rutgers Business School, State University of New Jersey, 1985

Marianne Klein

Executive Vice President, Corporate Services, Age 50

Background:
- Joined Astar in the Marketing Communications Department in 1988 after six years with the PR firm Franklin & Whitehead.
- Progressed through a series of assignments in Market Research, Corporate Communications, and Investor Relations.
- Since 2000, responsible for a range of functions, including Corporate Marketing, Corporate Communications, Investor Relations, and Facilities Management.

Accomplishments:
- From 1999 to 2002, led a highly effective supply chain management effort.
- Currently leading the company's productivity and outsourcing initiative, which is on track to reduce SG&A costs 10%.
- Two-time finalist for Investor Relations Society's Professional of the Year award.

Profile:
- Exceptionally poised, articulate, and effective.
- Excellent administrative skills.
- Able to balance competing priorities.
- High quality standards.
- Able to impart a sense of mission and purpose.
- A quick study.
- Strong people management and development skills.
- Extremely collaborative. Works well on cross-functional initiatives.
- A highly credible leader who understands the needs of customers, shareholders, employees, and external groups.
- Working to increase her understanding of field operations as well as visibility in the industry.

Education:
- B.A., English, Swarthmore College, 1978
- M.A., Journalism, University of North Carolina, Chapel Hill, 1982

MEDIUM-TERM (2+ YEARS)

Brian Jacobs

Senior Vice President, Sales and Marketing, Astar Consumer Products Group, North America, Age 42

Background:
- Joined Astar in late 2005 in current role.
- Began career as an Assistant Brand Manager for Thomas's Snack Foods; quickly rose through marketing ranks. Led its first Superstore sales and marketing team.
- Recruited by Church & Blackstone's Consumer Products Group in 1995 as Director/General Manager of a $150 million product P&L.
- Served as a member of the Church & Blackstone Global Marketing Committee.
- Promoted to run a $300 million product P&L that targets channels similar to Astar's.

Accomplishments:
- Managed smooth transition into current role.
- Organized a highly successful national sales meeting three months after arriving.
- Has received extremely positive customer feedback.
- Has begun initiative to upgrade the quality of both brand and field sales management.

Profile:
- Outstanding executive presence and communication skills.
- Creative; outstanding marketing mind.
- Able to operate strategically and tactically at the same time.
- Able to leverage customer relationships.
- Able to make consumer focus a priority in this organization.
- Able to quantify the financial impact of marketing and business decisions.
- Needs to continue learning Astar's business and organization as well as build relationships with internal support functions.

Education:
- B.S., Business Administration and Economics, University of Texas, 1986

analyst from Pratt & Morrow: "He's been able to get a level of attention and service from the agencies far beyond what you'd expect for a company Astar's size."

Bennett was also highly active and visible in industry groups and was often featured in trade publications. The personal relationships he'd developed through these associations had been central to several of Astar's successful acquisitions.

The new global strategy was expected to increase revenues to $5 billion within three years, primarily through organic growth, although the company hadn't ruled out a few additional niche acquisitions. Astar had maintained a relatively small presence in northern Europe and Japan for some time; now the new strategy called for a significant increase in international marketing and distribution. Accordingly, the firm had begun setting up regional sales and service units around the world and was quietly shopping for production facilities in Europe. It had also established supply sources in the Far East and Australia. Other steps taken to fuel growth included a significantly higher level of media spending and new investment in costly slotting allowances in Europe, some outsourcing of operations, and an aggressive hiring effort both to build Astar's international units and to create a greater depth of talent in several essential functional areas at headquarters.

The global strategy wasn't without risk. Astar was carrying a much higher level of debt than in the past, and the amount of capital raised through the equity markets had heightened institutional investors' earnings expectations. In addition, several of Astar's products were beginning to come under regulatory scrutiny in both the United States and Europe. Its Untamed hair color, for instance, had provoked a debate about the accuracy of its labeling, and a few consumer groups had questioned the company's disposal of certain manufacturing waste. Although media coverage had been relatively minor, these concerns had been highlighted in both the trade and New York press.

Overshadowing the media buzz, however, was concern over competitive pressures. Bennett knew that Astar would have to move quickly to secure distribution in Europe and Asia and build its regional sales, service, and manufacturing capabilities before its much larger and better-established competitors could preempt the company's strategy.

A Restless Board

Over the years, Bennett had handpicked the majority of Astar's board members, and they felt a strong allegiance to him. However, two members, both of whom had just recently joined, had begun to push Calloway to more forcefully raise the issue of succession planning. Ann Rinaldi, a powerful senior executive from Radient Corporation, had taken over as head of the compensation committee last year. From the beginning, she had called attention to Bennett's age and tenure, arguing that Astar's stock price and bond ratings would take a major hit if Bennett were to leave or be incapacitated unexpectedly – especially now that the new strategy was in place. Her passion on the subject was reinforced by her own experience. When she was a young woman, her uncle, the head of a large privately held company, had died suddenly without an internal successor. She could vividly recall the resulting business problems that befell the company.

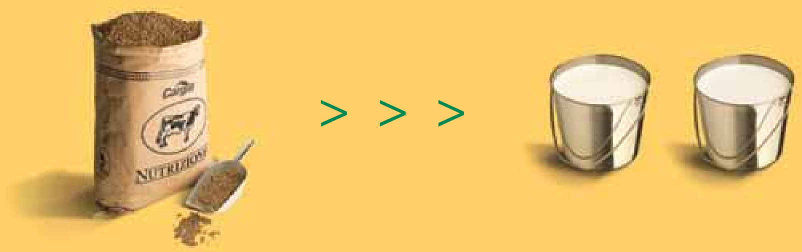
"What does he think he is, immortal?" Calloway thought to himself.

Fred Henderson, the other new member, had been assigned to the nominating committee, which also served as the board's governance committee. Henderson was a longtime senior executive at Luton Industries, an enormously successful global manufacturing company with a rich tradition of succession planning and executive development. Other board members were familiar with Luton's reputation for producing world-class senior executives. They had been intrigued to learn of the extent to which Luton's board had been involved in a highly publicized series of promotions among the company's senior management ranks. Henderson argued that the lack of attention to CEO succession at Astar was a major lapse in the board's fiduciary responsibilities, as well as a possible violation of SEC regulations and the rules governing listings on the New York Stock Exchange. In short, Astar's board, long passive on the subject of succession planning, was showing an increased desire to join with Bennett in a more-detailed discussion of the topic – although some members counseled caution for fear of signaling displeasure with Bennett's performance.

Preparation, at Last

That same day, Gail Thompson, Astar's veteran senior vice president of human resources, seeing the door open, walked into Bennett's office for their 11:00 AM meeting. Normally, she enjoyed rolling up her sleeves to work with Bennett. He was an engaging manager, and Thompson loved the light, tasteful look of his office: the sweeping view of the Astar campus, the Andy Warhol silk screen print, the blond 1960s Danish furniture, and the framed cover of *AdAge* that featured Bennett. Even the inscribed baseball bat leaning in the corner, a present from the New York Yankees for a joint promotion a few years ago involving the Modern Man line of deodorants and body washes. That last project had been a labor of love for Bennett, a die-hard Yankees fan who regularly held senior executive events at Yankee Stadium. Thompson fondly recalled sitting in the Astar box at several games and the chance these outings provided to develop a real rapport with her normally hard-charging boss.

Today's issue, however, was volatile. While Bennett typically approached issues in a focused, businesslike way, succession planning, Thompson had found, was likely to set off a tirade. After many requests on her part, the two had met the previous week, along with Astar's former vice chairman, Vincent Dalton,



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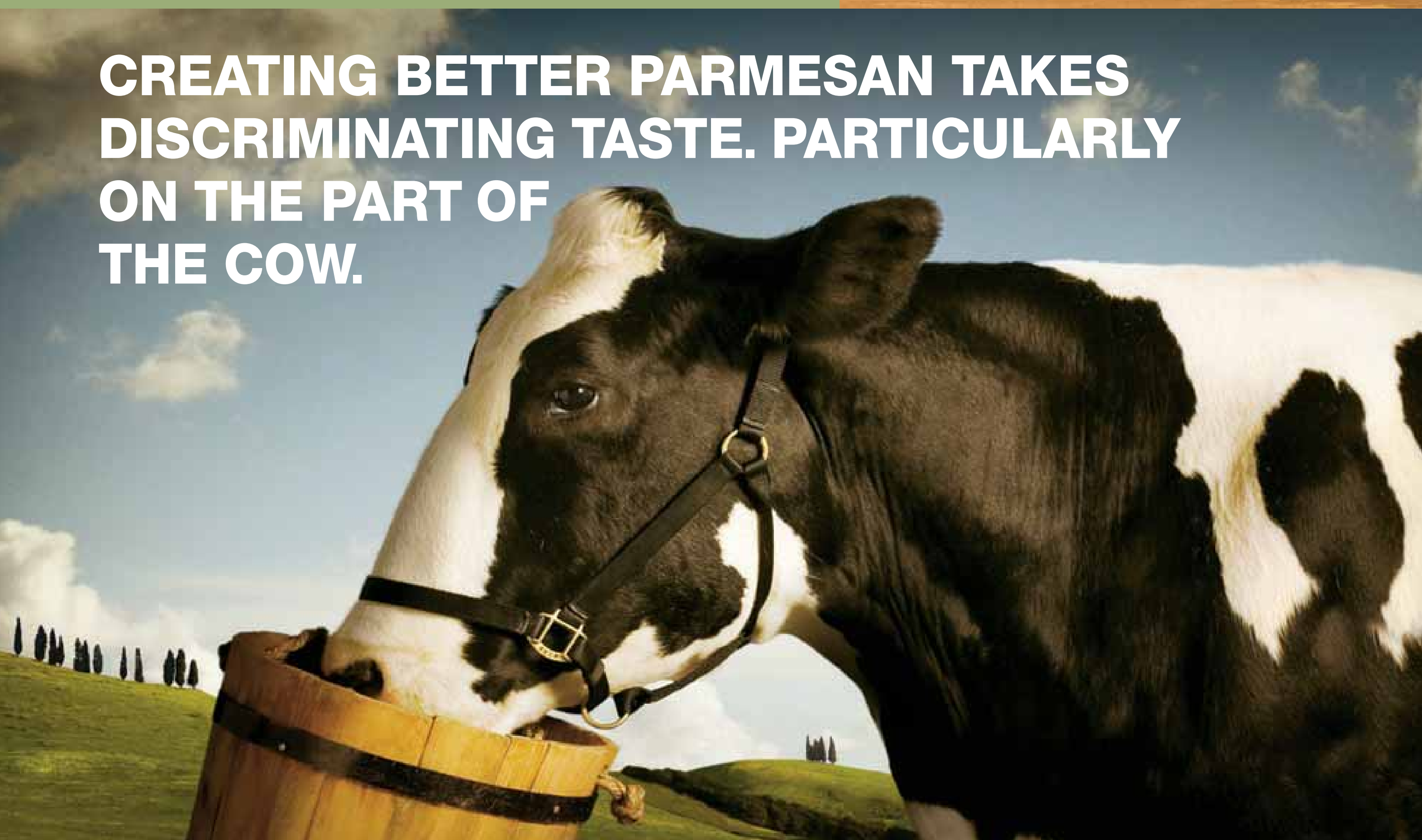

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to put together a list of potential CEO candidates. Bennett had included Dalton in the discussion to tap into his deep knowledge of the company, especially since Dalton was retired and had no particular loyalties or axes to grind. Thompson and Bennett were meeting again today so that the CEO could review the materials Thompson had put together following that conversation. But before she could hand him the folder, Bennett exploded. "When will these guys back off? I've told them who the candidates are. Why do we need to talk about it? Why do they need to 'get to know' them better? If, God forbid, something happens to me, Tom Terrell could step into my shoes tomorrow."

He went on to sing the praises of the four managers who had made the list they'd prepared. Terrell, his number two, had a strong sales and marketing background and a long history with the company, not to mention great people and financial management skills. The other three candidates were nearly as strong and would only need, as Bennett put it, "time to grow into the job."

Astar had just made two key hires, Bennett continued – potential superstars, just one level down – who added bench strength to the current list of possible successors. The headhunter who'd brought in the new players had told Bennett that Astar had a great reputation on the street, so the company could easily recruit an outsider for the top job, if need be. In Bennett's mind, the board's "sudden interest" in succession planning would merely distract his team from the strategic tasks at hand – to outmaneuver the industry behemoths and satisfy investors. "The last thing I need is for the board to trigger a horse race or for Terrell and the rest to focus on building their visibility with the board," he rumbled. "Don't they trust my judgment? They know I'm not going anywhere soon. I'm as healthy as a 50-year-old! What are they trying to do – run me off?"

As she had learned to do from previous conversations on the topic, Thompson let this particular storm blow over. After a while, Bennett calmed down, and she was able to engage him in reviewing the draft succession-planning materials for next week's board meeting. But as she left his office, Thompson had the feeling she was watching an impending train wreck, one she could do nothing to avert.

Over the past six months, she had fielded several concerned calls from board members on the subject of succession planning, and she had been collared by two after the last board meeting. She also knew that the board was unlikely to consider Tom Terrell, the current vice chairman, as a bona fide successor for anything beyond a brief transition phase in an emergency situation. Although Calloway and the others respected Terrell for his knowledge of and loyalty to the company and for his implementation ability, he was seen as Bennett's perennial lieutenant, and there were concerns about his strategic ability. Only one of the other three candidates was familiar to the board – Marianne Klein, executive vice president of corporate services, who presented to them regularly on investor relations issues. Robert Glenn, head of Astar's Consumer Products Group, North America, had met with the board only for a few tightly controlled presentations, and board members had barely even heard of Brian Jacobs, the vice president of sales and marketing reporting to Glenn. As for Dalton, Thompson questioned his objectivity: He had done little to challenge his former boss's view of the candidates when they had met last week.

Thompson knew from talking with other executives at Consortium 50, a networking group of corporate HR heads, that succession planning could be the toughest personnel-related issue for CEOs to deal with, given the highly personal nature of the topic. Still, she was surprised by how hard she had had to work to get Bennett to agree to last week's meeting. Planning for the global growth strategy had included staffing needs from day one, and she and Bennett had met regularly to pinpoint recruiting requirements. On several occasions, she had tried to play off of Bennett's respect for the Yankees' vaunted minor league farm team in hopes of making the point that developing talent for the long term helped make a championship organization. But she had never been successful in drawing the analogy to succession planning for Astar's own team.

Normally, Thompson looked forward to the chance to interact with the directors at Astar's board meetings. But this upcoming session was sure to be difficult, and she dreaded the prospect of being caught in the middle.

Bennett exploded. "When will these guys back off? I've told them who the candidates are. Why do we need to talk about it?"

Still Twisting the Rat

Later that day, after his conference call and a luncheon on behalf of Charles River Community Boating, one of his favorite causes, Calloway returned to his office and reflected on his morning conversation with Bennett. Although Bennett had agreed to a discussion of succession planning at the next board meeting, Calloway still had doubts about how open and constructive the CEO would be, given his seeming aversion to the topic. As he unconsciously twisted his college ring, Calloway truly hoped that the packet of succession-planning materials Bennett had promised to send along would be thoughtful and indicate a willingness to work with the board on the subject. If not? Calloway still struggled with devising a game plan if Bennett continued to refuse to play ball.

How should Calloway and the board approach the issue of succession at Astar Enterprises? • Five commentators offer expert advice beginning on page 44.

John W. Rowe is the executive chairman of Aetna, which is based in Hartford, Connecticut.

The board certainly needs to engage Edward Bennett in a discussion. Even though the CEO has no immediate intention to retire, he has to give the board some rough outline of his plans–specifically his timing–especially considering his age. Then he and the board need to establish the selection criteria for his successor, which they should use to inform the development process for Robert Glenn, Marianne Klein, and Brian Jacobs. It's pretty clear, at least from HR head Gail Thompson's perspective, that while Bennett's number two, Tom Terrell, might be able to step in during an emergency, he's very unlikely to become CEO on a permanent basis. What the board should do is involve Terrell in the process and be straight with him about his prospects of becoming CEO. He deserves a clear view of his chances of stepping up, in the event that another opportunity outside the company arises. Of course, the board would be risking an adverse reaction, but where's he going to go at 62? He's got a great job, he's well compensated, and he's not going to go become CEO at another company. Why not get him to help?

Given that there's been no discussion of CEO succession at Astar, one of the rumors going around among the executive team must be, "He [Bennett] is so old. We're so young. They never invite us to board meetings. So they must be looking outside." That's of more concern to me than Bennett's notion that a horse race will distract his team from its goals. It's not intrinsically distracting so long as team members don't believe a decision will be made in the next six to 12 months, unless the succession process becomes intensely political and erodes their cooperative spirit. (It's the CEO's job to prevent that.) If anything, a horse race might encourage them to work harder and deliver on their plans.

At Aetna, the board reviews succession management plans for the top 200 executives–both the immediate successor for each position, should the incumbent fall ill or leave, and the possible longer-term successors. For the top 40 (the five or six top positions in each function), we go into more detail. As for my job, I became executive chairman in February after serving six years as chairman and CEO, and we were fortunate to have an internal candidate succeed me as CEO who will also assume the chairman role when I retire in October. Like everyone at Aetna, he had a development plan, and we had a window of a couple of years during which we could keep the requirements of the CEO job in mind in his plan. Thus, we were able to ensure that he had the opportunity to develop in any areas where he might not have been ready.

That's what Astar should be doing with Glenn, Klein, and Jacobs. If you look at the company's strategy, you can see that it entails a fair amount of international activity in terms of product distribution, developing new suppliers, and so forth. It seems it would be appropriate for the new CEO to have some experience outside the U.S., which none of them has to any great extent. Bennett might start giving them international assignments to ready them for that aspect of the job.

It's also clear that these three have had very little exposure to the board. If I were Tom Calloway, I'd talk to Bennett about making sure each has a chance to present to the board three or four times in the next 18 months and also have them attend dinners with its members. Over the course of a year or two, board members will get a reasonable exposure to the candidates in a number of settings. My experience has been that executives always appreciate visibility with the board, and its members certainly benefit from getting to know business leaders in informal or social settings.

The rumor among the executive team must be, "Bennett's so old. We're so young. They never invite us to board meetings. So they must be looking outside."

WENDY WRAY

This is a story about leadership–or the apparent lack thereof on the part of the board. Calloway may be frustrated, but he needs to take a more active role as chairman, rather than sit there fuming about Bennett's lack of cooperation.

Astar is fortunate in several ways. It has Tom Terrell, who can step in as a stopgap if Bennett gets hit by the proverbial truck. It has experienced board members. It has a couple of talented people coming up in the company–Glenn and Klein. Both are fairly unidimensional at this point, but their skills are complementary. And Astar has a hidden treasure in Thompson, a wise HR person who understands the need to get a succession management process in place.

I wouldn't put Bennett into the chairmanship, now or when he retires as CEO.

What Bennett's put together for the board is not a succession plan. It doesn't say anything about development of the candidates. The transition to CEO is an order of magnitude more dramatic a change in responsibility than any other promotion, and it's the board's and the CEO's responsibility to shareholders, customers, and employees to ensure that the people who are in line for the job will be ready when the time comes.

Astar has just launched a strategy to increase the size of the company by more than 60%, mostly through international growth, but the candidates don't have the experience to execute that plan. I'm not even sure Glenn has a passport. Klein has good interpersonal skills but little operational experience. Jacobs seems like a candidate to replace Glenn.

Glenn is 48. He's been with the company for eight years. If he's as good as he looks on paper, he's going to want to be CEO of some company before long. I'm not in favor of a clear–heir apparent strategy, where you secretly promise the job to one person, but if he doesn't get an indication that some progress is being made in the succession plan, Astar may lose him. Same with the others.

It would also not be unreasonable to cast about for external candidates, though internal successors tend to perform better. It might actually make sense to add a couple of new executives, ideally with international experience. A $5 billion company could stand to have a fuller executive team.

Contrast Astar's lack of preparedness with the recent news at Microsoft. Time will tell what will happen, but on the face of it, Bill Gates's June announcement of his succession plans was the result of a carefully crafted process. He's developed Steve Ballmer for a long time, and he's brought in Ray Ozzie as his new chief of technology. He's announced his ultimate retirement two years in advance. He's also reassured shareholders by communicating his confidence in his team's ability to run the business without him. What's more, Gates can walk away because he has somewhere to go, as he assumes the role of head of the Gates foundation. You get the sense that he's not going to reappear in two years and grab back his old position.

That does happen. A CEO reluctantly relinquishes the job and waits in the wings for the newcomer to stumble, whereupon the hero returns to take back the reins. That's why in Calloway's place I wouldn't put Bennett into the chairmanship, now or when he retires as CEO. We don't know why Astar has taken the somewhat unusual step of separating these roles, but under the circumstances it's a clear advantage. The risk is that employees, investors, and customers would continue to look to Bennett, and given his history he would probably have difficulty ceding control.

Calloway himself is a retired CEO. He's made a successful transition, and he more than anyone can demonstrate to Bennett that there is indeed a life after Astar Enterprises. To be persuaded to release the reins, Bennett needs a clear line of sight into what will happen to him in the future. He is hugely valuable at this risky crossroads. But in the end, board members must remember that with or without Bennett's enthusiastic support, they are responsible for the long-term well-being of their company.

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Jay A. Conger (jay.conger@claremontmckenna.edu) is the Henry Kravis Research Professor of Leadership at Claremont McKenna College and a visiting professor of organizational behavior at the London Business School. His most recent article for Harvard Business Review *is "Developing Your Leadership Pipeline," with Robert M. Fulmer (December 2003).*

Douglas A. Ready (dready@icedr.org) is a visiting professor of organizational behavior at London Business School. He is the author of the Harvard Business Review *article "How to Grow Great Leaders" (December 2004).*

Paradoxically, if Bennett were to die suddenly without a qualified successor, it might be good news for shareholders in the short term. When L-3 Communications' charismatic and entrepreneurial CEO Frank Lanza (a man much like Bennett) died unexpectedly in June without a successor, the share price actually went up. That happens again and again: The lack of bench strength makes the company seem ripe for a takeover, so investors buy up shares. They scramble when the company is most vulnerable.

Bennett needs to be approached with a soft touch. You only go behind his back as a last resort.

But that's not a good strategy for the longer term. And when you lose a strong CEO for other reasons, including retirement, the stock price suffers if you don't have a solid succession plan in hand. Xerox's share price has yet to recover after outsider Richard Thoman took over from Paul Allaire and was then ousted in 2000. Even a strong outsider like Bob Nardelli at Home Depot hasn't been able to do much for the company's stock price.

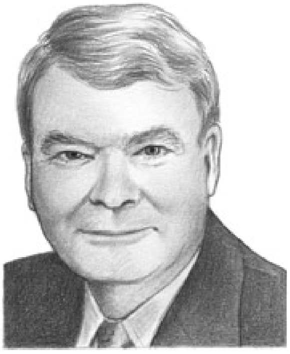
Astar's list of possible successors is woefully inadequate. Bennett's "ready now" candidate is only two years younger than he is. If the CEO retires in, say, three years, Terrell will be 65, which isn't ideal for a company with an aggressive global growth strategy on its plate, even if he were a more strategic thinker. This is not an unusual scenario. CEOs often consider their number two as heir apparent, and that person tends to have complementary strengths–frequently financial or operational skills as opposed to vision and charisma – so he or she doesn't necessarily have what it takes to be a CEO. This is what happened at Coke after Roberto Goizueta died and left the company in the hands of his number two, Douglas Ivester, who proved unqualified for the job.

As for the other three, Glenn is the only one who's remotely ready–and he's probably a good five years away. He has P&L experience, but he's weak on external stakeholder management. A counterintuitive next placement for him might be senior vice president of governance and regulatory affairs. Then he needs an international role. Klein hasn't had one day of P&L experience; she's at least seven to eight years out. And Jacobs is a successor for Glenn's job – in three or four years – but not Bennett's.

Bennett is a classic workaholic. There's no indication that, other than his interest in baseball, he has any life outside Astar. The company is his family, and he doesn't want to leave. His concern about distracting his team and having other priorities is a complete smoke screen. A fundamental part of his job as CEO is to make sure he has a cadre of suitable executives to continue the legacy. That said, Bennett needs to be approached with a soft touch. You only go behind his back as a last resort, because if the relationship between Bennett and the board becomes confrontational, the media will get wind of it, and all the great things Bennett's done for the company will be overshadowed by his end-of-career derailment.

One idea, since he's a maniacal Yankees fan, would be for Thompson to try to engineer a once-in-a-lifetime opportunity to sit down with Yankees manager Joe Torre, who's known for his farm teams. Fred Henderson could also arrange for Bennett to meet the CEO of Luton, which is known for succession management. CEOs greatly value off-line discussions with peers. And Calloway himself could help Bennett see that there can be life beyond Astar, or a different life with Astar, having made the transition from Puritan to Pedigree.

One final thought: This is not just a Bennett problem. Calloway has been on the board for eight years, chairman for four. When he became chairman, Bennett was 60. Bennett is anxious about the process and he's pouting, but the board is letting him get away with it. In this, it has shrunk from one of its most important fiduciary responsibilities.



Michael Jordan is the CEO of Electronic Data Systems Corporation in Plano, Texas.

This is not an unfamiliar problem. If Bennett is 64, then he could be one year away from his company's nominal retirement age. That's what's really bugging the guy. He doesn't want to talk about succession because he doesn't want to leave. He doesn't want to get pushed out at a time when he thinks he's indispensable to the company. Nor, if I were on the board, would I want him to leave: Clearly, execution of the new strategy would suffer if Astar were to lose him.

Assuming that's the case, assuming that the board doesn't want him out in a year, the first thing I would do in Calloway's position is to make it clear that this is a three- or four-year process, because if Bennett thinks a successor will be named in only a year, he's going to subvert every attempt to come up with a transition plan.

If he wants to stay longer than four years, though, Calloway has to say, "That's not good governance for us." That doesn't mean Bennett couldn't stay on as chairman, but at some point enough's enough, and you need a new leader.

If Bennett still drags his feet, I'd ask him the beer truck question: "What happens to this company if you get hit by a beer truck?" If he says his number two can step in – which is exactly what Bennett will say – I'd reply, "No, he can't. Under no circumstances are we putting your buddy in the job. And if we have to go through an unplanned transition, all the hard work you've done could go out the window. The stock could crash. Terrell isn't the guy – if we had to put him in, he wouldn't last nine months – and we don't want to make two transitions in a year." I'd paint a pretty bad picture.

Bennett's sort of a one-man band, a dominant leader who enjoys being in control. So even after Calloway deals with the CEO's personal anxieties about how long he can stay and emphasizes the consequences of an unplanned transition, Bennett may continue to resist. Then I'd get tough and say, "I, as chairman, am going to meet and spend time with the company's top 20 people – not just to inform the succession management process but also because the chairman should understand the talent. I want to get to know them because that's my job."

You would be surprised by what you learn. For instance, you may have some idea of who the candidates are, and one may seem like the obvious front-runner, but over time as you get to know them all, others may emerge who have better strategic skills or better insights. Bennett may dismiss Calloway's wish to spend time with the potential successors, but every board should at the very least become familiar with the CEO's direct reports. I'd look at the very high-potential people at the next level, too. After all, Reginald Jones selected Jack Welch from the second level of General Electric's executive ranks.

The board needs to do more than just develop a succession plan; it needs to revisit that plan with some frequency. Twice a year, it should meet to talk about high-potential people: what skills they need to develop and how much progress they're making. The plan may change over time because the company's needs may change. Sometimes, you want a strategic leader, a boat rocker who will make lots of changes. Sometimes, you want a stable administrator who will lead along the established track. It depends on the board's assessment of the leadership style that the particular situation calls for. There is no such thing as a universal CEO.

If Bennett thinks a successor will be named in only a year, he's going to subvert every attempt to come up with a transition plan.

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A new model explains the mental calculations people make before choosing to trust someone.

The Decision to Trust

by Robert F. Hurley

ROUGHLY HALF OF ALL MANAGERS don't trust their leaders. That's what I found when I recently surveyed 450 executives of 30 companies from around the world. Results from a Golin-Harris survey of Americans back in 2002 were similarly bleak: 69% of respondents agreed with the statement "I just don't know who to trust anymore." In that same year the University of Chicago surveyed 800 Americans and discovered that more than four out of five had "only some" or "hardly any" confidence in the people running major corporations. Granted, trusting corporate leaders in the abstract is different from trusting your own CEO, and some companies and executives are almost universally considered trustworthy; but the general trend is troubling.

It's troubling because a distrustful environment leads to expensive and sometimes terminal problems. We hardly need reminding of the recent wave of scandals that shattered the public's faith in corporate leaders. And although you'll never see a financial statement with a line item labeled "distrust," the WorldCom fiasco underscores just how expensive broken trust can be. When I teach executive seminars on trust, I ask participants to describe how a working environment feels when it is characterized by low levels of trust. The most frequent responses include "stressful," "threatening," "divisive," "unproductive," and "tense." When asked how a high-trust work environment feels, the participants most frequently say "fun," "supportive," "motivating," "productive," and "comfortable." Clearly, companies that foster a trusting culture will have a competitive advantage in the war for talent: Who would choose to stay in a stressful, divisive atmosphere if offered a productive, supportive one?

DOUG FRASER

It is crucial, then, for managers to develop a better understanding of trust and of how to manage it. I define trust as confident reliance on someone when you are in a position of vulnerability. Given the pace of change in organizations today – mergers, downsizing, new business models, globalization – it is not surprising that trust is an issue. Fortunately, 50 years of research in social psychology has shown that trust isn't magically created. In fact, it's not even that mysterious. When people choose to trust, they have gone through a decision-making process – one involving factors that can be identified, analyzed, and influenced.

This article presents a model that sheds light on how the decision to trust is made. (We will ignore the extremes of complete trust based on blind faith and total distrust based on paranoia, and focus instead on the familiar situation in which uncertainty, possible damage, and multiple other reasons to trust or distrust are combined.) By understanding the mental calculations behind the decision whether or not to trust, managers can create an environment in which trust flourishes.

A Model for Trust

Building on the social psychologist Morton Deutsch's research on trust, suspicion, and the resolution of conflict, and on my own experience over the past 15 years consulting with organizations and executives on trust, I developed a model that can be used to predict whether an individual will choose to trust or distrust another in a given situation. (See the exhibit "To Trust or Not to Trust?") I have tested this model, which identifies ten factors at play in the decision-making process, with hundreds of top executives. Using it, they were able to identify relationships that would benefit from greater trust and to diagnose the root causes of distrust. Armed with that knowledge, they took concrete steps that made it easier for others to place confidence in them.

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Decision-maker factors. The first three factors concern the decision maker himself: the "truster." These factors often have little to do with the person asking for trust: the "trustee." They are the result of a complex mix of personality, culture, and experience.

Companies that foster a trusting culture will have an advantage in the war for talent: Who would choose to stay in a stressful, divisive atmosphere if offered a productive, supportive one?

Risk tolerance. Some people are natural risk takers; others are innately cautious. How tolerant people are of risk has a big impact on their willingness to trust – regardless of who the trustee is. Risk seekers don't spend much time calculating what might go wrong in a given situation; in the absence of any glaring problems, they tend to have faith that things will work out. Risk avoiders, however, often need to feel in control before they place their trust in someone, and are reluctant to act without approval. Not only do they not trust others, they don't even trust themselves. Research by the organizational anthropologist Geert Hofstede suggests that at some level, culture influences risk tolerance. The Japanese, for instance, tend to have a lower tolerance for risk than Americans.

Level of adjustment. Psychologists have shown that individuals vary widely in how well adjusted they are. Like risk tolerance, this aspect of personality affects the amount of time people need to build trust. Well-adjusted people are comfortable with themselves and see the world as a generally benign place. Their high levels of confidence often make them quick to trust, because they believe that nothing bad will happen to them. People who are poorly adjusted, by contrast, tend to see many threats in the world, and so they carry more anxiety into every situation. These people take longer to get to a position of comfort and trust, regardless of the trustee.

For example, Bill, a senior vice president at a major financial services firm, was a poorly adjusted person who always operated in "high alert" mode. He micromanaged his direct reports, even his most talented ones, because he couldn't feel secure unless he was personally involved in the details. His inability to delegate had little to do with the trustees and everything to do with his own nature; he regularly chose suspicion over trust because he saw even the slightest mistake as a potential threat to his reputation.

Relative power. Relative power is another important factor in the decision to trust. If the truster is in a position of authority, he is more likely to trust, because he can sanction a person who violates his trust. But if the truster has little authority, and thus no recourse, he is more vulnerable and so will be less comfortable trusting. For instance, a CEO who delegates a task to one of her vice presidents is primarily concerned with that person's competence. She can be reasonably confident that the VP will try to serve her interests, because if he doesn't, he may face unpleasant repercussions. The vice president, however, has little power to reward or sanction the CEO. Therefore, his choice to trust the CEO is less automatic; he must consider such things as her intentions and her integrity.

Situational factors. The remaining seven factors concern aspects of a particular situation and of the relationship between the parties. These are the factors that a trustee can most effectively address in order to gain the confidence of trusters.

Security. Earlier we dealt with risk tolerance as a personality factor in the truster. Here we look at the opposite of risk–security–as it relates to a given situation. Clearly, not all risks are equal. An employee who in good times trusts that his supervisor will approve the funding for his attendance at an expensive training program might be very suspicious of that same supervisor when the company is making layoffs. A general rule to remember: The higher the stakes, the less likely people are to trust. If the answer to the question "What's the worst that could happen?" isn't that scary, it's easier to be trustful. We have a crisis of trust today in part because virtually nobody's job is truly secure, whereas just a generation ago, most people could count on staying with one company throughout their careers.

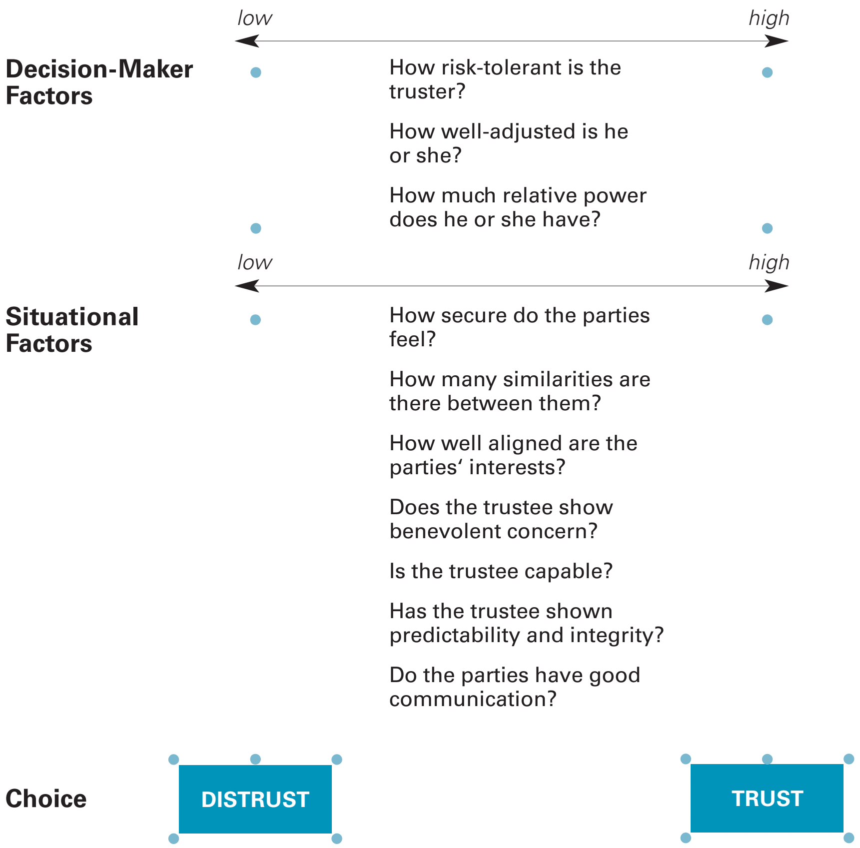
Number of similarities. At heart we are still quite tribal, which is why people tend to more easily trust those who appear similar to themselves. Similarities may include common values (such as a strong work ethic), membership in a defined group (such as the manufacturing department, or a local church, or even a gender), and shared personality traits (extroversion, for instance, or ambition). In deciding how much to trust someone, people often begin by tallying up their similarities and differences.

Imagine that you are looking to hire a consultant for a strategy assignment. The first candidate walks into your office wearing a robe; he speaks with an accent and has a degree from a university you've never heard of. When you meet the second candidate, she is dressed very much like you and speaks as you do. You learn that she also attended your alma mater. Most people would feel more comfortable hiring the second candidate, rationalizing that she could be counted on to act as they would in a given situation.

That's partly why companies with a strong unifying culture enjoy higher levels of trust–particularly if their cultural values include candor, integrity, and fair process – than companies without one. A good example of this is QuikTrip, a convenience store chain with more than 7,000 employees, which has been named to *Fortune*'s 100 Best Companies to Work For in each of the past four years. One of the company's bedrock values is do the right thing–for the employee and for the customer. This meaningful and relevant shared value serves as a foundation for an exceptionally strong culture of trust. On the flip side, a lack of similarities and shared values explains why, in many organizations, the workaholic manager is suspicious of his family-oriented employee, or the entrepreneurial field sales group and

To Trust or Not to Trust?

When deciding whether to trust someone, people weigh ten basic factors. Three relate to the decision maker alone – the "truster" – and seven reflect the specific situation involving him or her and the person asking for trust – the "trustee." The more factors that score on the high end of the scale, the more likely the decision maker is to choose trust.



the control-oriented headquarters never get along: It's more difficult to trust people who seem different.

Alignment of interests. Before a person places her trust in someone else, she carefully weighs the question "How likely is this person to serve my interests?" When people's interests are completely aligned, trust is a reasonable response. (Because both the patient and the surgeon, for instance, benefit from a successful operation, the patient doesn't need to question the surgeon's motives.) A fairly unsophisticated leader will assume that everyone in the organization has the same interests. But in reality people have both common and unique interests. A good leader will turn critical success factors for the company into common interests that are clear and superordinate.

Consider compensation policies. We've all heard of companies that have massive layoffs, drive their stock prices up, and reward their CEOs with handsome bonuses – in the same year. It's no wonder that so many employees distrust management. Whole Foods Market, by contrast, has a policy stating that the CEO cannot make more than 14 times the average employee's salary; in 2005 CEO John Mackey forfeited a bonus of $46,000. That policy helps demonstrate to workers that the CEO is serving the best interests of the company, not only his own. Aligned interests lead to trust; misaligned interests lead to suspicion.

This factor also operates on a more macro-organizational level. In "Fair Process: Managing in the Knowledge Economy" (HBR July–August 1997), W. Chan Kim and Renée Mauborgne described how a transparent, rigorous process for decision making leads to higher levels of organizational trust. Opaque decision-making processes, which may appear to serve special interests whether they do or not, breed distrust.

Benevolent concern. Trust is an issue not because people are evil but because they are often self-centered. We've all known a manager whom employees don't trust because they don't believe he will fight for them. In other words, he has never demonstrated a greater concern for others' interests than for his own. The manager who demonstrates benevolent concern – who shows his employees that he will put himself at risk for them – engenders not only trust but also loyalty and commitment.

Aaron Feuerstein, the former CEO of Malden Mills, represents an extreme example of benevolent concern. In 1995 a fire destroyed his textile mill in Lawrence, Massachusetts, which had employed some 3,200 people. He could have taken the insurance money and moved his manufacturing overseas. Then 70, he could have retired. Instead Feuerstein promised his workers that he would rebuild the mill and save their jobs, and he kept them on the payroll. Feuerstein's benevolent concern for his employees, despite the cost to himself, gained their trust. Unfortunately, it lost the trust of his banks, which probably would have preferred that more benevolent concern be directed toward them. The resulting debt eventually forced the company to file for bankruptcy protection. This points to a real challenge in managing trust: how to balance multiple and sometimes competing interests.

Capability. Similarities, aligned interests, and benevolent concern have little meaning if the trustee is incompetent. (If you're going to have surgery, you're probably more concerned about your surgeon's technical skills than about how much the two of you have in common.) Managers routinely assess capability when deciding to trust or delegate authority to those who work for them.

Capability is also relevant at the group and organizational levels. Shareholders will be suspicious of a board of directors that can't establish reliable processes for compensating CEOs fairly and uncovering unethical behavior. A customer will not trust a firm that has not demonstrated a consistent ability to meet his or her needs.

Predictability and integrity. At some point in the trust decision the truster asks, "How certain am I of how the trustee will act?" A trustee whose behavior can be reliably predicted will be seen as more trustworthy. One whose behavior is erratic will be met with suspicion. Here the issue of integrity comes into play – that is, doing what you say you will do. Trustees who say one thing but do another lack integrity. The audio does not match the video, and we are confused as to which message to believe. The result is distrust.

In my executive-coaching work, I have seen some managers consistently overpromise but underdeliver. These people are well-intentioned, and they care passionately about their work, but their enthusiasm leads them to promise things they simply cannot produce. Despite their hard work and good intentions, colleagues don't trust them because of their poor track records.

Take the case of Bob, the managing partner of a global consulting firm. Bob was a creative and strategic thinker who was well liked by everyone. He had good intentions and had demonstrated benevolent concern for employees. But the other partners in the firm did not trust Bob, because he often failed to deliver what he had promised when he had promised it. Despite his good intentions, people in the firm said that any project that relied on Bob was in a "danger zone." With time and coaching, Bob learned to delegate more and to live up to his commitments. But the point here is that when a person fails to deliver, he's not just missing a deadline; he's undermining his own trustworthiness.

Level of communication. Because trust is a relational concept, good communication is critical. Not surprisingly, open and honest communication tends to support the decision to trust, whereas poor (or no) communication creates suspicion. Many organizations fall into a downward spiral: Miscommunication causes employees to feel betrayed, which leads to a greater breakdown in communication and, eventually, outright distrust.

Consider how the Catholic Church handled allegations of sexual abuse by priests in the Boston area. Cardinal Bernard Law failed to openly communicate the nature and scope of the allegations. When the details emerged during legal proceedings, parishioners felt betrayed, and trust was destroyed. The word "cover-up" was frequently used in the media to describe Law's response to the crisis. His lack of candor caused people to feel that the truth was being obscured at the expense of the victims.

Around that time I witnessed an example of excellent communication within the same Catholic Church. I sat with my family one Sunday while, in an agonizingly uncomfortable homily, a priest confessed from the altar that he had had an inappropriate encounter 20 years earlier with a woman employed by the parish. He acknowledged his mistake, talked about how he had dealt with the issue, and asked for forgiveness. Over time his parishioners came once again to regard him as a trusted spiritual leader. His offense was less serious than Law's, but his story shows that honest communication can go a long way toward building or repairing relationships and engendering trust. To some degree, one person's openness induces openness in others, and the decision to put faith in others makes it more likely that they will reciprocate.

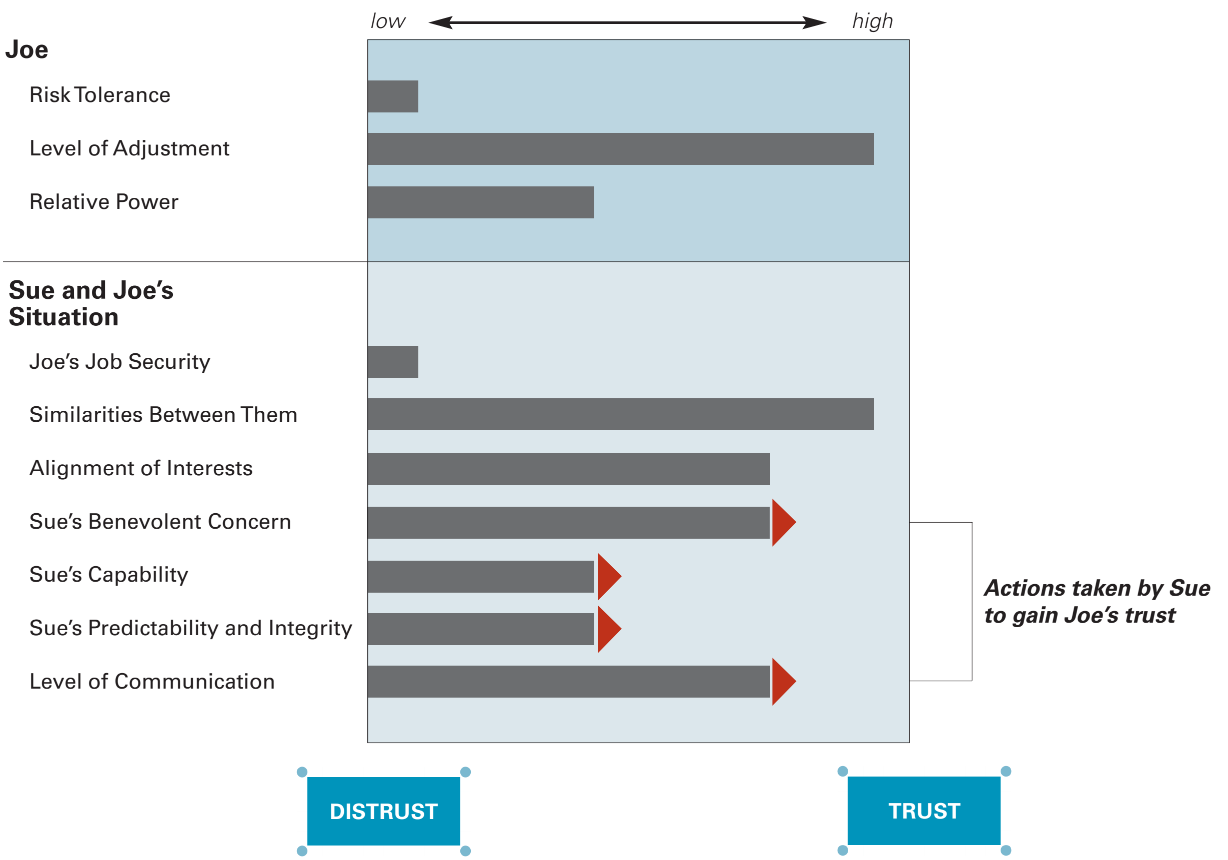
Managing with the Trust Model

Once these ten factors are understood, executives can begin managing trust in their own relationships and within their organizations.

Consider the example of Sue and Joe, a manager and her direct report in a

Trust Intervention: Sue and Joe

Sue, a VP of sales, needed to make some personnel changes in her department. Joe, her direct report, wasn't inclined to trust Sue, because the company was going through a turnaround and he feared for his job. Moreover, since she was relatively new to the company, he couldn't predict what she would do or gauge how capable she was. Sue used the trust model to identify what she could do to change Joe's feelings. By getting approval from her own boss for alternate positions for Joe, for instance, she demonstrated capability in finding solutions. And by empathizing with Joe's feeling of insecurity and openly discussing his options with him, she demonstrated both benevolent concern and increased communication. The result was that Joe found it easier to place his faith in Sue.



Fortune 500 consumer goods company that was in the midst of a major turnaround. Sue, a relatively new VP of sales, wanted to make some aggressive personnel moves in response to pressure from her boss to improve performance. Joe, one of Sue's employees, was three years shy of his retirement date. He had been a loyal employee for 17 years and had been successful in previous staff roles. Recently, however, he had taken on a new job as a line manager in sales and was not performing well. In fact, Sue's boss had suggested that it was time to move Joe out.

Joe was a confident person (high level of adjustment), but he knew that he was in the wrong job and wanted to find a different way to contribute (high alignment of interests with Sue). He was concerned about how candid to be with Sue, because he was afraid of being terminated (low risk tolerance and low security). And because Sue was a new VP, Joe was uncertain whether she was the decision maker and had any real control (low predictability and low capability).

As the situation originally stood, Joe wasn't inclined to trust his manager; there were too many risks and uncertainties. The trust model helped Sue identify what she could do to change the situation and create a climate of trust afterward. (See the exhibit "Trust Intervention: Sue and Joe.") Sue and I realized, for instance, that we could do little to raise Joe's tolerance for risk. Cautious by nature, he was genuinely–and quite rightly–fearful of losing his job. So I encouraged Sue to demonstrate greater benevolent concern: to have a candid but supportive conversation with Joe and give him time to go through a self-discovery process using an outside consultant. After that process, Joe requested a transfer. I also coached Sue to work with her boss to gain approval for some alternate options for Joe, thus increasing her capability and predictability in Joe's eyes. In addition, Sue began communicating more frequently and openly to Joe about his options in the organization and was sincerely empathetic about how this career uncertainty would affect him and his wife – showing still more benevolent concern. Eventually Joe was moved into a more suitable position. He wasn't shy in sharing his positive feelings about the whole process with his former colleagues, who still reported to Sue. As a result, those people were more apt to place their faith in her, and trust increased in the department even though it was experiencing major change.

The trust model can also be applied on a broader, organizational scale. Consider the situation at Texaco in the 1990s. In 1994 a group of minority employees filed a racial-discrimination suit against the oil giant, charging that black employees were being paid less than white employees for equal work. Two years later tensions reached a crisis level when senior Texaco executives were secretly recorded denigrating black workers. It's safe to say that among black workers, trust in their company's executives bottomed out. Then-chairman and CEO Peter Bijur recognized the graveness of the situation and knew he needed to act quickly to repair the broken trust.

Bijur started by hiring outside counsel to investigate the matter; bringing in a neutral third party alleviated any suspicions that conflict of interest would taint the investigation. He also created a special board of directors committee, which was charged with evaluating the company's diversity training. That step demonstrated that Texaco placed a high value on diversity. New diversity and sensitivity training led to a corporate culture built on shared values. Those who didn't belong – specifically, the senior executives heard speaking offensively on the tape – were terminated, suspended, or had their retirement benefits cut off. To make the company's actions more predictable for employees,

Practical Ways of Managing Trust

If this factor is low…	then you should:
Risk Tolerance	Spend more time explaining options and risks. Evaluate processes and results separately; recognize excellent work regardless of the outcome. Offer some sort of safety net.
Level of Adjustment	Be patient; it simply takes longer to build trust with some individuals. Try to enhance confidence by recognizing achievements and by correcting failures through coaching rather than harsh discipline.
Relative Power	Provide choices when possible; avoid being coercive. Communicate that leadership decisions aren't made arbitrarily by explaining how they serve organizational interests.
Security	Find ways to temper the risk inherent in the situation. Expect to invest time in raising comfort levels.
Number of Similarities	Use the word "we" more and the word "I" less. Emphasize what you have in common (values, membership, and so on).
Alignment of Interests	Be clear yourself about whose interests you are serving. Take others' interests into account and find a way to accommodate them where possible. Focus on the overarching strategy, vision, and goals. Shape a culture that reinforces doing the right thing for the enterprise.
Benevolent Concern	Take actions that demonstrate a genuine concern for others. Serve others' interests even if, on occasion, you bear some loss (and find a tasteful way to show that – by your choice – they gained more than you did). Engage in fair process.
Capability	Find ways to demonstrate competence in carrying out the task at hand. Acknowledge areas of incompetence and compensate by sharing or delegating responsibility.
Predictability and Integrity	Underpromise and overdeliver. If you can't fulfill your promises, explain why honestly. Describe the values that drive your behavior so that others see consistency rather than randomness.
Level of Communication	Increase the frequency and candor of your communications. Build a relationship beyond the constraints of your respective roles – for example, by going out to lunch or playing golf.

Bijur hired a respected judge to evaluate Texaco's HR policies, and the company changed those that were deemed unfair or not transparent. Moreover, senior executives were sent to all company locations to apologize for the humiliation to which black workers had been subjected. These meetings not only demonstrated benevolent concern but also opened up lines of communication between skeptical employees and top management.

Collectively, these actions made it easier for disillusioned workers to place their faith in the company again. Trust wasn't restored overnight – there's no quick fix for broken faith – but concerted efforts to correct the sources of distrust eventually paid off. In 1999 Bijur received an award from a national African-American group for commitment to diversity, and in 2000 Texaco received praise from SocialFunds.com for being a "model for challenging corporate racism."

Broken trust can be mended over time if leaders consistently engage in the right behaviors. The exhibit "Practical Ways of Managing Trust" identifies some behaviors that are particularly effective.

• • •

Trust is a measure of the quality of a relationship – between two people, between groups of people, or between a person and an organization. In totally predictable situations the question of trust doesn't arise: When you know exactly what to expect, there's no need to make a judgment call. The turbulence of outsourcing, mergers, downsizing, and changing business models creates a breeding ground for distrust.

Leading in such an environment requires acting in ways that provide clear reasons to decide to trust. There is no returning to the days when organizations expected – and received – unconditional loyalty from employees. But by using this model, you may be able to create a more dynamic and sustainable foundation for productive relationships.

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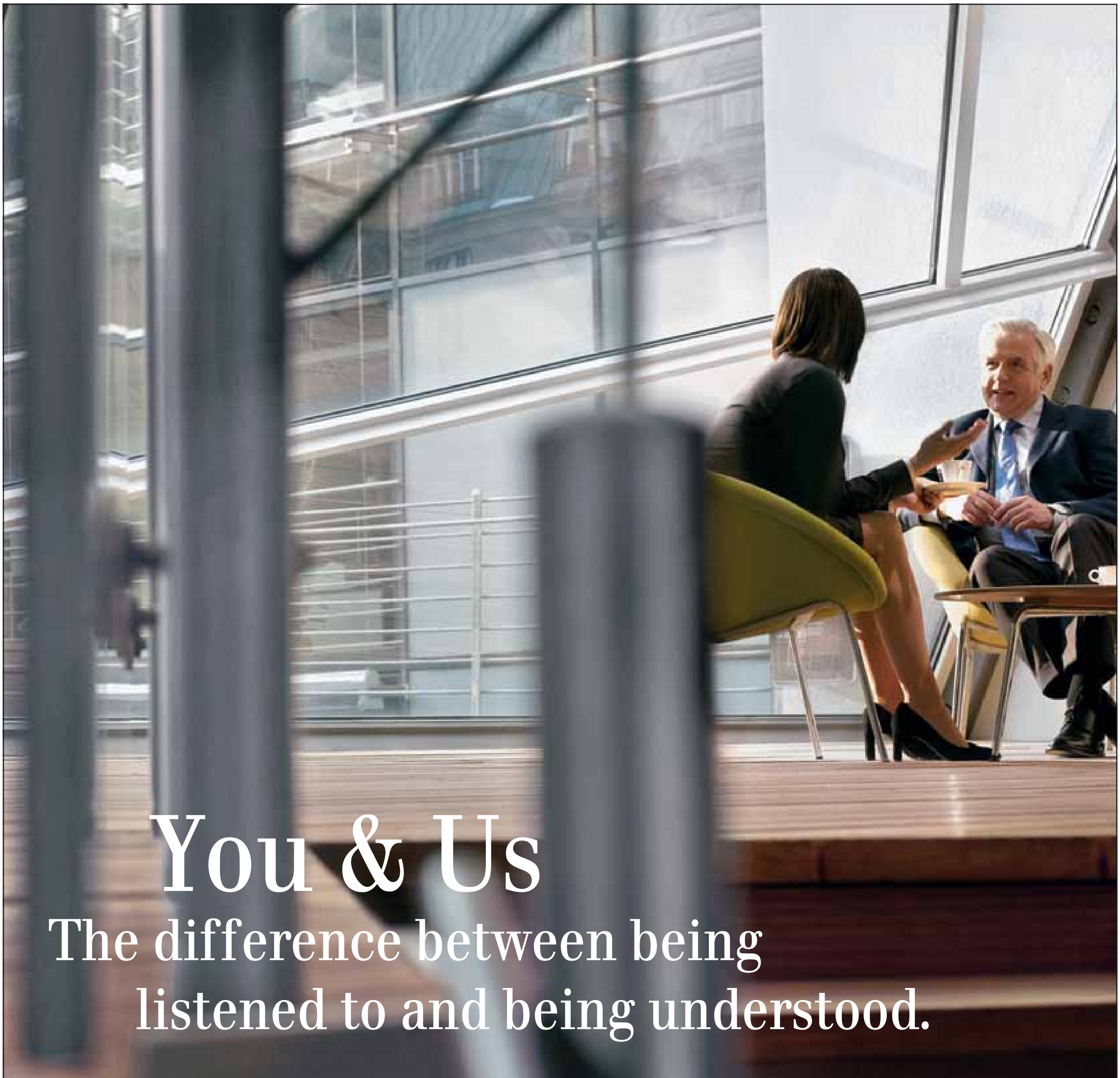

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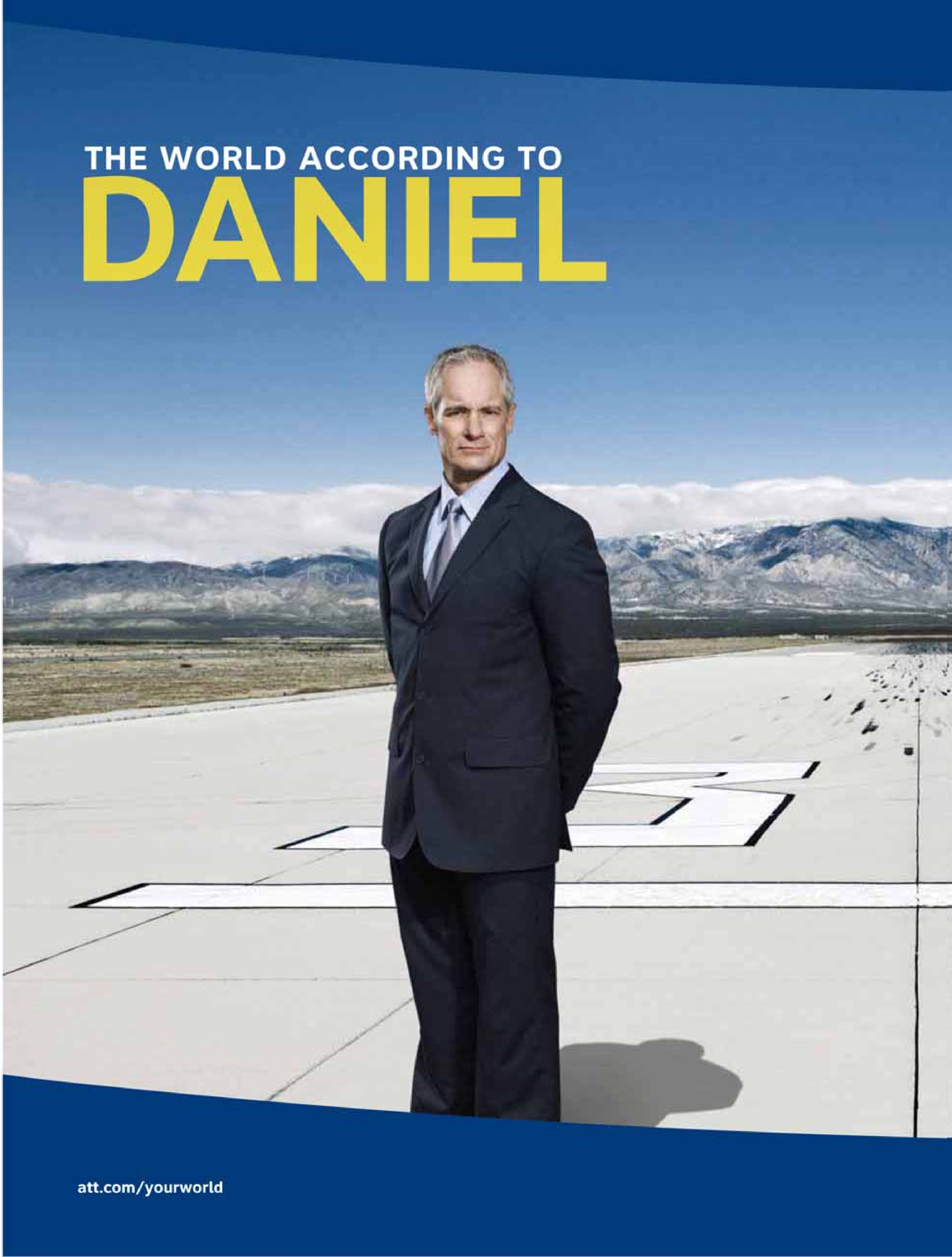
THE WORLD ACCORDING TO
DANIEL
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My contact center is an integrated, intelligent hub that can't falter in the face of the unexpected. And there's nothing I like less than losing customers on my watch.
Dynamic Networking from AT&T anticipates traffic and proactively allocates additional resources in response, all while working seamlessly with your existing systems. So Daniel's customers become more loyal with each experience. Learn how Dynamic Networking can enable your business.
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10 Ways to Create Shareholder Value

by Alfred Rappaport

Companies profess devotion to shareholder value but rarely follow the practices that maximize it. What will it take to make your company a level 10 value creator?

IT'S BECOME FASHIONABLE to blame the pursuit of shareholder value for the ills besetting corporate America: managers and investors obsessed with next quarter's results, failure to invest in long-term growth, and even the accounting scandals that have grabbed headlines. When executives destroy the value they are supposed to be creating, they almost always claim that stock market pressure made them do it.

The reality is that the shareholder value principle has not failed management; rather, it is management that has betrayed the principle. In the 1990s, for example, many companies introduced stock options as a major component of executive compensation. The idea was to align the interests of management with those of shareholders. But the generous distribution of options largely failed to motivate value-friendly behavior because their design almost guaranteed that they would produce the opposite result. To start with, relatively short vesting periods, combined with a belief that short-term earnings fuel stock prices, encouraged executives to manage earnings, exercise their options early, and cash out opportunistically. The common practice of accelerating the vesting date for a CEO's

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The competitive landscape, not the shareholder list, should shape business strategies.

options at retirement added yet another incentive to focus on short-term performance.

Of course, these shortcomings were obscured during much of that decade, and corporate governance took a backseat as investors watched stock prices rise at a double-digit clip. The climate changed dramatically in the new millennium, however, as accounting scandals and a steep stock market decline triggered a rash of corporate collapses. The ensuing erosion of public trust prompted a swift regulatory response – most notably, the 2002 passage of the Sarbanes-Oxley Act (SOX), which requires companies to institute elaborate internal controls and makes corporate executives directly accountable for the accuracy of financial statements. Nonetheless, despite SOX and other measures, the focus on short-term performance persists.

In their defense, some executives contend that they have no choice but to adopt a short-term orientation, given that the average holding period for stocks in professionally managed funds has dropped from about seven years in the 1960s to less than one year today. Why consider the interests of long-term shareholders when there are none? This reasoning is deeply flawed. What matters is not investor holding periods but rather the market's valuation horizon – the number of years of expected cash flows required to justify the stock price. While investors may focus unduly on near-term goals and hold shares for a relatively short time, stock prices reflect the market's long view. Studies suggest that it takes more than ten years of value-creating cash flows to justify the stock prices of most companies. Management's responsibility, therefore, is to deliver those flows – that is, to pursue long-term value maximization regardless of the mix of high- and low-turnover shareholders. And no one could reasonably argue that an absence of long-term shareholders gives management the license to maximize short-term performance and risk endangering the company's future. The competitive landscape, not the shareholder list, should shape business strategies.

What do companies have to do if they are to be serious about creating value? In this article, I draw on my research and several decades of consulting experience to set out ten basic governance principles for value creation that collectively will help any company with a sound, well-executed business model to better realize its potential for creating shareholder value. Though the principles will not surprise readers, applying some of them calls for practices that run deeply counter to prevailing norms. I should point out that no company – with the possible exception of Berkshire Hathaway – gets anywhere near to implementing all these principles. That's a pity for investors because, as CEO Warren Buffett's fellow shareholders have found, there's a lot to be gained from owning shares in what I call a level 10 company – one that applies all ten principles. (For more on Berkshire Hathaway's application of the ten principles, please read my colleague Michael Mauboussin's analysis in the sidebar "Approaching Level 10: The Story of Berkshire Hathaway.")

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PRINCIPLE 1

Do not manage earnings or provide earnings guidance.

Companies that fail to embrace this first principle of shareholder value will almost certainly be unable to follow the rest. Unfortunately, that rules out most corporations because virtually all public companies play the earnings expectations game. A 2006 National Investor Relations Institute study found that 66% of 654 surveyed companies provide regular profit guidance to Wall Street analysts. A 2005 survey of 401 financial executives by Duke University's John Graham and Campbell R. Harvey, and University of Washington's Shivaram Rajgopal, reveals that companies manage earnings with more than just accounting gimmicks: A startling 80% of respondents said they would decrease value-creating spending on research and development, advertising, maintenance, and hiring in order to meet earnings benchmarks. More than half the executives would delay a new project even if it entailed sacrificing value.

What's so bad about focusing on earnings? First, the accountant's bottom line approximates neither a company's value nor its change in value over the reporting period. Second, organizations compromise value when they invest at rates below the cost of capital (overinvestment) or

forgo investment in value-creating opportunities (underinvestment) in an attempt to boost short-term earnings. Third, the practice of reporting rosy earnings via value-destroying operating decisions or by stretching permissible accounting to the limit eventually catches up with companies. Those that can no longer meet investor expectations end up destroying a substantial portion, if not all, of their market value. WorldCom, Enron, and Nortel Networks are notable examples.

PRINCIPLE 2

Make strategic decisions that maximize expected value, even at the expense of lowering near-term earnings.

Companies that manage earnings are almost bound to break this second cardinal principle. Indeed, most companies evaluate and compare strategic decisions in terms of the estimated impact on reported earnings when they should be measuring against the expected incremental value of future cash flows instead. Expected value is the weighted average value for a range of plausible scenarios. (To calculate it, multiply the value added for each scenario by the probability that that scenario will materialize, then sum up the results.) A sound strategic analysis by a company's operating units should produce informed responses to three questions: First, how do alternative strategies affect value? Second, which strategy is most likely to create the greatest value? Third, for the selected strategy, how sensitive is the value of the most likely scenario to potential shifts in competitive dynamics and assumptions about technology life cycles, the regulatory environment, and other relevant variables?

At the corporate level, executives must also address three questions: Do any of the operating units have sufficient value-creation potential to warrant additional capital? Which units have limited potential and therefore should be candidates for restructuring or divestiture? And what mix of investments in operating units is likely to produce the most overall value?

PRINCIPLE 3

Make acquisitions that maximize expected value, even at the expense of lowering near-term earnings.

Companies typically create most of their value through day-to-day operations, but a major acquisition can create or destroy value faster than any other corporate activity. With record levels of cash and relatively low debt levels, companies increasingly use mergers and acquisitions to improve their competitive positions: M&A announcements worldwide exceeded $2.7 trillion in 2005.

Companies (even those that follow Principle 2 in other respects) and their investment bankers usually consider price/earnings multiples for comparable acquisitions and the immediate impact of earnings per share (EPS) to assess the attractiveness of a deal. They view EPS accretion as good news and its dilution as bad news. When it comes to exchange-of-shares mergers, a narrow focus on EPS poses an additional problem on top of the normal shortcomings of earnings. Whenever the acquiring company's price/earnings multiple is greater than the selling company's multiple, EPS rises. The inverse is also true. If the acquiring company's multiple is lower than the selling company's multiple, earnings per share decline. In neither case does EPS tell us anything about the deal's long-term potential to add value.

Sound decisions about M&A deals are based on their prospects for creating value, not on their immediate EPS impact, and this is the foundation for the third principle of value creation. Management needs to identify clearly where, when, and how it can accomplish real performance gains by estimating the present value of the resulting incremental cash flows and then subtracting the acquisition premium.

Value-oriented managements and boards also carefully evaluate the risk that anticipated synergies may not materialize. They recognize the challenge of postmerger integration and the likelihood that competitors will not stand idly by while the acquiring company attempts to generate synergies at their expense. If it is financially feasible, acquiring companies confident of achieving synergies greater than the premium will pay cash so that their shareholders will not have to give up any anticipated merger gains to the selling companies' shareholders. If management is uncertain whether the deal will generate synergies, it can hedge its bets by offering stock. This reduces potential losses for the acquiring company's shareholders by diluting their ownership interest in the postmerger company.

Approaching Level 10: **The Story of Berkshire Hathaway**

by Michael J. Mauboussin

Do any companies in America make decisions consistent with all ten shareholder value principles? Berkshire Hathaway, controlled by the legendary Warren Buffett, may come the closest. Not only is Buffett the company's largest shareholder, but he is also in the rare position of viewing the drivers of shareholder value through the eyes of a major investor and executive. He observes, "I'm a better businessman because I am an investor and a better investor because I am a businessman. If you have the mentality of both, it aids you in each field."[1]

In Berkshire's communications, for example, Buffett makes it clear that the company does not "follow the usual practice of giving earnings 'guidance,'" recognizing that "reported earnings may reveal relatively little about our true economic performance" (see Principle 1). Instead, the company vows to be "candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less" (Principle 10).

Berkshire's capital allocation decisions, especially when earnings growth and value creation conflict, are also consonant with the shareholder value principle. Writes Buffett, "Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that are not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable" (Principles 2 and 3).

Shareholder-value companies recognize the importance of generating long-term cash flows and hence avoid actions designed to boost short-term performance at the expense of the long view. Berkshire's 2005 annual report explains the company's position: "If a management makes bad decisions in order to hit short-term earnings targets, and consequently gets behind the eight-ball…, no amount of subsequent brilliance will overcome the damage that has been inflicted."

Berkshire is also exceptional with regard to its corporate governance and compensation. There's no doubt that Buffett's wealth and that of the company's vice chairman, Charlie Munger, rise and fall with that of the other shareholders: Berkshire stock represents the vast majority of their substantial net worth (Principle 9). As Buffett notes, "Charlie and I cannot promise you results. But we can guarantee that your financial fortunes will move in lockstep with ours for whatever period of time you elect to be our partner."

The company's compensation approach is also consistent with the shareholder value principle and stands in stark contrast to common U.S. compensation practices. Buffett's $100,000 annual salary places him in the cellar of *Fortune* 500 CEO pay, where median compensation exceeds $8 million. Fur-

PRINCIPLE 4

Carry only assets that maximize value.

The fourth principle takes value creation to a new level because it guides the choice of business model that value-conscious companies will adopt. There are two parts to this principle.

First, value-oriented companies regularly monitor whether there are buyers willing to pay a meaningful premium over the estimated cash flow value to the company for its business units, brands, real estate, and other detachable assets. Such an analysis is clearly a political minefield for businesses that are performing relatively well against projections or competitors but are clearly more valuable in the hands of others. Yet failure to exploit such opportunities can seriously compromise shareholder value.

A recent example is Kmart. ESL Investments, a hedge fund operated by Edward Lampert, gained control of Kmart for less than $1 billion when it was under bankruptcy protection in 2002 and when its shares were trading at less than $1. Lampert was able to recoup almost his entire investment by selling stores to Home Depot and Sears, Roebuck. In addition, he closed underperforming stores, focused on profitability by reducing capital spending and inventory levels, and eliminated Kmart's traditional clearance sales. By the end of 2003, shares were trading at about $30; in the following year they surged to $100; and, in a deal announced in November 2004, they were used to acquire Sears. Former shareholders of Kmart are justifiably asking why the previous management was unable to similarly reinvigorate the company and why they had to liquidate their shares at distressed prices.

Second, companies can reduce the capital they employ and increase value in two ways: by focusing on high value-added activities (such as research, design, and marketing) where they enjoy a comparative advantage and by outsourcing low value-added activities (like manufacturing)

ther, Berkshire is the rare company that does not grant any employee stock options or restricted stock. Buffett is not against equity-based pay per se, but he does argue that too few companies properly link pay and performance (Principle 6).

Buffett uses Geico, Berkshire's auto insurance business, to illustrate the company's compensation philosophy. The goals of the plan, Buffett explains, "should be (1) tailored to the economics of the specific operating business; (2) simple in character so that the degree to which they are being realized can be easily measured; and (3) directly related to the daily activities of plan participants." He states that "we shun 'lottery ticket' arrangements…whose ultimate value…is totally out of the control of the person whose behavior we would like to affect" (Principles 7 and 8).

So far, Berkshire looks like a complete level 10 value-creation company – one that applies all ten principles. But it doesn't closely adhere to Principle 4 (carry only assets that maximize value) and has never acted on Principle 5 (return cash to shareholders). In both cases, however, Buffett and Munger's writings and comments suggest that Berkshire evaluates its investments in light of these principles even if it doesn't directly apply them to itself.

Principle 4 advises selling operations if a buyer offers a meaningful premium to estimated value. Buffett states flatly, "Regardless of price, we have no interest at all in selling any good businesses that Berkshire owns," noting that this attitude "hurts our financial performance."

And despite sitting on more than $40 billion in excess cash at year-end 2005, Berkshire has not returned any cash to its shareholders to date. However, the company does apply a clear test to determine the virtue of retaining, versus distributing, cash: Management assesses "whether retention, over time, delivers shareholders at least $1 of market value for each $1 retained." This test, of course, is a restatement of the core shareholder value concept that all investments should generate a return in excess of the cost of capital. Consistent with Principle 5, Buffett is clear about the consequence of failing this test. He says, "If we reach the point that we can't create extra value by retaining earnings, we will pay them out and let our shareholders deploy the funds."

Buffett's influence extends beyond Berkshire to companies for which he has served as a board member. For example, the Washington Post and Coca-Cola were among the first companies to voluntarily expense employee stock options in 2002. Companies with which Buffett has been involved also have a history of repurchasing stock.

1. Sources for quotations include Berkshire Hathaway's own publications and various public news outlets.

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when these activities can be reliably performed by others at lower cost. Examples that come to mind include Apple Computer, whose iPod is designed in Cupertino, California, and manufactured in Taiwan, and hotel companies such as Hilton Hospitality and Marriott International, which manage hotels without owning them. And then there's Dell's well-chronicled direct-to-customer, custom PC assembly business model, which minimizes the capital the company needs to invest in a sales force and distribution, as well as the need to carry inventories and invest in manufacturing facilities.

PRINCIPLE 5

Return cash to shareholders when there are no credible value-creating opportunities to invest in the business.

Even companies that base their strategic decision making on sound value-creation principles can slip up when it comes to decisions about cash distribution. The importance of adhering to the fifth principle has never been greater: As of the first quarter of 2006, industrial companies in the S&P 500 were sitting on more than $643 billion in cash – an amount that is likely to grow as companies continue to generate positive free cash flows at record levels.

Value-conscious companies with large amounts of excess cash and only limited value-creating investment opportunities return the money to shareholders through dividends and share buybacks. Not only does this give shareholders a chance to earn better returns elsewhere, but it also reduces the risk that management will use the excess cash to make value-destroying investments – in particular, ill-advised, overpriced acquisitions.

Just because a company engages in share buybacks, however, doesn't mean that it abides by this principle. Many companies buy back shares purely to boost EPS, and, just as in the case of mergers and acquisitions, EPS accretion or dilution has nothing to do with whether or not a buyback makes economic sense. When an immediate boost to EPS rather than value creation dictates share buyback decisions, the selling shareholders gain at the expense of the nontendering shareholders if overvalued shares are repurchased. Especially widespread are buyback programs that offset the EPS dilution from employee stock option programs. In those kinds of situations, employee option exercises, rather than valuation, determine the number of shares the company purchases and the prices it pays.

Value-conscious companies repurchase shares only when the company's stock is trading below management's best estimate of value and no better return is available from investing in the business. Companies that follow this guideline serve the interests of the nontendering shareholders, who, if management's valuation assessment is correct, gain at the expense of the tendering shareholders.

When a company's shares are expensive and there's no good long-term value to be had from investing in the business, paying dividends is probably the best option.

PRINCIPLE 6

Reward CEOs and other senior executives for delivering superior long-term returns.

Companies need effective pay incentives at every level to maximize the potential for superior returns. Principles 6, 7, and 8 set out appropriate guidelines for top, middle, and lower management compensation. I'll begin with senior executives. As I've already observed, stock options were once widely touted as evidence of a healthy value ethos. The standard option, however, is an imperfect vehicle for motivating long-term, value-maximizing behavior. First, standard stock options reward performance well below superior-return levels. As became painfully evident in the 1990s, in a rising market, executives realize gains from any increase in share price – even one substantially below gains reaped by their competitors or the broad market. Second, the typical vesting period of three or four years, coupled with executives' propensity to cash out early, significantly diminishes the long-term motivation that options are intended to provide. Finally, when options are hopelessly underwater, they lose their ability to motivate at all. And that happens more frequently than is generally believed. For example, about one-third of all options held by U. S. executives were below strike prices in 1999 at the height of the bull market. But the supposed remedies – increasing cash compensation, granting restricted stock or more options, or lowering the exercise price of existing options – are shareholder-unfriendly responses that rewrite the rules in midstream.

Value-conscious companies can overcome the shortcomings of standard employee stock options by adopting either a discounted indexed-option plan or a discounted equity risk option (DERO) plan. Indexed options reward executives only if the company's shares outperform the index of the company's peers – not simply because the market is rising. To provide management with a continuing incentive to maximize value, companies can lower exercise prices for indexed options so that executives profit from performance levels modestly below the index. Companies can address the other shortcoming of standard options – holding periods that are too short – by extending vesting periods and requiring executives to hang on to a meaningful fraction of the equity stakes they obtain from exercising their options.

Companies need to balance the benefits of requiring senior executives to hold continuing ownership stakes and the resulting restrictions on their liquidity and diversification.

For companies unable to develop a reasonable peer index, DEROs are a suitable alternative. The DERO exercise price rises annually by the yield to maturity on the ten-year U.S. Treasury note plus a fraction of the expected equity risk premium minus dividends paid to the holders of the underlying shares. Equity investors expect a minimum return consisting of the risk-free rate plus the equity risk premium. But this threshold level of performance may cause many executives to hold underwater options. By incorporating only a fraction of the estimated equity risk premium into the exercise price growth rate, a board is betting that the value added by management will more than offset the costlier options granted. Dividends are deducted from the exercise price to remove the incentive for companies to hold back dividends when they have no value-creating investment opportunities.

PRINCIPLE 7

Reward operating-unit executives for adding superior multiyear value.

While properly structured stock options are useful for corporate executives, whose mandate is to raise the performance of the company as a whole – and thus, ultimately, the stock price – such options are usually inappropriate for rewarding operating-unit executives, who have a limited impact on overall performance. A stock price that declines because of disappointing performance in other parts of the company may unfairly penalize the executives of the operating units that are doing exceptionally well. Alternatively, if an operating unit does poorly but the company's shares rise because of superior performance by other units, the executives of that unit will enjoy an unearned windfall. In neither case do option grants motivate executives to create long-term value. Only when a company's operating units are truly interdependent can the share price serve as a fair and useful indicator of operating performance.

Companies typically have both annual and long-term (most often three-year) incentive plans that reward operating executives for exceeding goals for financial metrics, such as revenue and operating income, and sometimes for beating nonfinancial targets as well. The trouble is that linking bonuses to the budgeting process induces managers to lowball performance possibilities. More important, the usual earnings and other accounting metrics, particularly when used as quarterly and annual measures, are not reliably linked to the long-term cash flows that produce shareholder value.

To create incentives for an operating unit, companies need to develop metrics such as shareholder value added (SVA). To calculate SVA, apply standard discounting techniques to forecasted operating cash flows that are driven by sales growth and operating margins, then subtract the investments made during the period. Because SVA is based entirely on cash flows, it does not introduce accounting distortions, which gives it a clear advantage over traditional measures. To ensure that the metric captures long-term performance, companies should extend the performance evaluation period to at least, say, a rolling three-year cycle. The program can then retain a portion of the incentive payouts to cover possible future underperformance. This approach eliminates the need for two plans by combining the annual and long-term incentive plans into one. Instead of setting budget-based thresholds for incentive compensation, companies can develop standards for superior year-to-year performance improvement, peer benchmarking, and even performance expectations implied by the share price.

PRINCIPLE 8

Reward middle managers and frontline employees for delivering superior performance on the key value drivers that they influence directly.

Although sales growth, operating margins, and capital expenditures are useful financial indicators for tracking operating-unit SVA, they are too broad to provide much day-to-day guidance for middle managers and frontline employees, who need to know what specific actions they should take to increase SVA. For more specific measures, companies can develop leading indicators of value, which are quantifiable, easily communicated current accomplishments that frontline employees can influence directly and that significantly affect the long-term value of the business in a positive way. Examples might include time to market for new product launches, employee turnover rate, customer retention rate, and the timely opening of new stores or manufacturing facilities.

My own experience suggests that most businesses can focus on three to five leading indicators and capture an important part of their long-term value-creation potential. The process of identifying leading indicators can be challenging, but improving leading-indicator performance is the foundation for achieving superior SVA, which in turn serves to increase long-term shareholder returns.

PRINCIPLE 9

Require senior executives to bear the risks of ownership just as shareholders do.

For the most part, option grants have not successfully aligned the long-term interests of senior executives and shareholders because the former routinely cash out vested options. The ability to sell shares early may in fact motivate them to focus on near-term earnings results rather than on long-term value in order to boost the current stock price.

To better align these interests, many companies have adopted stock ownership guidelines for senior management. Minimum ownership is usually expressed as a multiple of base salary, which is then converted to a specified number of shares. For example, eBay's guidelines require the CEO to own stock in the company equivalent to five times annual base salary. For other executives, the corresponding number is three times salary. Top managers are further required to retain a percentage of shares resulting from the exercise of stock options until they amass the stipulated number of shares.

But in most cases, stock ownership plans fail to expose executives to the same levels of risk that shareholders bear. One reason is that some companies forgive stock purchase loans when shares underperform, claiming that the arrangement no longer provides an incentive for top management. Such companies, just as those that reprice options, risk institutionalizing a pay delivery system that subverts the spirit and objectives of the incentive compensation program. Another reason is that outright grants of restricted stock, which are essentially options with an exercise price of $0, typically count as shares toward satisfaction of minimum ownership levels. Stock grants motivate key executives to stay with the company until the restrictions lapse, typically within three or four years, and they can cash in their shares. These grants create a strong incentive for CEOs and other top managers to play it safe, protect existing value, and avoid getting fired. Not surprisingly, restricted stock plans are commonly referred to as "pay for pulse," rather than pay for performance.

In an effort to deflect the criticism that restricted stock plans are a giveaway, many companies offer performance shares that require not only that the executive remain on the payroll but also that the company achieve predetermined performance goals tied to EPS growth, revenue targets, or return-on-capital-employed thresholds. While performance shares do demand performance, it's generally not the right kind of performance for delivering long-term value because the metrics are usually not closely linked to value.

Companies seeking to better align the interests of executives and shareholders need to find a proper balance between the benefits of requiring senior executives to have meaningful and continuing ownership stakes and the resulting restrictions on their liquidity and diversification. Without equity-based incentives, executives may become excessively risk averse to avoid failure and possible dismissal. If they own too much equity, however, they may also eschew risk to preserve the value of their largely undiversified portfolios. Extending the period before executives can unload shares from the exercise of options and not counting restricted stock grants as shares toward minimum ownership levels would certainly help equalize executives' and shareholders' risks.

PRINCIPLE 10

Provide investors with value-relevant information.

The final principle governs investor communications, such as a company's financial reports. Better disclosure not only offers an antidote to short-term earnings obsession but also serves to lessen investor uncertainty and so potentially reduce the cost of capital and increase the share price.

One way to do this, as described in my article "The Economics of Short-Term Performance Obsession" in the May–June 2005 issue of *Financial Analysts Journal,* is to prepare a corporate performance statement. (See the exhibit "The Corporate Performance Statement" for a template.) This statement:

- separates out cash flows and accruals, providing a historical baseline for estimating a company's cash flow prospects and enabling analysts to evaluate how reasonable accrual estimates are;
- classifies accruals with long cash-conversion cycles into medium and high levels of uncertainty;

The Corporate Performance Statement

Investors need a baseline for assessing a company's cash flow prospects and a clear view of their potential volatility. The corporate performance statement provides a way to estimate both things by separating realized cash flows from forward-looking accruals.

Operating cash flows. The first part of this statement tracks only operating cash flows. It does not replace the traditional cash flow statement because it excludes cash flows from financing activities – new issues of stocks, stock buybacks, new borrowing, repayment of previous borrowing, and interest payments.

Revenue and expense accruals. The second part of the statement presents revenue and expense accruals, which estimate future cash receipts and payments triggered by current sales and purchase transactions. Management estimates three scenarios – most likely, optimistic, and pessimistic – for accruals of varying levels of uncertainty characterized by long cash-conversion cycles and wide ranges of plausible outcomes.

Management discussion and analysis. In the third section, management presents the company's business model, key performance indicators (both financial and nonfinancial), and the critical assumptions supporting each accrual estimate.

Operating Cash Flows

$		**Total revenue**
–		Operating expenses:[1]
		Production
		Selling and marketing
		Administration
		Current taxes
=		**"Cash" operating profit after taxes**
±		Change in working capital
=		**Cash flow from operations**
–		Investments:
		Capital expenditures (minus proceeds from asset sales)
		Research and development
		Other intangible investments
=$		**Free cash flow (for debt holders and shareholders)**

Revenue and Expense Accruals

	most likely	optimistic	pessimistic
Medium-uncertainty accruals			
Unrealized gains on long-term contracts	$		
Uncollectible receivables			
Warranty obligations			
Restructuring charges			
Deferred income taxes			
High-uncertainty accruals			
Defined benefit pensions			
Employee stock options			

Management Discussion and Analysis

1. Excludes noncash charges, such as depreciation, amortization, deferred taxes, and asset and liability revaluations.

Source: Adapted from Alfred Rappaport, "The Economics of Short-Term Performance Obsession," *Financial Analysts Journal,* May–June 2005.

Value-creating growth is **the** *strategic challenge, and to succeed, companies must be good at developing new, potentially disruptive businesses.*

- provides a range and the most likely estimate for each accrual rather than traditional single-point estimates that ignore the wide variability of possible outcomes;
- excludes arbitrary, value-irrelevant accruals, such as depreciation and amortization; and
- details assumptions and risks for each line item while presenting key performance indicators that drive the company's value.

Could such specific disclosure prove too costly? The reality is that executives in well-managed companies already use the type of information contained in a corporate performance statement. Indeed, the absence of such information should cause shareholders to question whether management has a comprehensive grasp of the business and whether the board is properly exercising its oversight responsibility. In the present unforgiving climate for accounting shenanigans, value-driven companies have an unprecedented opportunity to create value simply by improving the form and content of corporate reports.

The Rewards – and the Risks

The crucial question, of course, is whether following these ten principles serves the long-term interests of shareholders. For most companies, the answer is a resounding yes. Just eliminating the practice of delaying or forgoing value-creating investments to meet quarterly earnings targets can make a significant difference. Further, exiting the earnings-management game of accelerating revenues into the current period and deferring expenses to future periods reduces the risk that, over time, a company will be unable to meet market expectations and trigger a meltdown in its stock. But the real payoff comes in the difference that a true shareholder-value orientation makes to a company's long-term growth strategy.

For most organizations, value-creating growth is *the* strategic challenge, and to succeed, companies must be good at developing new, potentially disruptive businesses. Here's why. The bulk of the typical company's share price reflects expectations for the growth of current businesses. If companies meet those expectations, shareholders will earn only a normal return. But to deliver superior long-term returns – that is, to grow the share price faster than competitors' share prices – management must either repeatedly exceed market expectations for its current businesses or develop new value-creating businesses. It's almost impossible to repeatedly beat expectations for current businesses, because if you do, investors simply raise the bar. So the only reasonable way to deliver superior long-term returns is to focus on new business opportunities. (Of course, if a company's stock price already reflects expectations with regard to new businesses – which it may do if management has a track record of delivering such value-creating growth – then the task of generating superior returns becomes daunting; it's all managers can do to meet the expectations that exist.)

Companies focused on short-term performance measures are doomed to fail in delivering on a value-creating growth strategy because they are forced to concentrate on existing businesses rather than on developing new ones for the longer term. When managers spend too much time on core businesses, they end up with no new opportunities in the pipeline. And when they get into trouble – as they inevitably do – they have little choice but to try to pull a rabbit out of the hat. The dynamic of this failure has been very accurately described by Clay Christensen and Michael Raynor in their book *The Innovator's Solution: Creating and Sustaining Successful Growth* (Harvard Business School Press, 2003). With a little adaptation, it plays out like this:

- Despite a slowdown in growth and margin erosion in the company's maturing core business, management continues to focus on developing it at the expense of launching new growth businesses.
- Eventually, investments in the core can no longer produce the growth that investors expect, and the stock price takes a hit.
- To revitalize the stock price, management announces a targeted growth rate that is well beyond what the core can deliver, thus introducing a larger growth gap.
- Confronted with this gap, the company limits funding to projects that promise very large, very fast growth. Accordingly, the company refuses to fund new growth businesses that could ultimately fuel the company's expansion but couldn't get big enough fast enough.

- Managers then respond with overly optimistic projections to gain funding for initiatives in large existing markets that are potentially capable of generating sufficient revenue quickly enough to satisfy investor expectations.
- To meet the planned timetable for rollout, the company puts a sizable cost structure in place before realizing any revenues.
- As revenue increases fall short and losses persist, the market again hammers the stock price and a new CEO is brought in to shore it up.
- Seeing that the new growth business pipeline is virtually empty, the incoming CEO tries to quickly stem losses by approving only expenditures that bolster the mature core.
- The company has now come full circle and has lost substantial shareholder value.

Companies that take shareholder value seriously avoid this self-reinforcing pattern of behavior. Because they do not dwell on the market's near-term expectations, they don't wait for the core to deteriorate before they invest in new growth opportunities. They are, therefore, more likely to become first movers in a market and erect formidable barriers to entry through scale or learning economies, positive network effects, or reputational advantages. Their management teams are forward-looking and sensitive to strategic opportunities. Over time, they get better than their competitors at seizing opportunities to achieve competitive advantage.

Although applying the ten principles will improve long-term prospects for many companies, a few will still experience problems if investors remain fixated on near-term earnings, because in certain situations a weak stock price can actually affect operating performance. The risk is particularly acute for companies such as high-tech start-ups, which depend heavily on a healthy stock price to finance growth and send positive signals to employees, customers, and suppliers. When share prices are depressed, selling new shares either prohibitively dilutes current shareholders' stakes or, in some cases, makes the company unattractive to prospective investors. As a consequence, management may have to defer or scrap its value-creating growth plans. Then, as investors become aware of the situation, the stock price continues to slide, possibly leading to a takeover at a fire-sale price or to bankruptcy.

Severely capital-constrained companies can also be vulnerable, especially if labor markets are tight, customers are few, or suppliers are particularly powerful. A low share price means that these organizations cannot offer credible prospects of large stock-option or restricted-stock gains, which makes it difficult to attract and retain the talent whose knowledge, ideas, and skills have increasingly become a dominant source of value. From the perspective of customers, a low valuation raises doubts about the company's competitive and financial strength as well as its ability to continue producing high-quality, leading-edge products and reliable postsale support. Suppliers and distributors may also react by offering less favorable contractual terms, or, if they sense an unacceptable probability of financial distress, they may simply refuse to do business with the company. In all cases, the company's woes are compounded when lenders consider the performance risks arising from a weak stock price and demand higher interest rates and more restrictive loan terms.

Clearly, if a company is vulnerable in these respects, then responsible managers cannot afford to ignore market pressures for short-term performance, and adoption of the ten principles needs to be somewhat tempered. But the reality is that these extreme conditions do not apply to most established, publicly traded companies. Few rely on equity issues to finance growth. Most generate enough cash to pay their top employees well without resorting to equity incentives. Most also have a large universe of customers and suppliers to deal with, and there are plenty of banks after their business.

It's time, therefore, for boards and CEOs to step up and seize the moment. The sooner you make your firm a level 10 company, the more you and your shareholders stand to gain. And what better moment than now for institutional investors to act on behalf of the shareholders and beneficiaries they represent and insist that long-term shareholder value become the governing principle for all the companies in their portfolios?

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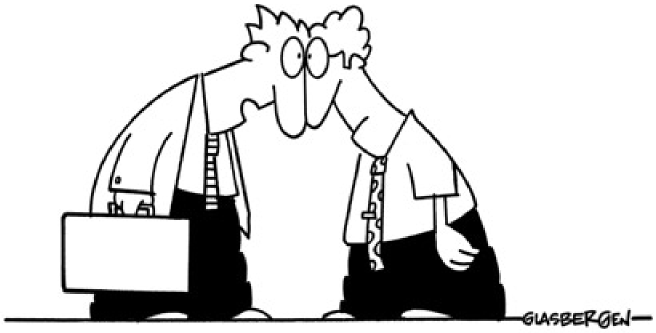

"I read somewhere that eye contact is a very important business skill."

RANDY GLASBERGEN

Sensitivity to race, religion, or gender is a good thing, but too often it is driven by fear. Rather than walk on eggshells, managers can learn to develop more productive, meaningful relationships at work.

Rethinking Political Correctness

by Robin J. Ely, Debra E. Meyerson, and Martin N. Davidson

A WHITE MANAGER FEARS she will be perceived as racist if she gives critical feedback to her Latino subordinate. A black engineer passed over for promotion wonders whether his race has anything to do with it, but he's reluctant to raise this concern lest he be seen as "playing the race card." A woman associate who wants to make partner in an accounting firm resists seeking coaching on her leadership style; she worries that doing so would confirm the notion that women don't have what it takes to make partner.

JULIETTE BORDA

These types of events occur daily in politically correct (PC) cultures, where unspoken canons of propriety govern behavior in cross-cultural interactions – that is, interactions among people of different races, genders, religions, and other potentially charged social identity groups. We embrace the commitment to equity that underlies political correctness, and we applaud the shifts in norms wrought by that commitment. We are troubled, however, by the barriers that political correctness can pose to developing constructive, engaged relationships at work. In cultures regulated by political correctness, people feel judged and fear being blamed. They worry about how others view them as representatives of their social identity groups. They feel inhibited and afraid to address even the most banal issues directly. People draw private conclusions; untested, their conclusions become immutable. Resentments build, relationships fray, and performance suffers.

Legal and cultural changes over the past 40 years ushered unprecedented numbers of women and people of color into companies' professional and managerial ranks. Overt prejudice and discrimination in the workplace, historically sanctioned by society, are far less acceptable today. Laws now protect traditionally underrepresented groups from blatant discrimination in hiring and promotion, and political correctness has reset the standards for civility and respect in people's day-to-day interactions.

INTERPRETATION is not the same as TRUTH.

Despite this obvious progress, we believe that political correctness is a double-edged sword. While it has helped many traditionally underrepresented employees to experience their workplace as more inclusive, the PC rule book can hinder employees' ability to develop effective relationships across potentially divisive group differences. Companies need to equip workers with skills – not rules – for building these relationships.

Our work suggests that high-quality relationships cannot be mandated. Sensitivity training and zero-tolerance policies at best impart some useful cultural knowledge or indicate that a company is serious about eliminating bias. At worst, such practices undermine relationships by reinforcing a restrictive and fearful atmosphere. Those to whom corrective actions are directed – men and whites, for example – walk on eggshells for fear of unwittingly transgressing the rules of political correctness.

We have found that political correctness does not only pose problems for those in the "majority." When majority members cannot speak candidly, *members of underrepresented groups also suffer:* "Minorities" can't discuss their concerns about fairness and fears about feeding into negative stereotypes, and that adds to an atmosphere in which people tiptoe around the issues and one another. These dynamics breed misunderstanding, conflict, and mistrust, corroding both managerial and team effectiveness.

Constructive engagement of differences – and, therefore, effective leadership in culturally diverse contexts – requires majority and minority individuals to develop a mind-set and skills that all parties currently lack. This article proposes how managers and employees can engage with one another to reap the benefits cultural diversity has to offer. It represents our collective insights from research, teaching, and consulting over the past 15 years in the areas of race and gender relations, diversity, and organizational change. It also incorporates findings from our research with Learning as Leadership, a San Rafael, California–based leadership development organization, in whose seminars we have observed dozens of managers and executives grappling with unproductive behavior patterns and experimenting with new ones. Applying our insights about these processes to classic diversity-related dilemmas, we have developed the following principles to guide people seeking a healthy approach to the tensions that commonly arise over difference:

- *Pause* to short-circuit the emotion and reflect.
- *Connect* with others in ways that affirm the importance of relationships.
- *Question yourself* to help identify your blind spots and discover what makes you defensive.
- *Get genuine support* that doesn't necessarily validate your point of view but, rather, helps you gain a broader perspective.
- *Shift your mind-set* from "*You* need to change" to "What can *I* change?"

These five principles require that all parties adopt a learning orientation in cross-cultural interactions. In this article, we spell out the challenges – and opportunities – of adopting such an orientation and offer some guidelines

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for leaders. First, though, let's explore the negative dynamics that result when open discussion is repressed and people fail to learn.

Identity Abrasions

Assaults to people's identities occur daily in most organizations: A white person confuses the names of two Asian-American coworkers; a black executive is addressed less formally than her white male counterparts; a woman's idea is misattributed to a male colleague. Repeated experiences of this kind can diminish people's sense of how much others value and respect them. Offense at a perceived slight may or may not be well-founded, but an attempt to discuss the possible insult risks, for example, the charge that one is overly sensitive.

Such assaults occur on the flip side as well, as when members of majority groups are accused of being prejudiced or of treating others unfairly. Because they often have meant no harm, they tend to respond defensively, upset by any suggestion that their moral goodness is being questioned.

These experiences produce what we call identity abrasions for people on both sides of the interaction. Identity abrasions cause people to burrow into their own camps, attend only to information that confirms their positions, and demonize the other side. The overall result is a number of negative dynamics, with costs both to individuals and to organizations. Below, we offer several classic examples; these and others throughout the article are real cases, but with the names changed.

Divisiveness. While participating in a large meeting, Tom, a white vice president of manufacturing in a household appliances company, describes his ordeal with the union as akin to "oriental torture." The VP of HR passes him a note and tells him that his reference is offensive to some people in the room, so before he finishes his address, Tom apologizes for the insensitive remark. As the meeting is coming to a close, a white regional manager, who is married to a Japanese-American woman, openly voices his distress at the remark, though expresses his appreciation that the VP recognized his gaffe and apologized. The following day, everyone in the firm knows about the incident. Some people feel that the regional manager has inappropriately shamed Tom. Others feel that Tom's boss needs to call him onto the carpet for his insensitive remark. That evening, more employees gather to recount numerous similar incidents from the past. The next day, some staff members call for the company to create a forum for educating employees; others conclude that race is too hot to touch in any company forum and vow to assiduously avoid the topic.

Self-doubt. Sophia, an African-American, is a newly appointed member of the board of a regional bank. In the first few meetings, she is relatively silent, but when the agenda during one meeting turns to her area of expertise, she joins the conversation confidently and with a well-informed point of view. The board chair interrupts while Sophia is talking, urging members to be brief so that they can get through the agenda. Sophia notes to herself that the chair never makes such comments when any of her white colleagues are speaking. She wonders, "Is he cutting me off because I'm a black woman?" – but she brushes off her worry. She thinks: "I can't go there. It takes too much out of me. I just need to move on." In subsequent meetings, she becomes increasingly reluctant to share her perspective; ultimately, she comes to dread the meetings because she feels marginal. She begins to wonder, "Do I have what it takes to be a fully contributing member of this board?"

Overprotection and underdevelopment. Rob, a white partner at a management consultancy, has always been sensitive to the lack of diversity at his firm and would like to do his part to help women and other minorities succeed. He mentors Iris, a young Latina associate who is competent, energetic, and well liked but is not doing enough to generate business. In a promotions committee meeting, a number of partners voice concerns about Iris's prospects for promotion to partner. Rob thinks these concerns may have some merit but is reluctant to share them with Iris. He fears that hearing the feedback would convince her that the partnership is simply not ready to promote a woman of color. Uncomfortable with his ambivalence, he unconsciously distances himself from Iris, leaving her bewildered about what she's done to alienate him.

Self-limiting behavior. Julie, an engineer, wants to prove to her overwhelmingly male colleagues that women are as good at engineering as men are. She consciously avoids being seen in gender-stereotypical ways: She doesn't sit next to other women in meetings, tries to solve problems on her own, avoids asking for help or clarification, shuns opportunities to mentor junior women, and makes sure her personal life is invisible at work. As a result, she isolates herself from potential sources of support, works harder and less efficiently than she needs to, develops skills more slowly, and contributes less to her firm than she otherwise might.

Polarization. A friendship between coworkers – Scott, an American Christian, and Mahmoud, a Muslim émigré from Pakistan – abruptly falls apart after they discuss events in the news. Seconds after Scott makes what he naively intends to be a conciliatory comment, the two become engrossed in a passionate debate in which Scott finds himself arguing for positions that he doesn't even support. The exchange ends when Scott storms out of Mahmoud's office while Mahmoud shouts after him. From then on, communication between them is minimal.

Suspicion and withdrawal. Bill, a black associate in a consulting firm, consistently receives mediocre ratings from his white clients. He wonders whether these ratings reflect a racial bias and raises the issue with his white boss. She balks, insisting that their clients are not biased. Bill is not convinced. He searches for evidence to bolster his claim, but the evidence is ambiguous, so he does not share it. He feels increasingly angry, resentful, and hopeless about his prospects at the firm. In his next review, his boss tells him she is concerned about his "bad attitude."

In each of these cases, people's judgments – and their fears of others' judgments – drive the negative dynamic. When we feel judged, it cuts to the core of our self-image as being good, competent, and worthy. To counter such identity abrasions, we deny our experiences, avoid difficult conversations, react angrily, and seek advice only to confirm our innocence. These behaviors have only one goal: self-protection. When self-protection becomes more important than the work, the group's mission, or relationships with others, people lose their connections to one another, making it difficult to take risks, learn, and solve problems creatively together. (While we have outlined these dynamics as they occur in the United States, we believe that the impulse to protect oneself manifests similarly in all interactions among members of groups that are marked by a history of prejudice, discrimination, or misunderstanding.)

Principles for Constructively Engaging Differences

Short-circuiting these emotional reactions is not easy, but our research suggests that when people replace their need to defend themselves with a desire to learn, the possibilities for constructive cross-cultural interactions increase enormously. Learning requires people to acknowledge their limitations and to suspend their need to be right or to prove their competence. In so doing, they make themselves vulnerable to others' judgments so that they can perform their jobs more effectively.

Of course, those who consciously hold and defend their prejudices offer little opportunity for constructive engagement. Nevertheless, we have seen that far too often people draw conclusions about others prematurely, missing crucial opportunities for advancing mutually held goals.

The five principles that follow are not sequential steps. They occur, sometimes simultaneously, throughout the learning process; together, they contribute to one's overall ability to handle identity abrasions constructively.

Principle 1: Pause. When we experience a threat to our identity, our first response is a negative emotion such as anger. We react by casting blame and judgment, which most often incites defensiveness in others. Taking time – even a few moments – to identify our feelings and consider our responses will help us to respond more effectively.

Consider the case of Mary, a 30-year veteran of a large and venerable law firm in which she was partner. Earlier in her career, when her male colleagues said or did something that she found offensive, Mary's immediate impulse was to "get in their faces" about it. In learning to step back and recenter herself when irritants arose, Mary found she could be more effective by drawing people in rather than pushing them away.

Mary's actions in a recent partner meeting are illustrative. When a male colleague told an off-color joke about women and others laughed, Mary felt her anger rising. Yet instead of lecturing her colleagues on the errors of their ways, as she might have done earlier in her career, she paused and took several deep breaths. She then checked her anger and jettisoned her sense of self-righteousness.

Mary recognized her anger as a signal, not as a springboard for reaction. Her feelings told her to be careful, that she was about to interpret reality in a way that might not be fully accurate or that might lead her to react in ways that would not serve her larger goals. Rather than admonishing her colleagues when she was offended by their remarks, she stepped back, calmed herself down, and refocused on what was important to her. This response enabled her to enact the next principle.

Principle 2: Connect. When we experience an identity abrasion, our impulse is to focus inward, to justify, explain, and defend ourselves. One way to resist this impulse is to focus outward, on goals that are larger than we are, such as advancing broad social ideals, contributing to a task, or striving to achieve an organization's mission. Goals such as these connect us with others by infusing our lives with meaning. Meaningful goals remind us of what is at stake in a given situation, giving us a reason to engage with others even if we feel threatened.

Mary, for example, learned to replace a defensive goal (demonstrating her moral superiority) with a generative one (making the law firm a place where women could more easily advance to partner). She was then able to see more clearly what was at stake in her interactions with her male colleagues. She could either alienate them or connect with them by focusing on a goal that mattered more to her than being right.

Once we've anchored on such a goal, we can clarify our intention for a given interaction. Our intentions shape how we come across to others and influence how they, in turn, respond. When we enter into an interaction from a stance of anger or defensiveness, we are likely to deepen the fissure in the relationship. In contrast, when we approach that interaction with the intention of broadening our understanding – whether of ourselves, the other person, the relationship, or the task – we are far more likely to repair the fissure and to move forward productively with our work.

> People who are able to turn IDENTITY ABRASIONS into opportunities have the capacity to radically shift their WAY OF THINKING – about themselves, their situations, and other people.

Mary demonstrated her intention to learn in the partner meeting. Searching for a way to connect with her colleagues, she realized that their laughter at the expense of women didn't fit with her core belief that they were good, decent men. So, in the moments following the joke, she reflected: What experiences underlie their disparaging humor about women? To engage them in this question, Mary responded to the joke, which alluded to a woman's lack of fit in an all-male culture, by describing her personal experience of entering the firm: what it was like to enter an environment filled with unspoken rules she didn't know, where everyone else seemed comfortable with one another, and where her energy and way of relating were foreign to the dominant culture. Her story was not a diatribe; her intention was not to teach or to blame but to engage and inquire. She then asked the men: What had it been like for them when women entered the firm? What did they feel they had lost? What might they have gained? The conversation went to a whole different level as people opened up. In the course of it, Mary was able to explain the range of feelings and judgments that come up for her – and that she has to work hard to suppress – when a well-meaning colleague tells an off-color joke.

When we have an intention to learn, we step out of the need to be right. A learning orientation motivates us to seek to understand – rather than to judge – the other person. Such understanding can help us connect with the other's humanity, which can provide further impetus for seeking mutually beneficial solutions.

Principle 3: Question yourself. This principle is probably the most challenging one. It requires taking risks precisely when we feel most in need of protecting ourselves from a perceived or actual threat. It demands that we ask ourselves such questions as, "What am I missing in the way I'm seeing this situation? How might my desire to be proven right or innocent be distorting my view of reality or of the other person?"

This principle is particularly challenging for women and people of color, whose concerns others have so often dismissed or trivialized. Consider the case of Brianna, the African-American CEO of a start-up that consulted to executives of nonprofit organizations. She became CEO when Jay, the company's white founder, stepped down from the position. Jay remained a close adviser to the leadership team, but his autocratic style rubbed Brianna the wrong way.

> People in the organization need to feel that, in QUESTIONING themselves or making themselves vulnerable, they will not be judged or punished. In other words, they need to FEEL SAFE.

The tension between the two reached a peak after a leadership team meeting when Jay told Brianna that she needed to "lighten up" on her push to market more vigorously to clients of color. He told her that she was being "too aggressive." Brianna's immediate impulse was dismissive; it seemed to her that Jay just couldn't bear the authority of a strong black woman.

Instead of going head-to-head with Jay, Brianna chose to shift to a self-questioning stance. Rather than presuming she knew the truth about Jay's intentions, she sought further clarification from him. She learned that Jay feared that her approach would narrow the firm's marketability and realized that she needed to better articulate how her strategy connected to the firm's mission. The discussion helped Brianna to question herself and, by doing so, to discover how her focus on pushing the team to see her point of view had caused her to miss theirs.

As the discussion became more open, Brianna told Jay what it felt like to be a black woman in her position. She was excited to be leading such a firm, she explained, but she also felt her success was a symbol of what black people can do when given sufficient resources and authority. She was anxious to set a positive example for those not used to seeing black women in such roles and thus put a good deal of pressure on herself to succeed. That Brianna felt any anxiety about anything had never occurred to Jay; she had always struck him as confidence personified.

Brianna's openness emboldened Jay to take risks and question himself as well. He began to reflect more deeply on his negative reaction to Brianna's marketing ideas and realized that he found them threatening: Consulting to executives of color pushed him (and probably others) too far outside his comfort zone. Brianna could well imagine his fears; she reflected on times when she was outside her comfort zone and how difficult that was for her. More important, she could see how her forcefulness had not made it any easier for her team to discuss their fears. It was slowly dawning on Brianna that her investment in being seen as a powerful black woman had gotten in the way of her actually *being* a powerful black woman.

In this conversation, Brianna and Jay were able to see that each had only a partial view of reality. This realization gave them an opportunity to create a different kind of connection with each other. Their shared commitment to the firm's mission had motivated them to take these risks, which strengthened their relationship. Their relationship, in turn, increased their capacity to work toward that mission more effectively.

The principle of self-questioning puts the learning orientation into action. Interrogating ourselves and asking others for clarification means abandoning our need to present and maintain a particular image of ourselves. It also opens the way for the other person to make a similar move. When people take risks with one another, they short-circuit defensive identity-related processes, enabling them to move forward in their work.

By this principle, we do not mean to suggest that people should question their experiences. On the contrary, feeling offended or threatened in an interaction provides an important signal that invites inquiry. Instead, we are suggesting that people question their interpretations of their experiences, their beliefs about what has happened, who is right, and so forth. Interpretation is not the same as truth. Questioning oneself means letting go of one's protective scripts, identifying what images of self feel threatened, being open to perspectives that may be difficult to hear, and seeing what can be learned.

Principle 4: Get genuine support. To help us sort through our reactions, identify a fuller picture of reality, and, most difficult, question our assumptions, we need other people. Unfortunately, most of us seek help from the wrong people, seeing those who challenge our point of view as threats and those who reinforce it as allies.

Receiving reinforcement may be comforting, but it often doesn't confer much learning. Before we look at what support is, let's consider what support is not.

Support is not necessarily validation that your interpretation of the situation is correct or that your behavior was appropriate or warranted. Although that kind of backing can feel good in the moment, it provides the opposite of what we really need. What's needed is the counsel of trusted colleagues who can help us identify choices we make about how to behave or what to believe, as well as what alternatives are available. When Brianna was at her wits' end with Jay, she sought support from two friends to whom she frequently vented her feelings. They agreed with Brianna's interpretation of his behavior, and Brianna felt vindicated, but she was not any closer to finding a way to work with him. Indeed, she felt angrier.

Next, Brianna sought the advice of an old and trusted mentor, a black professor from her MBA program. He helped her sort through her feelings and priorities and asked her to identify what she felt Jay, at his best, had to offer her and the firm. He suggested that she approach her next interaction with Jay as if he had her best interests at heart and, from that standpoint, see what she might be able to learn from him. Brianna's mentor was able to hear her concerns, but instead of reinforcing her anger, he pushed back and helped her develop a more useful approach.

Giving genuine support means challenging the person seeking it; receiving that support means not reacting defensively. Virtually every time we've seen someone address an identity abrasion effectively, there has been genuine support.

Principle 5: Shift your mind-set. We have found that people who are able to turn identity abrasions into opportunities have the capacity to radically shift their way of thinking–about themselves, their situations, and other people. Such people tend to be highly self-aware, but they were not born with self-awareness; they continuously develop it as they systematically reflect on and analyze the behavioral patterns that underlie dissatisfaction in their lives. Through self-reflection, people break out of negative patterns. The fundamental shift is away from a mind-set that says, "You need to change," to one that asks, "What can I change?"

Take Richard, a white codirector of a financial services firm. One morning, Richard e-mailed a board member about his disagreement with a policy that his black business partner, Michele, supported, and he inadvertently copied Michele on the message. Michele was understandably furious.

Richard felt bad and apologized, but over the next several days, he had a more complicated reaction, including strong feelings of anger toward Michele. They had genuine disagreements that needed to be hashed out, but as Richard saw it, Michele didn't seem interested in discussing them. Increasingly, it seemed to Richard, she had become controlling, domineering, cold, and withholding. Richard saw himself as fair-minded and progressive and felt somewhat uncomfortable challenging a black woman. He decided not to say anything.

Still, Richard cared deeply about the company, and he was self-aware enough to realize that his inability to collaborate with Michele was hampering their work. Richard decided that something needed to change, and he understood that the only thing he could change was himself. To start, Richard asked himself: "Could I be wrong about Michele?" He realized he had to stop assuming the worst about her, so he looked more carefully at his feelings.

As he reflected, with the support of two trusted colleagues, Richard saw that what truly bothered him most about Michele was that she always made him feel guilty. He had apologized about the e-mail incident – he knew what he had done was wrong – but his apology seemed to fall on deaf ears. As he further contemplated his reactions, Richard realized that, as was often the case, he had been looking for Michele's approval. When she wouldn't offer it, he'd retaliate. (Indeed, it occurred to him that such a motive might have unconsciously prompted the e-mail incident.) Richard concluded that his reactions to Michele, which he had always believed were her fault, were in fact driven by his own needs and anxieties: He wanted Michele's reassurance that he wasn't a bigot. With this insight, Richard was ready to try a different approach.

Rather than seeking Michele's approval, Richard decided to learn how he might give her support. He invited her to a series of meetings in which they could discuss their individual agendas with an eye to better understanding each other. Richard learned that worries about the firm's increasing volume of work had driven Michele – anxious to belie the racial stereotype that she was unqualified for the job – to become highly detail oriented. With so many balls in the air, she worried that something important was bound to fall. Richard had interpreted her detail orientation as a need for control and as implicit criticism of him. Angry, he had withdrawn, which had fueled her anxiety; her reactions, then, had fueled his anger. The vicious cycle was clear.

Recognizing this pattern went a long way toward easing tensions between them. They decided to manage their workload by continuing to meet weekly to discuss their goals, task allocation, and means of supporting one another. This arrangement helped ease Michele's concerns about the work and pushed Richard to take on more of the load. Richard put his insecurities aside and sought only appropriate, task-related feedback from Michele. This change made it easier for her to be supportive of him, which gave Richard the confidence to disagree with her without feeling that he was risking her condemnation.

A year later, Richard and Michele were coleading the firm in an energizing rather than enervating way. Richard's success in turning his relationship with Michele around rested on his ability to make a fundamental mindset shift. In so doing, he was able to move from feeling powerless to taking effective action.

The clarity that comes from making such a shift often reveals a business problem that turns out to have little directly to do with cultural issues. (In the case of Richard and Michele, the engine of their problem was an increased volume of work, which they were ultimately able to address with relative ease.) Until the shift is made, threats to identity take up the center stage, hampering people's ability to see other problems clearly and to achieve truly effective partnerships.

Guidelines for Leaders

Leaders who follow the above principles of engagement and who demonstrate personal resilience in the face of identity abrasions inspire the same behavior in others. Company leaders can support and encourage people to confront identity abrasions directly and constructively by doing the following.

Create safety. People in the organization need to feel that, in questioning themselves or making themselves vulnerable, they will not be judged or punished. In other words, they need to feel safe. Leaders create safety by publicly stating their assumption that people are well-intentioned and by overtly ensuring that well-intentioned actions will not lead to punishment. They resist the judgmental tone that diversity discussions so often acquire, by making it clear that mistakes will not impugn anyone's moral character. Being candid themselves, they also encourage others to be candid. Perhaps most important, such leaders acknowledge their own fallibility in cross-cultural interactions. When they describe publicly their own learning, they legitimate discussions of identity-related experiences, giving permission to employees to provide and solicit feedback, air conflicts, and learn from their missteps.

Creating a safe environment requires care in determining what kind of misconduct is punishable. Zero-tolerance policies, for example, can cut two ways. Leaders create safety when they express zero tolerance for intentional forms of harassment – for instance, "hate e-mail" directed toward specific groups. Such incidents require swift, public repudiation, but zero tolerance does not mean zero discussion. Immediate removal of employees responsible for these acts may well be called for, but often these sorts of firings stir as many fears as the violations themselves. Leaders who support a learning orientation offer forums for discussing such incidents and for delving more deeply into questions about how and why they occurred. These forums can include "town hall meetings," in which large groups of employees convene with the chief executive to air different points of view. Alternatively, the forums can consist of systematic inquiry, with focus groups of employees led by experienced professionals who summarize and feed back their findings to management and to groups of employees for collective review. Very often, outright misconduct is the culminating event of a long history of identity abrasions that have been occurring under the radar. Effective leaders see these incidents as a signal that the company's culture requires attention.

Assiduously model the third principle. We believe leaders should model all the principles above, but the most difficult – and rewarding – is that of questioning oneself. This principle is challenging for managers because it runs counter to the image of the confident, decisive leader. As it turns out, however, leaders who question themselves and learn from others in the service of clear goals do not bespeak a lack of confidence; rather, they demonstrate humility, clarity, and strength. Indeed, the leaders we have observed who exemplify this principle generate fierce respect and loyalty from their followers. They model vulnerability, respond nondefensively to questions and challenges, are aware of their own biases and emotional triggers, demonstrate resilience in the face of identity abrasions, and openly rely on others to test the validity of their perspective. As one leader we worked with noted, being a role model involves "making myself vulnerable in the face of attack so that others see my humanity."

> When others accuse us of holding prejudicial attitudes, we should INTERROGATE ourselves; when we believe others are treating us unfairly, we should REACH OUT to understand their actions.

Seek out others' experience. Leaders need to understand how social identities influence the way employees experience the organization's work and culture. By developing a deeper understanding of those who differ from them in gender, race, ethnicity, sexual orientation, and so on, leaders learn to anticipate how employees are likely to read situations. That way, leaders can intervene early and respond effectively when difficult situations arise, as they inevitably will. Moreover, when conflicts occur, the leader's ability to understand all sides increases employees' trust that difficult situations will be handled fairly – that is, not biased by anyone's identity-based interests. To develop that kind of insight, leaders can build trusting personal relationships with senior-level staff who represent the organization's diversity. They can also meet with networking groups composed of employees with shared social identities.

Foster people's investment in relationships. Leaders who support a learning orientation in cross-cultural interactions give employees a reason to put their self-images at risk and to invest more deeply in relationships with coworkers. By taking every opportunity to link the mission of the company with the five principles outlined above, leaders reinforce the message that a learning orientation to diversity issues will promote productive and fulfilling relationships.

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The five principles we have identified are difficult to enact. They entail taking risks and opening up when we feel most vulnerable and in need of self-protection. When others accuse us of holding prejudicial attitudes, we should interrogate ourselves; when we believe others are treating us unfairly, we should reach out to understand their actions. These prescriptions do not sell easily; self-righteousness feels more satisfying. But self-righteousness can also lead to divisive conflict, alienation, and ultimately, poor performance.

When people treat their cultural differences – and the conflicts and tensions that arise from them – as opportunities to seek a more accurate view of themselves, each other, and the situation, trust builds and relationships become stronger. To support this approach, leaders should put aside the PC rule book and instead model and encourage risk taking in service of building the organization's capacity to foster high-quality relationships. The value of these skills will reverberate through every dimension of the company's work.

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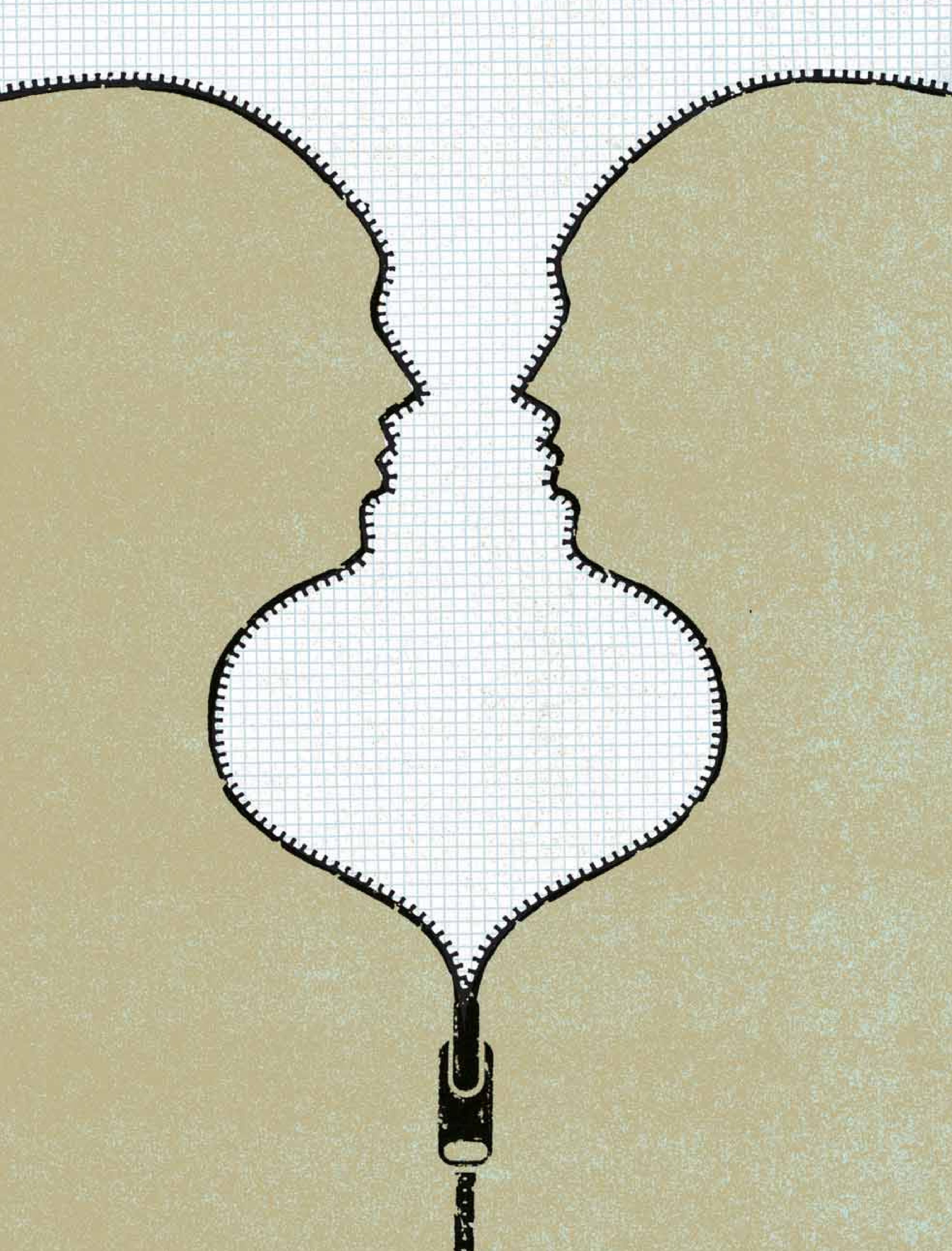

While in-depth analysis of competitors and suppliers is de rigueur in formulating strategy, surprisingly few companies pay much attention to firms that sell complementary products and services.

WITH FRIENDS LIKE THESE

The Art of Managing Complementors

by David B. Yoffie and Mary Kwak

In business, as in war, "Know yourself" and "Know your enemy" have long been rules number one and two. But a third maxim–"Know your friends"–is steadily moving up the list. The focus on supply chain management in the past two decades is an example of this principle at work.

Suppliers and distributors are not the only partners with a potential up or down vote on your success. Companies that independently

THE HEADS OF STATE

provide complementary products or services directly to mutual customers–those that increase the value of each other's offerings in customers' eyes and the size of the total pie–can play an equally important role. Intel and Microsoft are probably the most widely known *complementors* in the world today, but complementors play crucial roles in all kinds of industries–printing, photography, video games, and cars, to name only a handful. The quality of relations with complementors can determine the degree to which a new product succeeds or fails and even whether a company thrives or dies. The success of digital cameras in recent years, for instance, depended heavily on the creation of affordable home photo printers, flash memory, and printing kiosks in retail outlets. In the future, if car manufacturers want to sell vehicles powered by fuel cells, they will need complementors to create a new network of hydrogen filling stations to turn that dream into a reality. Similarly, electronics companies developing e-books will have to persuade traditional publishers to make a wide range of their products available in electronic form at a price that consumers will find attractive.

At a time when increasing numbers of companies are focusing their businesses on the areas in which they have a distinct advantage and growing more dependent on third parties to create complete solutions for customers, excelling in strategically managing complementors could not be more important. Yet while many companies rigorously analyze their competitors and suppliers, surprisingly few firms invest heavily in understanding their complementors. The reason may be that executives often overestimate common interests with complementors and repeatedly underestimate the potential for conflict, as well as the investment required to align strategic interests. Even companies that have excelled in aligning their supply chains are typically less skilled at managing relationships with enterprises they neither buy from nor sell to.

Although complementors share many goals–notably, the desire to expand their common market–their interests are frequently misaligned. In their mutual desire to enlarge the pie, they may overlook the fact that the economics of their businesses and their strategies are radically different. They may mistakenly assume that production schedules or marketing programs are in sync or that both companies would naturally support the same standards. As a result, tensions can develop in many areas, such as pricing, technology, and, perhaps most important, control of the market–both in terms of which company has the most influence over customers and which one gets the bigger slice of the pie.

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The Dark Side of Complementor Relations

Relationships with complementors are typically double-edged, as Adam Brandenburger and Barry Nalebuff point out in *Co-opetition,* the book that introduced complementors to a broad audience. "When a complementor enters the game, the pie grows. That's win-win," they write. "But then there's a tug-of-war with your complementor over who's going to be the main beneficiary. If your complementor gets less of the pie, that leaves more for you."

The issue of pricing perfectly captures this tension. Ideally, you'd like to price your goods high while your complementors price theirs low. Airlines, for instance, would be happy to see vacation lodgings go for a song, while destination resorts could raise rates substantially and still fill their rooms if customers could fly there for free.

Take the example of Handspring, which competed directly with Palm before being acquired by the larger company in 2003. Handspring had a promising initial strategy: It invited third parties to add modules to the Visor, its expandable personal digital assistant, whose retail price ranged from $149 to $249 when it was introduced in 1999. These modules could turn the PDA into a digital camera, an Internet access device, or practically anything you could imagine. Handspring hoped that the modules would be priced at around $25 to $50 each.

Because Handspring was a new company, however, it had little leverage over potential partners. Moreover, it did not really understand the economics of producing and selling modules. In the end, Handspring's complementors delivered a variety of creative products that were generally priced between $150 and $250. Virtually no one bought them, forcing Handspring to find a new strategy: It created the Treo, a very different product that sold at a different price point. The Treo integrated key features (including wireless, messaging, Web-browsing, and e-mail capabilities, as well as a QWERTY keyboard) directly into an all-in-one PDA phone. Handspring still relied on outside companies to provide complements ranging from e-mail services to thousands of software applications. However, compared with Handspring's original product, the Treo, which initially retailed in 2002 at $399 if purchased with a wireless service contract, had much more out-of-the-box appeal to consumers. The device has been a great success.

Conflicts like those Handspring encountered in its early days are hard to manage. You can increase your leverage with suppliers by increasing your purchases with them; you can increase your leverage with customers by tailoring the purchasing process or your products in ways that lock them in. Your complementors, however, often do not do business with you, which makes the challenge of persuading them to meet your terms especially difficult.

Complementor Analysis

The first step in managing complementors is to develop a deep understanding of their economics, their strategies and goals, their existing capabilities, their incentives for cooperation, and any potential areas of conflict.

A complementor's business model, unlike that of a competitor, will often bear little resemblance to your own. Consider the case of hardware provider Apple and one of its complementors, the application software company Intuit. Even with a market share of only 2% to 4%, Apple makes money by selling its computers at a premium over Windows-based personal computers made by companies like Dell and Hewlett-Packard. Relatively low fixed costs help make this model work: For example, Apple dedicates just 5% of sales to R&D. In contrast, Intuit pours as much as 20% of its revenues into research. High volume is critical to Intuit's ability to cover these costs, which makes the vast Windows-based market much more attractive than the relatively small Apple market. This is why Steve Jobs has had so much difficulty over the years convincing Intuit to continue producing versions of popular programs like Quicken and TurboTax for Apple's computers.

After considering your complementors' economics, you need to dive into the details of their business models: How do they time their product introductions? Are they primarily interested in creating new markets or serving the installed base? Are they leaders or followers? And most important, where does your business model overlap with theirs? Are there inherent conflicts in such areas as pricing, speed of product introduction, market creation, or customer education? The more you know about the potential conflicts, the better you can anticipate them and build the necessary resources to manage them effectively.

Once you understand your complementors' business models, you can employ a broad range of techniques to influence their behavior. The most obvious tools fall into the category of what Harvard political scientist Joseph S. Nye, Jr., calls "hard power": resorting to inducements or coercion to get what you want. Paying complementors to cooperate or threatening dire consequences if they don't can often secure at least short-term gains. Bill Gates's threat to halt development of Office for Mac unless Apple adopted Microsoft's Web browser was an example of hard power. A more benign exercise of hard power was Sony's bid to attract developers to its video game platform by cutting industry-standard licensing fees in half.

Carrots and sticks, however, are not the only instruments that companies can use to push and pull complementors onto a common path. Savvy strategists know that what Nye dubs "soft power" can sometimes yield the same results – or at least significantly reduce the cost of using blunter tools. Soft power relies on persuasion through indirect means. As Nye explains in his 2004 book, *Soft Power: The Means to Success in World Politics,* "If I am persuaded to go along with your purposes without any explicit threat or exchange taking place…soft power is at work." It leads others to want what you want instead of forcing or bribing them to do as you wish. Rather than rely solely on traditional measures of strength, like market share or cash, skillful wielders of soft power also use intangible resources to build legitimacy and trust. Soft power

Executives often overestimate common interests with complementors and repeatedly UNDERESTIMATE THE POTENTIAL FOR CONFLICT.

might involve providing complementors with market intelligence or information about future product plans to foster cooperation. It might take the form of supporting institutions that serve an industry or professional community. It might be a matter of entering into strategic commitments to further a common goal, such as establishing a new standard or jointly developing a new technology.

Building Hard Power

All managers seek to develop hard-power resources to strengthen their position vis-à-vis suppliers and customers. But all too often they fail to think about how they can use hard power to manage complementors. As a result, they may overlook important sources of leverage. Hard power is typically based on traditional sources of strength, such as market share, brand equity, control of distribution channels, or cash. But companies can also employ other means to enhance their hard power.

One way to shift the balance in your favor is to reduce your dependence on complementors by producing some or all strategically significant complements in-house. In the 1880s, Eastman Kodak had limited success in selling its newfangled product, photographic film. Professional photographers, who made up most of the potential market, had little interest in switching from cameras using dry plates to cameras using film. Camera manufacturers, as a result, had little interest in building film cameras. To drive adoption of its film, Kodak embarked on a strategy of making and marketing simple cameras for the masses and offering developing and printing services.

In theory, this approach has many advantages. By determining the performance and price of key complements, companies can control customers' perceptions of the value of their products or services – something Handspring learned the hard way. They can also profit from economies in marketing and sales and, perhaps, increase barriers to entry. What's more, complementary products may generate the lion's share of profits – especially if the complements are consumables such as the ink for Hewlett-Packard printers or the toner and paper for Xerox copiers. Most important, a company that controls its complements has a much better shot at controlling its own destiny.

In practice, however, complete in-house production is rarely the best option. Internalization can be an effective strategy for companies that require a limited number of complements and have the resources to develop them on their own. In most cases, however, it makes more sense to give third parties incentives to produce at least some of the complements you need. (See the exhibit "When Should You Produce Your Own Complements?")

Consider PalmSource (now a subsidiary of Access), the developer of the Palm operating system for handheld devices. PalmSource ultimately will thrive or die depending on how many must-have applications are developed to run on its platform. Even if PalmSource were many times its current size (about $70 million in revenues), neither it nor its parent would ever have the resources to match the creative energy and investment dollars of the entire software community. Consequently, while PalmSource has always developed a few critical applications, its focus has been on encouraging third-party development.

Many companies seek a middle ground by simultaneously cultivating independent complementors and limiting their power by producing certain strategically important complements themselves. Nintendo used the magazine *Nintendo Power* in this manner. In 1991, three years after the video game company launched the publication, *Adweek* reported that the initially ad-free monthly had 1.2 million subscribers who were each paying $15 per year. Reason enough to enter the publishing business, perhaps. But there was an additional benefit for Nintendo. As well as news and tips, the magazine fed game reviews to its dedicated readership – giving independent developers one more reason to toe the line. Even when *Nintendo Power* began to run ads, the company refused to carry advertising for video games. Developers that wanted to reach this coveted audience would do so through Nintendo or not at all. (Nintendo was also masterful in the other ways it curbed the power of its individual complementors. In addition to developing games in-house, it limited the number of games that a licensee could produce in a given year.)

Hard power can be highly effective in managing complementors, but it has disadvantages. Perhaps most important, turning repeatedly to hard power does little to build trust between companies. So while hard power can help keep potentially errant complementors in line, it is also likely to discourage deep cooperation. Therefore, relying heavily on hard power for an extended period of time can be costly. This is literally true when hard power takes the form of outright payments rather than coercion. Absent a real sense of common purpose, which helps keep incentives automatically aligned, complementors have to be lured back to the trough over and over.

Ultimately, however, the greatest danger of hard power is that it can inspire a backlash. It is likely to drive complementors to limit their dependence on a more powerful partner and to strive to reshape the structure of the industry in their favor.

Exercising Hard Power: Lessons from Microsoft and Intel

Some aspects of the relationship between Microsoft and Intel, which have come to light only in recent years because of the U.S. Department of Justice's antitrust investigation of Microsoft, illustrate the advantages and disadvantages of exercising hard power. They show how even sophisticated, successful managers can be blindsided and fail if they lack a deep understanding of complementor relations.

Since 1980, when IBM chose an Intel microprocessor and a Microsoft operating system as the core components of its new Personal Computer line, Intel and Microsoft have been joined at the hip. Today, roughly 80% of personal computers worldwide ship with "Intel Inside," and more than 90% of PCs come with Microsoft Windows preinstalled.

Microsoft and Intel have obvious incentives to promote two shared goals: growth in the overall personal computer market and improvement in the Wintel standard. By coordinating investments in new features and performance, the two companies can not only expand the market but also raise barriers to imitation and make it even more difficult for competitors to grab a piece of the pie with alternative offerings. This commonality of interests has yielded much fruitful collaboration. Time and time again, Microsoft has created new software to take advantage of the processing power delivered by Intel's latest generation of chips. As Bill Gates once told Intel management, "We will fill the vessels you build with more software."[1]

But conflict has also been a constant theme in the Wintel relationship. Forced to work together while pursuing interests of their own, the two companies have often looked, in the words of one Intel executive, "like two porcupines trying to mate." Both sides have emerged bruised and bloodied from these battles, but Intel historically had the worst of the deal. Microsoft has repeatedly used hard power to bend Intel to its will.

The conflicts between the two are rooted in the differences in their business models and the competitive conditions they face. Intel makes money on sales of microprocessors that go into new PCs. This makes constant innovation critical to Intel's strategy: The promise of better performance is what keeps computer sales strong. And to deliver such innovation, Intel needs Microsoft's active support. For example, it often takes a new operating system to unleash the full power of a latest-generation chip. Microsoft, on the other hand, can prosper for a while without Intel's help because it generates a significant share of its profits by selling upgrades and applications to the installed base. What's more, Microsoft has had little price competition for much of its history, while hungry chip makers have long nipped at Intel's heels. The upshot is that Microsoft has often needed Intel less than Intel needs Microsoft–which means that when the two sides have clashed, Microsoft has frequently had the upper hand.

The MMX fiasco. A leading example of such conflict is the battle in the mid-1990s over MMX, a set of 57 new instructions Intel planned to add to its microprocessor to speed multimedia processing. Intel had invested tens of millions of dollars in its development and intended to spend another $250 million to make sure the new MMX microprocessor took off. But Intel's plans could go nowhere without Microsoft's support: Unless Microsoft agreed to make a relatively simple modification to Windows, most applications would be unable to access the performance advantages of Intel's new chip.

MMX created a difficult problem for Microsoft. At least one other chip maker, Advanced Micro Devices, was pressing Microsoft to support its own multimedia technology, 3DX. If Intel went ahead with MMX, the hardware platform could split into competing strands. Microsoft would have to supply an MMX-enabled version of Windows for Intel-based computers and a different version for PCs built on AMD's chips, which could confuse customers and multiply Microsoft's costs.

WHEN SHOULD YOU PRODUCE YOUR OWN COMPLEMENTS?

If your need for a wide assortment of complements is:

If your capacity to invest is:	High	Low
High	Produce some complements yourself, but have third parties produce most of them.	Make all complements yourself.
Low	Have third parties make all complements.	Produce most complements yourself but have third parties produce some of them.

Even companies that have excelled in aligning their supply chains are typically less skilled at managing relationships with ENTERPRISES THEY NEITHER BUY FROM NOR SELL TO.

To solve this problem, Microsoft turned to hard power. It demanded that Intel license MMX to other chip makers at no charge in return for Microsoft's support for the new standard. Intel was understandably reluctant to comply. MMX was a potential source of competitive advantage that Intel had developed at great expense. In the end, however, Intel saw no choice but to accede to Microsoft's terms: MMX for everyone was better than MMX for no one. In 1997, Intel introduced MMX as part of the Pentium II launch. AMD also built MMX into its next-generation microprocessors, and both companies had Microsoft's support. The processors with MMX were a huge success. But because Intel could not use MMX to differentiate itself, the average selling price for its microprocessors was much lower than planned, and so were its profits.

The limits of hard power. Intel management ultimately learned two essential lessons from this and similar experiences with Microsoft. First was the importance of understanding Microsoft's business model. Andy Grove later confessed to Harvard Business School case writers that he simply had not understood the model well at the time. To remedy this shortcoming, Intel started investing heavily in understanding its complementor. It stationed its own employees on the Microsoft campus full-time, and senior managers of the two companies held regular discussions to coordinate product plans, marketing efforts, and joint engineering initiatives.

Second, Intel learned that when business models conflict, it is critical not to be too dependent on a complementor. Despite its prominence in the PC industry, Intel had remained vulnerable to Microsoft's whims. Accordingly, Intel made explicit moves to lessen its dependence on Microsoft and limit the software giant's ability to use hard power.

One such move was Intel's support for Linux–the leading competitor to Windows. In the late 1990s, Intel invested in Red Hat and VA Software, two major providers of Linux software and services. In 2000, Intel became a founding sponsor of the Open Source Development Labs, which focuses on driving corporations to adopt Linux. The benefits of this strategy are clear. Not only did Intel reap a windfall when Red Hat and VA Software went public, but it also continues to profit by supplying most of the chips used in Linux servers. In addition, the company strengthened its position in relation to Microsoft–both by diversifying its business and by making itself a swing player in Microsoft's battle against Linux. In other words, Microsoft would not always be able to take Intel's support for granted.

Microsoft should have learned an important lesson from this episode as well: If you push a complementor too hard, you risk a backlash. In the case of MMX, by using hard power to take away an important complementor's intellectual property and competitive differentiation, Microsoft probably went too far.

Building Soft Power

A particular asset can serve as the foundation for both hard and soft power. The larger your market share is, for example, the more attractive complementors are likely to find any offer you make. This effect doesn't rely on direct payments or coercion; it simply means that complementors know where their self-interests lay. A larger market for you means a larger market for them.

Traditional measures of strength also underwrite other sources of soft power, such as strategic commitments that reduce the risks that complementors face. One of the greatest stumbling blocks in relationships with complementors is the chicken-and-egg problem: Typically, you need complementors on board to get your product rolling, but they're reluctant to sign on until you have a large installed base. One way to address this problem is by building industry support for your chosen platform.

An example is how Intel helped make Wi-Fi the standard for wireless computing. In 2003, Intel introduced Centrino, a new product for laptop computers that included a new microprocessor, Wi-Fi chips, and software. Intel thought Wi-Fi was the best solution for connecting millions of mobile computers to the Internet, but its executives also realized that no one would buy a Centrino laptop if there was no Wi-Fi service (the complement). Accordingly, Intel launched a $300 million marketing campaign to assure complementors that the chip maker was deeply committed to Wi-Fi. Its strategy worked: Complementors–ranging from T-Mobile (which leapt into the

Wi-Fi service market) to Starbucks and airports (which made Wi-Fi available at their sites)–jumped on the Wi-Fi bandwagon.

Less tangible assets are also important sources of soft, or co-optive, power – what Joseph Nye describes in *Soft Power* as "the ability to shape what others want." Sharing information, for example, plays a critical role in many soft-power strategies. Information can take the form of private intelligence, such as market forecasts, insights into proprietary technologies, or unannounced product plans. Equally important, it can take the more public form of a compelling vision in which all parties have a stake. Managers are usually better at articulating their vision for their own company and their customers than in formulating a vision that also incorporates the health and welfare of their complementors. But those who master this latter task, like Steve Jobs, are more likely to succeed.

In 2002, Jobs began his campaign to persuade the major music companies to sell tracks to iPod users through the iTunes Music Store, an online retail site that Apple would launch in April 2003. After being burned by illegal file-sharing services like Napster and Kazaa, most industry executives just wanted digital music to go away. But Jobs's passionate vision persuaded them to climb on board. He convinced them that Apple's service would protect their interests by being secure – and a smash hit. Apple's technology was designed to make it difficult for users to share downloads; Jobs promised that the combination of 99-cent pricing and Apple's marketing prowess would yield millions of sales, and the fact that Apple's platform was just plain cool didn't hurt. One music industry executive told *BusinessWeek Online* that just seeing the iTunes store changed many people's views: "Suddenly, people said 'I want to work with them.' It changed the debate from 'why do I have to give digital rights to X service' to 'we have an exclusive track for Apple that we want to do.'"

Jobs relied primarily on direct contacts with music executives and stars such as Bono and Sheryl Crow. But in many cases, working through trade associations and other institutions that serve an industry community can be equally, if not more, effective. Such organizations lower the costs of evangelism by providing a forum where companies can reach many potential complementors at once. The repeated contacts a company cultivates can make it familiar to, and trusted within, the community. And perhaps most important, by endorsing a company's vision, such interactions can amplify the firm's voice and increase its legitimacy in others' eyes.

As a start-up, Netscape, the Web browser pioneer, was a master of this game. It persuaded powerful trade organizations such as the World Wide Web Consortium (W3C) and the Internet Engineering Task Force to endorse its preferred technology standards over competing standards. The backing of these groups strengthened Netscape's claim to industry leadership and increased the pressure on third parties to support its browser. These independent complementors ranged from software companies that made plug-ins for browsers to webmasters, who built their sites around Netscape's (rather than Microsoft's) standards.

Soft power, of course, has limitations. In the face of a determined assault, soft power can fail – as Netscape discovered in later years when Microsoft defeated it in the browser wars by using hard power to lure away

complementors. Netscape was overwhelmed by a combination of Microsoft's tactics, which included bundling Internet Explorer into Windows; requiring PC manufacturers to use Internet Explorer (and in some cases, remove Netscape from the Windows desktop); and paying service providers such as AOL to make Microsoft the exclusive default browser.

Another limitation of soft-power resources, as Nye notes, is that they are "slower, more diffuse, and more cumbersome to wield than hard-power resources." Finally, their precise effects can be difficult to trace. While soft power can be employed to shape the business environment over time–by encouraging complementors to share a particular point of view, for example–it rarely produces sudden changes in direction.

Nonetheless, soft power should play an important role in any manager's arsenal. For large companies, soft power often sets the stage for the more effective use of hard power. For small companies, it may be their only choice.

Wielding Soft Power: Lessons from IBM and Linux

One of the companies that have most successfully exploited soft power in recent years is also one of the world's true powerhouses: IBM. The firm's deftness in applying soft power has allowed it to play a leadership role in establishing the free Linux operating system as a force in enterprise computing–a success that not coincidentally is enormously beneficial to IBM.

IBM's expensive gambit to regain control over the personal computer industry through its OS/2 operating system taught it the limits of hard power. From the late 1980s through the 1990s, the company spent a total of \$4 billion to establish OS/2–much of it to develop complements in-house and to encourage independent software developers to write applications. Nonetheless, complementors decided that Microsoft and Windows offered greater opportunities, and IBM had to abandon OS/2. In the mid-1990s, the rise of Linux offered IBM a second chance to reduce its dependence on Microsoft, expand its influence, and change the dynamics of the information technology industry.

Hard power was not a viable option for pursuing these goals. Linux developers were fanatically independent, making them difficult, if not impossible, to coerce or bribe. They were also suspicious of large corporations. Any hint that IBM was seeking to control or dominate Linux development could defeat the company's efforts to influence its course and pace. So, beginning in 2000, IBM turned to soft power to get complementors on board. The results have been impressive: IBM has become an acknowledged leader of the Linux movement and has succeeded in accelerating its development in directions generally favorable to the company.

IBM began by dispatching engineers to speak with members of the Linux community and making small investments in several Linux start-ups, such as Red Hat. Then in late 1999, then–senior VP Samuel Palmisano championed a new vision, which called for retooling IBM's entire hardware and software portfolio to focus on Linux. This was an extraordinary decision by a company used to controlling its destiny through hard power. Thousands of engineers across the company embarked on the costly process of creating Linux software for all of the company's markets. By 2005, IBM claimed to have invested over \$1 billion in Linux development.

At the same time, IBM implemented an ambitious program for working with the Linux community that broke with the company's historical insistence on mandating technology directions and controlling projects. IBM's use of soft power came in three flavors: First, it consistently articulated a vision for Linux that would appeal to the developer community. Second, it helped to create and support industry organizations without demanding control. Third, it committed enormous resources to the collective effort and gave away technology to the Linux community without attaching the usual strings.

Articulating a vision. IBM's conception of Linux as an industrial-strength operating system that can overthrow the empires created by Microsoft and Sun has helped the company draw many of the Linux community's 1.2 million developers to its side. Even Linus Torvalds, the creator of Linux, has seen IBM as an ally in his efforts to drive the world to open source software. IBM and Torvalds were tapping into a powerful "anybody but Microsoft" sentiment. IBM made sure its message got through by launching a TV advertising campaign in 2003 that focused on the virtues of Linux–reliability, speed, security, and cost-effectiveness–and did not try to sell IBM.

Fostering leadership. In another important step, IBM joined forces with Intel, Hewlett-Packard, Computer Associates, and NEC to launch the Open Source Development Labs in 2000. OSDL, which has grown to 66 member and affiliate companies in 2006, is a foundation dedicated to accelerating the use of Linux in enterprise computing. Led by Linus Torvalds, it makes high-end testing facilities accessible to Linux developers, seeks to channel investment to the areas of greatest need, and generally serves as a "center of gravity" for the Linux community.

Contributing to the cause. IBM has donated a vast amount of money, people, and intellectual property to the Linux community. One of IBM's most visible contributions was its decision in January 2005 to make 500 Linux-related patents freely available to the entire Linux community. In addition, it has donated copyrights, Linux-specific software, and engineers' time to standard-setting organizations such as W3C and Ecma International. The scale of IBM's investment in Linux dwarfs that of other companies. As many as 600 IBM engineers have been

Hard power in action was Bill Gates's threat to halt development of Office for Mac UNLESS APPLE ADOPTED MICROSOFT'S WEB BROWSER.

working primarily on open source Linux projects, and thousands of other IBM engineers contribute to Linux activities. IBM's total commitment of people, money, and intellectual property is probably at least five times greater than that of any other company, and much of these resources have been devoted to activities that benefit the entire Linux community, not just IBM.

For example, IBM has invested $50 million in work on Eclipse, a development environment that makes it much easier to test and debug Linux software. IBM has taken the lead in this project, but it has welcomed the participation of hundreds of other firms. In addition, the company has helped create a nonprofit foundation to manage and coordinate the project and conduct user and market research on its behalf–a model it has successfully applied to several other large-scale development efforts.

Increasingly, the complementor community of Linux developers and users looks to IBM for help in making Linux work. Consider SAP, a company with which IBM both competes and cooperates. More than 200 employees of IBM Global Services were recently assisting SAP on Linux projects. Yes, such actions could strengthen competition in some segments of IBM's business. Nonetheless, its management believes that the potential gains IBM can reap by getting important global companies such as SAP to support Linux easily justify the risk.

Finally, IBM has been active in defending the Linux community as a whole. One of the most conspicuous examples is the action it took after the SCO Group, which owns the original code as well as key intellectual property underlying the Unix operating system, threatened to sue Linux users for alleged patent infringements. In an attempt to ensure that SCO's threat did not slow adoption of Linux, IBM and Intel took the lead in setting up a defense fund: They together contributed $3 million to what became a $10 million fund (managed by OSDL) to help pay the targets' litigation costs.

Despite its massive investments, IBM has never tried to own Linux. To reassure developers that IBM will not try to turn Linux into a proprietary product, the company has pledged never to sell or distribute the operating system. IBM customers who need Linux are referred to third-party distributors, such as Red Hat and Novell.

IBM's reward for supporting Linux? Some developers have told us that the entire Linux community loves IBM. These warm feelings have paid off in concrete ways. An IBM executive chairs OSDL, and Linux developers report that IBM's influence in standard-setting organizations has grown considerably in recent years. When IBM wants Linux to move in a particular direction, its voice is likely to be heard. For example, when the company let it be known that it wanted Linux to support a technology known as multithreading, which allows multiple parts of a program to run simultaneously, complementors burst into action and delivered the capability within months.

IBM has largely succeeded in achieving its goals of improving Linux, giving Linux credibility, and putting pressure on Microsoft. Although it is impossible to quantify the bottom-line impact of IBM's Linux strategy, the company certainly has reaped substantial indirect benefits: a somewhat weaker Microsoft and a trend toward turning the server operating system into a commodity, which is good for IBM's server business.

IBM's reliance on soft power, however, carries risks. Its lack of direct control over critical assets is a vulnerability. Despite all of IBM's efforts, the Linux community could still evolve in directions detrimental to its interests. In addition, IBM's leadership position in the community makes it a prominent target of Linux's rivals. For example, when SCO carried out its threat to sue Linux users for allegedly infringing on its patents, it sought $1 billion in damages from IBM.

Smart Power

Microsoft's battles with Intel and IBM's efforts to work with the Linux community demonstrate that both hard power and soft power can be effective tools for handling complementor relations. How, then, should companies decide which approach to use? The answer to this question starts with a careful diagnosis of the strategic situation they face. Three factors, in particular, play significant roles in determining the relative value of hard and soft power: a company's capacity to exercise hard power; the importance of having a large variety of complements; and the severity of the "holdup" problem, meaning the threat that one complementor may extract most or all of the value at the expense of others.

Capacity. By and large, exercising hard power successfully requires extensive resources. The ability to make direct payments or coerce complementors depends heavily on

SOFT POWER LEADS OTHERS TO WANT WHAT YOU WANT, instead of forcing or bribing them to do as you wish.

such assets as a leading market position, strong ties to other essential partners, and stockpiles of cash. Consequently, the effective use of hard power may not lie within every company's grasp.

Soft power, by contrast, offers more options to smaller firms that lack the deep pockets of a major corporation. In fact, when it comes to the use of soft power, weaker players may even have an advantage: Potential partners are often more willing to work with them, having less reason to fear that the velvet glove of soft power hides an iron fist.

Variety. If success in your industry depends on tight integration with one vital complement, hard power may be relatively cost-effective. Rather than spreading your resources over many potential partners, you might be better off concentrating them on one or a few complementors and focusing on attaining the perfect product or service match. Over time, the complementor may get locked into the relationship so that hard power becomes even easier and cheaper to use. But the key to making this strategy work lies in consistently maintaining the upper hand in any one-on-one relationship, as Microsoft has frequently done. Otherwise, you may be the one facing a dearth of strategic options when your interests and those of your partner diverge.

In many cases, however, the more the merrier when it comes to the range of complements that customers can buy, and, as a result, the number of complementors. Car manufacturers, for example, have benefited from service stations being everywhere, with multiple vendors competing on price. Under such conditions, hard power can be more than a resource drain; it can turn into an exercise in herding cats. Soft power may be more effective because it often relies on the creation of public goods, which can be extended to additional complementors at little or no cost. Sharing a strategic vision with more rather than fewer partners, for example, makes it more compelling, not less. Similarly, strategic commitments to reduce complementors' risks, such as momentum-building campaigns, can often be extended to multiple partners without becoming less effective.

Holdup. If, for their products to become a good match with yours, potential partners must make large, irreversible, and highly specific investments, they are bound to be much more wary of getting trapped in a relationship that could go sour. Then the cost of using hard power is likely to soar as complementors seek reassurance that you're committed to making the relationship work–and insurance against the possibility that you're not. Consequently, as the danger of holdup rises, a little soft power–particularly measures to reduce risk and build trust–can potentially go a long way.

Combining hard and soft power. In the end, choosing between hard and soft power is not an either-or decision. To get the most out of complementors, companies should dip into both toolboxes, often at the same time. As Nye reminds us, "Smart power is neither hard nor soft. It is both." For example, when Apple opened the iTunes store in 2003, it relied primarily on soft power, cajoling the music companies into making their libraries available. It reduced the risks they faced by offering safeguards against piracy, as well as a hip product (the iPod) that would drive sales. When Apple's contracts with the music companies came up for renewal last April, however, it turned to hard power. By then, iTunes had captured 80% of the market for legal downloads, which gave Jobs the upper hand. The music companies, which were receiving between 60 and 70 cents per download, wanted more. If the iTunes Music Store would only charge $1.50 or $2.00 per track, they reasoned, they could double or even triple their revenues and profits. Figuring that he could sell more iPods only if music was cheap, Jobs was determined to keep the price of a download at 99 cents and to maintain Apple's margins. Given iTunes' dominant position, the music companies had no choice but to relent.

Ultimately, conflict among complementors is inevitable. It is one thing to say you are trying to create win-win scenarios; it is quite another to expect even the closest of partners to do you the favor of abandoning its own business model, technology preferences, or desire to grab most of the pie. As a result, even the most successful partnerships are never trouble free. But together, hard and soft power can help companies manage the dark side of complementor relationships and take full advantage of the opportunities that cooperation should create.

1. This quotation from Bill Gates and the following one from the Intel executive were recorded in David B. Yoffie, Ramon Casadesus-Masanell, and Sasha Mattu, "Wintel (A): Cooperation or Conflict," Harvard Business School Case 9-704-419.

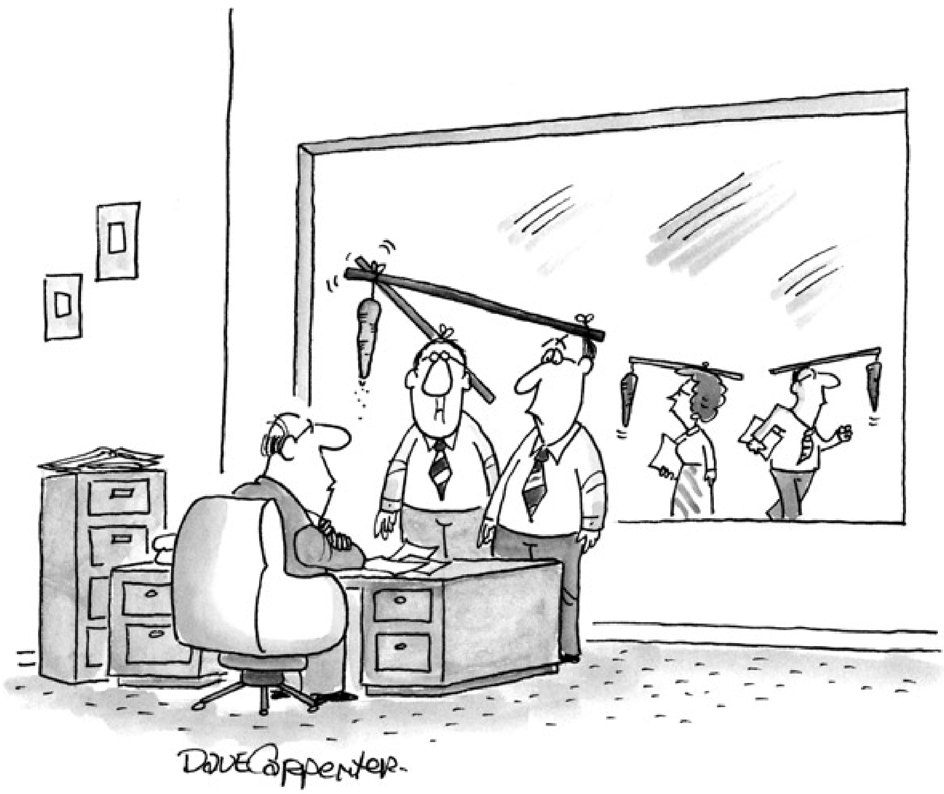
Reprint R0609E; HBR OnPoint 1085
To order, see page 159.

Power Hungry

"There are some people who are all too happy to obtain power, which they then wield like a cudgel instead of a surgeon's knife."

James Waldroop and Timothy Butler
"Managing Away Bad Habits"
Harvard Business Review
September–October 2000

"Miss Powell, come in and step on Mr. Hutchin's fingers!"



"Higgins, both you and Ferguson will be going after the same carrot."

DAVE CARPENTER, ROY DELGADO, SAM RAY, AND BOB SCHOCHET

"Our last meeting started out with everyone, except Mr. Simms, heartily laughing at Mr. Baine's joke..."


PUBLISHING ASSOCIATION
To: Anyone eyeing my corner office.
From: Laurel, who's just been diagnosed with an aneurysm.
Don't even think about it.
And don't play with any of my desk toys.
I'll be back next week.
Stronger than ever.
And if anyone's been sitting in my new Italian leather chair
there'll be hell to pay.
I'll be checking my e-mail right up to the operation.
And a few days later I'll be discharged.
Don't bother sending flowers or grapes.
I'll see you Monday, bright and early.
Love,
Laurel
Publishing Association
New York, Los Angeles, Chicago

How to Keep A PLAYERS Productive

Just because they think they're great doesn't mean they're not.

by Steven Berglas

AFTER GRADUATING FROM HARVARD BUSINESS SCHOOL with highest honors, Jane rapidly moved up the corporate ladder at a large advertising firm, racking up promotions and responsibilities all along the way. By the time she became the company's creative director, she was, in everyone's estimation, an "A player"–one of the organization's most gifted and productive employees. But although she received an extraordinarily generous pay package and had what some people considered to be one of the most stimulating jobs in the company, Jane was talking to headhunters behind the scenes.

Jane's problem was that she felt underappreciated. She consistently overperformed, and her boss said she did great work. This was the highest accolade he ever gave anyone, but Jane needed more. She worked harder and harder, but more fulsome praise

JOHN RITTER

never came her way. Her boss's inability to amply reward her achievement was exasperating. Eventually, she was lured away to a competing company that, by her own admission, offered less challenging work. Both Jane and the advertising firm she left behind lost out.

Not all A players are as vulnerable as Jane. Some superstars soar to stunning heights needing little or no special attention. They have the natural self-confidence and brilliance to stay at the top of their game with elegance and grace. Of course, these are your most prized employees, and they pose their own challenges and risks. (See the sidebar "Nobody's Perfect.") But as every manager knows, megastars with manageable egos are rare. Far more common are people like Jane who are striving to satisfy an inner need for recognition that is often a sign of irrationally low self-esteem. If you do not carefully manage the often unconscious needs of these A players for kudos and appreciation, they will burn out in a way that is damaging to themselves and unproductive for you.

Certainly, managers aren't therapists or executive coaches, and they don't have to be. But it will help your organization if you try to understand what makes your A players tick. In my work with more than 30 CEOs, a dozen COOs, and nearly as many law firm managing partners, I have observed persistent patterns among superachievers that can give you valuable insight into how to manage them and their careers. In the following pages, I will explore the psychology and behaviors of A players and suggest some ways that you can turn your high performers into even more effective stars.

The Superior Worm

When we think of A players, a fairly consistent picture comes to mind for most of us. A players are the people with the "right stuff." They are the most fiercely ambitious, wildly capable, and intelligent people in any organization. Yet despite their veneer of self-satisfaction, smugness, and even bluster, a significant number of your spectacular performers suffer from a lack of confidence. Ron Daniel, a former managing director of McKinsey & Company, the blue-chip management consulting firm, made the point when he told *Fortune* that "The real competition out there isn't for clients, it's for people. And we look to hire people who are first, very smart; second, insecure and thus driven by their insecurity; and third, competitive." Translated, many A players are insecure overachievers. They're often the people who went to the right schools and who pushed themselves to win all the prizes. But if they are so smart and competitive, why are they so insecure?

In my observation of many A players, I have concluded that childhood really matters. Often these high performers come from demanding backgrounds where unconditional approval was withheld. Getting As, for example, did not meet with admiration from parents. The achievement was typically followed up with the message, "You can do better," which is never rewarding and often damaging. From your star's perspective, feedback of this sort obligated him to work endlessly to reach an unattainable goal. The psychologist Anna Freud (Sigmund Freud's daughter) and others who studied children raised in this manner discovered that these individuals end up with extraordinarily punishing superegos. At first, the pressure comes from outside authority figures; later, A players impose it on themselves and on others. Winston Churchill, who adored his often abusive father, is a case in point. As an adult, Churchill ended each day with a merciless ritual: "I try myself by court martial to see if I have done anything effective during the day."

Churchill is not alone. A players often assume the parental role and end up voluntarily pushing themselves to extremes, producing more and better work in every endeavor they undertake. I once knew a high achiever from a prominent law firm. When he got his annual review, he turned out to be the leading performer among his cohorts. His superiors described his work as excellent and superb, but rather than rejoice in having received such amazing accolades, the attorney worried aloud to his wife that his work was sometimes described as merely excellent rather than superb. This intense concern with the precise language of praise sounds strange and self-absorbed to most people, particularly when a prized employee is essentially drawing the distinction between an A+ and an A++ evaluation. But vulnerable stars are highly attentive to the language of the person judging them precisely because they spent their childhoods looking intently for clues about whether or not they had fulfilled parental expectations.

What do people get out of such self-defeating behavior? The psychologist Alfred Adler, the man who brought inferiority and superiority complexes into our everyday language, offered an explanation almost 100 years ago. Adler argued that the most fundamental human need is for superiority, a need that arises from universal feelings of inferiority experienced by us all in early childhood when we are helpless and dependent on others. If we manage these feelings appropriately, we go on to lead well-adjusted lives. But if powerful authority figures thwart our efforts to overcome these feelings, then complexes develop, causing narcissistic grandiosity that can linger for the rest of our lives. Adler asserted that if a person suffers either

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from an inferiority or a superiority complex (which for Adler were opposite sides of the same coin), then whatever he achieves it will never be enough. As I once heard it put: "Some people go through life feeling superior; others go through life feeling like worms. Narcissists go through life feeling like superior worms." One might assume that A players' feelings of superiority are a tremendous boon to them since, among other things, these feelings help them to communicate enormous self-confidence to others. But the plight of the overachiever who feels like a superior worm is that he must live with the constant anxiety that he might in fact be inferior to others. Only when you can help your stars address their inflated senses of superiority can they begin to deal with underlying issues of poor self-worth.

Can't Say No

One of the biggest challenges for A players is their inability to set boundaries for themselves. Ordinary people usually know how to step back from situations where vague requests make them uncomfortable; but insecure overachievers typically exceed expectations because they are prepared to operate outside their comfort zones in their efforts to win recognition. When given an ambiguous request such as "I need directions to Rome," they will not only provide a map of all roads leading to Rome but also give you all air routes, water routes, and railway routes as well – just as any overachiever would. I know one superstar who was asked to find a few examples of the best insurance policies that the company had produced in the

Nobody's Perfect

Because I am hired by companies to work with supertalented A players who have problems, I do not typically coach what I call the "well-oiled wheels." These A players move through organizations with grace, achievement, and, most significantly, little inner torment. I doubt that these individuals have ever seen the inside of a psychiatrist's office and trust they never will. However, this does not mean they do not have specific needs or areas of professional development that require nurturing. Although those needs are few and easily addressed, it is wise to make doing so a top priority since these are the A players you can least afford to lose to the competition.

Smart but not savvy. Because your well-oiled A players will not behave in ways that call for you to mentor them like insecure A players (unlike insecure overachievers, they don't violate boundaries), you may forget that they will be on a career trajectory that puts them in business settings that demand social skills they may not be prepared to handle. Like a child who skips grades in elementary school and is a 13-year-old high school senior with no idea how to act at a prom, an A player might be moved along a career path in ways that prevent him from developing interpersonal skills. In law, the practice of having associates serve as second chairs provides novice litigators guidance about how to develop the social skills needed to behave in court. Having a well-oiled A player be your second chair whenever you meet with customers or clients will allow him to observe the manner in which a professional deals effectively with others. As a result, he will gain invaluable skills.

Tolerant but not collegial. Although well-oiled A players are not hostile toward juniors the way insecure A players are, it is doubtful that they consider B and C players their colleagues. Like insecure A players, they, too, were teachers' pets throughout their formative years and were more comfortable relating to authority figures. Consequently, as they become ready to assume managerial positions, they find that they are unable to form peer networks at the very point in their careers when doing so matters most. Given their lack of inner turmoil, however, well-oiled A players will usually have little difficulty serving as mentors to others. For this reason, I advise using them whenever possible to coach C players who need help mastering tasks. The literature on mentoring demonstrates that one result of mentoring is the development of an intimate bond between mentor and mentee. Soon, your A players will develop a network of friendly work relationships as a result of their tutoring.

Ambitious but not challenged. The only occasions when I have been called in to coach well-oiled A players is when they were suffering burnout born of midcareer boredom. All fast-track careers slow down. You rise rapidly, your pay goes up quickly, you sprint ahead of the cohort with whom you were hired. But after a point, the curve starts to flatten. (For more on this topic, see Robert Morison, Tamara Erickson, and Ken Dychtwald, "Managing Middlescence," HBR March 2006.) That is the exhilarating nature of a horse race: running from the gate, jockeying for position around the first turn, and then running for the lead. However, if you are three furlongs ahead of the pack, the long, long straightaway down the backstretch is mind-numbing. For A players accustomed to action and rewards, this long backstretch is fraught with danger; there's less that is new, and boredom can set in. The only answer to this dilemma is to provide these individuals with challenges. It is almost impossible to overload well-oiled A players if you collaborate with them on defining the nature of a challenge. They will approach such growth opportunities with passion. If you don't provide them, someone else will.

A PLAYERS crave praise, but unless it is sincere and tailored to them, they will suspect that it is fabricated and dismiss it out of hand.

last five years. He didn't conclude his research until he had reviewed every policy the company had written in the last 25 years. While overextensions such as these may be impressive, they are not always a productive use of time. Additionally, when word of such efforts spreads across the organization, it can cause unnecessary disruption as other high performers feel that they, too, have to overachieve to such extremes to get the attention they need.

If you think about your stars' unconscious motivations, this overeagerness to please makes a lot of sense. People raised in an environment where praise was carefully meted out typically do not try to challenge the rules; they follow them. When presented with a request that he thinks is unreasonable or unclear, the A player is most likely just to back down and try to comply rather than to question authority. That makes your superstar particularly dependent on powerful figures in situations that subject him to unclear directions or sudden shifts in the rules. Since A players have tried to appease influential people all their lives in order to "know" how to behave, they are not prepared to follow through appropriately on requests that are not straightforward.

For a case in point, consider Jack, a rising star at a prestigious consulting firm, and an A player in terms of his dazzling brilliance and drive. (Not all A players are men, but the problem A players I have worked with are mostly men.) When one of the directors asked Jack to chair an important research project that the firm was conducting, Jack pushed his team to produce a report that was considerably in excess of anything the other research teams had done. When he hinted to the director that he didn't get the recognition he deserved, his supervisor responded, "Nobody asked you to do all that work." A more savvy boss would have understood that Jack's inability to set boundaries was a problem he needed help with, and he certainly would not have added fuel to the fire.

In some situations, of course, that kind of overachievement is built into a company's business model. Blue-chip law firms, management consultancies, and investment banks offer huge salaries and great opportunities for A players in exchange for agonizingly backbreaking work. But in these professional firms, everyone recognizes the deal. Such companies rely on churning out A players and constantly replacing them with recruits from the top business and graduate schools, who are more than eager to join these prestigious firms. It makes for a highly productive workforce. In the best of all possible worlds, the experienced A player moves on to greener pastures before he suffers burnout. When he goes, the firm has benefited from the services of a spectacular achiever, and the A player leaves with another superb credential on his CV.

This business model, however, does not apply to the vast majority of companies that find it hard to attract A players and that need to retain them in order to fight for, and maintain, competitive edge. In these organizations, the failure of stars to set boundaries will almost certainly lead them to walk out in frustration or rage. Unfortunately, unless your company is a McKinsey or a Goldman Sachs, you will have to struggle more to replace these star performers.

The Dissing Dan

The A Player is usually very comfortable keeping company with his boss, which is obviously an asset to him in his career (and to his boss). He is likely to have developed this ease with authority figures early in life, by first appeasing a demanding parent. Later, the star usually becomes a teacher's pet who grows into a company man or woman and maintains a capacity for pleasing those who are higher up.

Sadly, such people usually don't get to capitalize on the goodwill they earn with their bosses because their hidden vulnerabilities often make them hostile to those hierarchically below them (whom they usually regard as being less able). Indeed, spectacular performers will often actively shun interactions with juniors if not directed to work with them in an amicable manner. Even then, they may not. This attitude creates havoc for the superstar as he interacts with subordinates. Often, he views them with disdain and finds endless reasons to criticize their work. In turn, they get defensive and fight back against the criticism, which only serves to make him react even more arrogantly in an attempt to bolster his ego. He will, for example, not only point out a current flaw but also go back months to chronicle a litany of mistakes that suggest his colleagues are routinely second-rate. This creates a vicious cycle that has derailed many a star performer's career because in time superiors recognize that the A player is repeatedly manufacturing ill will in otherwise functional teams.

Consider a vice president in an advertising agency who acquired the nickname Dissing Dan because of his disrespect for his subordinates. A high performer greatly valued by his superiors, Dan would subtly dismiss junior members of the company, undercutting them with irony and wit. At the team's weekly meeting, for example, Dan dominated the show, criticizing the ideas of other team members. Immediately after the meetings, however, he dashed off memos to the executive vice presidents, claiming the team's best ideas for himself.

Thanks to Dan, every senior manager in the company kept abreast of the newest thinking in the company. But when it became obvious to his teammates that he was grabbing credit for their work, they demanded a new leader. Dan was allowed to complete his current project, but his reputation for being condescending to the "little people" had spread across the company and many subordinates refused to work with him. In the end, his contemptuous attitude toward juniors turned out to be less a problem for managers than a career killer for him. When an opportunity for advancement presented itself, Dan was passed over and his career stalled.

Managing Their Insecurities

The good news for bosses coping with complicated A players is that managing superstars is not as difficult as it seems. The biggest challenge is simply recognizing that these driven stars have these hidden vulnerabilities. Once you've understood their unexpected weaknesses and needs, you can apply some straightforward guidelines and techniques to help them overcome their limitations.

Let them triumph. In dealing with stars, you should always begin by searching your own emotions about them. It can be hard to manage people with the talent, intellect, and imagination that A players possess and not be envious of them. Their apparent self-confidence makes the task even harder. But you have to recognize and control your own emotions if want to manage your high achievers effectively. In their desire to impress, A players can easily push your buttons. I recall sitting in a finance committee meeting once where a dazzling high achiever, the comptroller, kept interrupting the CFO to inject his expertise. When the meeting ended, the comptroller looked toward the CFO for kudos. Instead, the CFO turned to me and said, "It's hard to appreciate genius, even when you know that you need genius to get the job done."

That's not to say you should let your A players ride roughshod over you. There are times when you have to push back: You're the manager, and it's up to you to set an overall strategy for your company or unit and to make sure that each individual is contributing to the benefit of all. The challenge is working out just when your concessions to the stars will help or hurt the team. Usually, you can give in quite a lot before you have to stop conceding. The best sports coaches, for example, often give in to the stars on practically all the little things, and the stars show their appreciation by being extra willing to follow the coach's strategy. In business, satisfied stars will reward you by attracting other stars to the team. Everyone wants to be associated with winning people or teams. In this way, your top performers can become the organization's best salespeople if you can successfully manage their grandiose needs.

Praise personally, praise often. Because they did not get the right sort of praise at an appropriate stage in their

STARS who walk out of their jobs because of burnout nearly always get themselves into the same difficulties in their next jobs.

emotional development, your stars have difficulty internalizing the good things they hear, and so they need to hear them spoken again and again. Of course, you will grow weary of having to reassure your most valuable player every day that he is number one and will be tempted to dish out the same old "atta boy." But generic praise will not do. A players are not fooled by false accolades; they crave discerning praise in order to attain their unconscious goal of genuine self-esteem. As a manager, the onus falls on you to personalize your praise if it is to be effective.

Personalizing praise means knowing not only when but *what* to honor when considering your star employee's spectacular performance. You must celebrate the unique competencies and aspirations that the A player values in herself, and you must admire her in a way that she can appreciate. Whatever you do, you must make sure that your praise is authentic. This is crucial when dealing with A players because they view those who evaluate their work with a jaundiced eye. They crave praise, but unless it is sincere and tailored to them, they suspect that it is fabricated and dismiss it out of hand.

Communicating authenticity is relatively easy to do: Avoid hyperbole, clichés, and platitudes. But determining how best to tailor your praise is much more difficult. Each A player has dispositions that make her either receptive or unreceptive to various forms of social interactions. When a boss calls someone into his office to tell her that her job is safe, for example, it's quite likely that the person will conclude that the boss had thought of firing her. You don't need to be a trained psychotherapist to see this danger. However, you do have to recognize that you must spend extra time observing your star players and listening to their special needs. Some players want to be in the limelight, so praise them publicly. Others need you to appreciate a personal quirk; don't hold back on your approval. Sometimes it can help for you to articulate to yourself what you most admire about your stars. If you do that, you will come very close to knowing what they need to have recognized and praised. Many managers are often afraid that giving such personalized praise will overindulge an A player, turning a productive narcissist into an uncontrollable prima donna. While there is some risk of that, in my observation withholding praise only alienates your key players, making them even less likely to be effective team players than they might otherwise have been.

Even managers who do work hard to give personalized praise may, over time, subtly raise the bar on their superachievers unfairly. It's a trap I call "success tolerance." Just as drug or alcohol abusers develop a tolerance to intoxicants and need ever-increasing dosages of a drug to achieve highs, managers develop a tolerance to the stellar work of their superstars. At first your megastar's performance inspires your awe and admiration. Eventually, however, you will come to expect that level of achievement from your star and see it as an average performance from her. For you to react to her work with, "Wow, Jennifer, terrific job," the superstar will have to up her dose of already superb performance to a level that is off the charts. This happens to everyone in organizations, but the problem is particularly acute for superachieving A players who are already eagerly seeking your praise.

The only antidote to success tolerance is to become aware of the tendency in yourself and to fight against it. One technique is to broaden the scope of your praise. For example, if you have an A player HR officer who is in charge of preparing your corporation for the upcoming demographic shock precipitated by aging baby boomers, compliment her from time to time for work she does outside of her immediate domain. This satisfies her need for kudos while avoiding praise inflation with respect to her core job.

Set clear boundaries. Given an A player's drive to please authority figures in order to secure praise, it has to be up to the authority figures to put a cap or outer limit on performance expectations. Stars are simply incapable of setting their own boundaries. As any executive coach will tell you, stars who walk out of their jobs because of burnout nearly always get themselves into the same difficulties in their next jobs–unless they are lucky enough to find a boss who knows how to manage them. (See the sidebar "Superstar Burnout.")

A good way to set boundaries is to allow your A players to help you build work groups, structure a project, or tailor a business plan. Then–and this is the critical point–ask them how they would like to be rewarded for completing those subtasks. By working with a star in this manner, you are not handing over the reins of strategic management of your department. You are negotiating a kind of contract with him.

Another useful tactic to help your A players develop boundaries is a variation of a psychotherapeutic technique that forces an individual to gain insight into her behavior. Rather than overtly asking, "Why did you kill yourself over that?" a manager might say, "Who asked you to do all this work?" From a psychodynamic point of view, the answer to the question *should be* "my parents." But since no one expects a superstar to have been through intensive psychotherapy, she'll probably say, "Well, you did." The skilled manager should then respond, "I'll see to it that I never push you to such extreme performance standards again. I thought I had set the bar lower. What did I say that made you feel that I hadn't?" In all such interventions, there must be dialogue about expectations. A manager has to communicate to his star performers that he doesn't want them to burn out. In this way, a manager will help his A players understand that they don't have to outperform themselves time and again. Indeed, it is precisely the perfectionist, overachieving A player who can benefit from G.K. Chesterton's wise counsel: "If a thing is worth doing, it is worth doing badly." While such advice would be disastrous for your B and C players, it is motivating for your superstar who is already going above and beyond the call of duty.

Make them play nice. Bosses must create an environment where top performers have to cooperate with other people in order to achieve their goals. That will certainly mean building the notion of shared effort into an A player's performance measures. At the same time, you must set realistic expectations for what you can achieve in this respect: Even seasoned psychotherapists recognize that the best that therapy has to offer is an amelioration of symptoms. Phobias, for example, are not cured; they are brought under control. Likewise, when dealing with A players, you should not expect them to feel warmly toward less-talented people.

The process that coaches call "surrendering the 'me' for the 'we'" is not easy to convey to A players who have not participated in team activities before. For these individuals, a more effective means of getting them to play along

Superstar Burnout

"Burnout" is a term that is imprecise and difficult to define, but we know it when we see it. Christina Maslach, a pioneer in the field of burnout research, described the phenomenon as a syndrome of emotional exhaustion and cynicism characterized by symptoms ranging from chronic fatigue and anger to a sense of feeling trapped in a job that has ceased to have personal meaning.

A players who feel burned out or underappreciated at one corporation often think they can solve the problem by changing jobs. Yet when your prized performer transfers to what he expects will be a problem-free arena – when he takes what psychologists call a "geographic cure" – he gambles that the new location will prove a panacea for all his past woes. Chances are good that he will take his problems with him. Indeed, geographic cures can even exacerbate the sufferer's symptoms. If he moves to Eden and his symptoms don't change as a result of that Garden's magical influence, he can only infer that his disease has worsened!

Take the case of John, a broker from a Boston investment firm whom I treated when I was at Harvard Medical School. A hedge fund manager, John came to me when his wife threatened to leave him because of his long hours on the job. He acknowledged that she had a point. He was only 38, no longer felt gratified by his multimillion dollar income, and knew he was only working to earn kiss-off money. While he said he hoped psychotherapy could help him, he never invested in it fully. Instead, he and a team of colleagues formed their own hedge fund, which John thought would give him more control over his life. To mollify his wife, he began attending his son's Little League games, promising to take a more active role in the things his boy loved.

Eighteen months after he finished psychotherapy and initiated a geographic cure from his old brokerage firm, John had to admit to himself that his attempt to avoid burnout was a total failure. Starting his own hedge fund involved harder work and longer hours. His attempt to become a Little League dad had backfired, too. He suspected that things were flying out of control when he began looking into the idea of purchasing a home stadium for his son's Little League team. Eventually, John began to abuse prescription drugs for relief from his anxieties. When his fellow partners staged an intervention, he was forced to enter rehab.

Like John, other A players who suffer burnout often start acting out, expressing their inner conflict in some form of destructive behavior – be it extramarital affairs, chemical dependencies, or gambling disorders. However disruptive this behavior may be for an organization, it can serve the sufferer well: The emotionally exhausted A player is no longer expected to live up to expectations until his problem is resolved. In addition, he may gain extra nurturing and attention from authority figures.

may be to repeatedly highlight the failures of other superstars, such as those of NBA player Bob McAdoo, who, despite his exceptional talent and many awards, almost ended his sports career with a reputation for not being a team player. This approach exposes your A players to the downside of too much self-reliance without making it personal. You never want to hold an A player's own shortcomings up for inspection in public because that would magnify his insecurities and drive him from your organization. But by carefully exposing a vulnerable star to what I call "sympathetic failure experiences," you can create enough awareness in most high achievers to have them see the benefits of "using"–if not fully embracing–members of their team to their advantage. Here, again, do not expect a megastar to exhibit true camaraderie; this is not the goal of the intervention. You can, however, modify his overt behavior toward subordinates if he sees that the consequences of going it alone can be more painful than following, however begrudgingly, the agendas of a group effort.

This brings me to a final tactic that great sports coaches reliably use to manage their superstars: They co-opt them. Great coaches often make star talent junior coaches to the team. This philosophy of asking stars to coach rather than mentor subordinates is that it does not ask an A player to come down to the level of a junior; rather, it raises your flawed star to your level and invites him to perform at a higher status. In their heart of hearts, narcissistic A players just don't have a yen for advancing the careers of juniors in an organization. No one remembers the names of great mentors, so asking your megastars to become big brothers or big sisters to colleagues will not appear rewarding to them. They want to surround themselves with other A players and to be seen as first among *them*. They also aspire to succeed their bosses. Indeed, an overachiever might view his elevated position as a signal that he is being groomed for the top spot. In fact, he may well be. If he performs well as a coach, that performance may improve his chances of subsequent promotions. When that logic computes into his calculus, he is usually more willing to "go along to get along" with the rest of the organization.

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Sooner or later, most managers will have to deal with an A player who is difficult to manage. You may be thinking, why not drop these stars and try to create a fully functioning team of A– and B+ players? The answer is not so simple. Even your flawed A players have an enormous amount to offer your organization. Research shows that 80% of a business's profits are generated by 20% of its workers–in other words, by these high-achieving A players. Of course, sometimes your stars will not be worth all your time and effort, and you'll have to encourage them to look for opportunities elsewhere – both for their own good and for the good of your organization. But in most cases, A players can make a huge difference to the bottom line. If you manage them well, you can multiply that value to your organization many times over.

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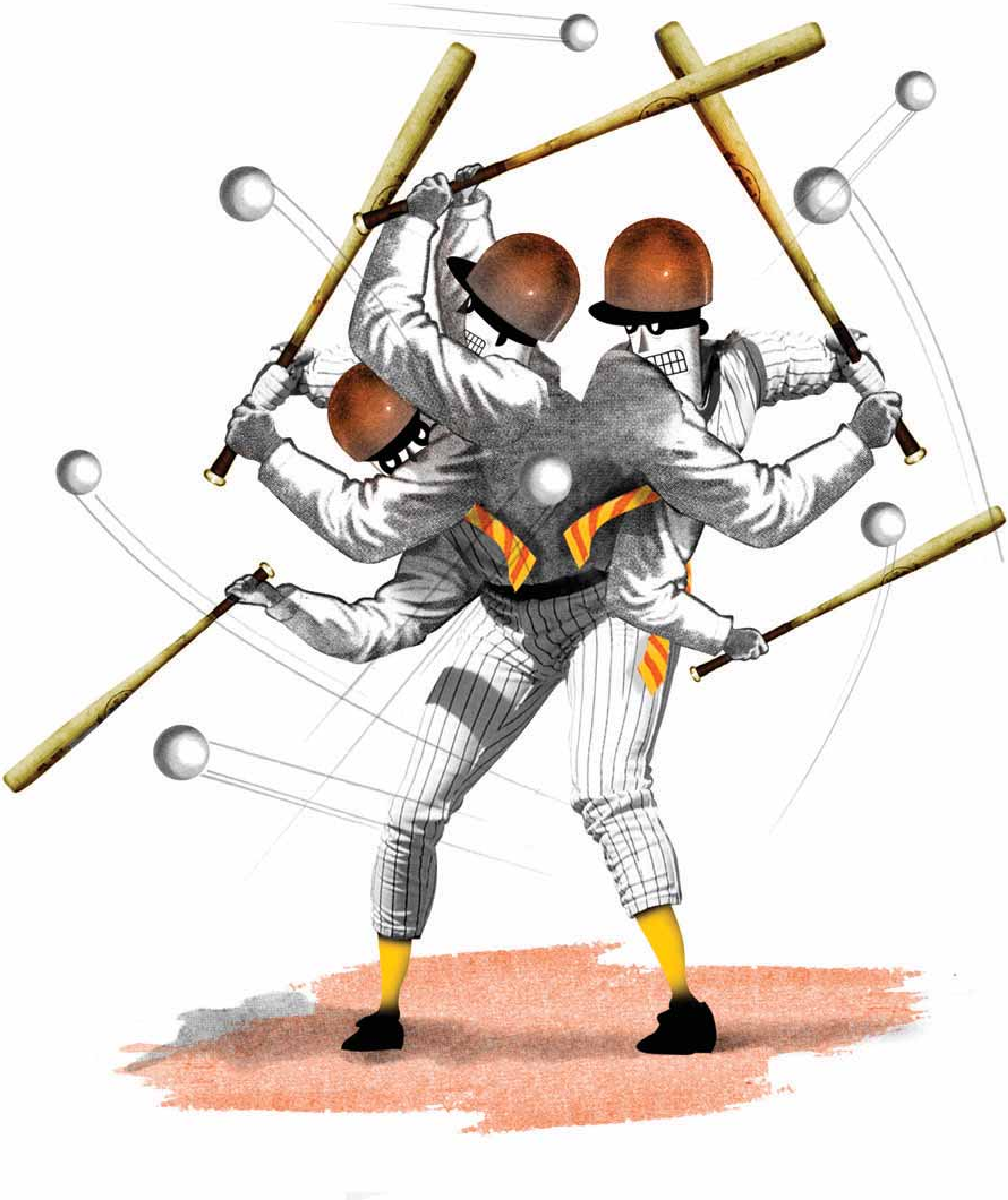
"Ooh, look! A real estate bubble."

SAM GROSS



BRETT RYDER

Curveball

Strategies to Fool the Competition

by George Stalk, Jr.

A COUPLE OF YEARS AGO, I coauthored with Rob Lachenauer an article called "Hardball: Five Killer Strategies for Trouncing the Competition." The piece, along with a subsequent book, was misunderstood by many people. Critics said that hardball meant playing dirty or mean, neither of which is true. What is true is that hardball – let's face it, competition in any form – is about winning at the expense of your rivals. Many people these days are a little uncomfortable with such a primitive notion, but hardball practitioners don't apologize for it in the least.

Of course, playing hardball – getting rough and tough with the competition – isn't the only way to clobber competitors. You can also fool them with a strategic curveball, one that will lead them either to *do something dumb* that they otherwise wouldn't have – that is, swing at a pitch that appears to be in the strike zone but in fact isn't – or to *not do something smart* that they otherwise would have – that is, fail to swing at a pitch that appears not to be in the strike zone but in fact is.

The aims of curveball and hardball strategies are the same: gaining an advantage that allows you to "strike out" your opponent. In fact, one of the hardball strategies we laid out in the previous article – deceive the competition – combines the tough-mindedness of hardball with the cunning of curveball.

This article examines some of the curves you can throw at competitors. For each type of curveball, I describe a particular strategy that exemplifies it, offer an extended example of that strategy in action, and suggest other situations or industries in which the move might prove useful. The curveball strategies described here, while not a comprehensive list, should spark creative thinking about the concept – and make for some fun strategy-setting sessions in the process.

These strategies aren't all new – over the years, smart companies have used some of them to tremendous advantage – but they aren't usually thought of as ways to fool a rival. And that's the point. Rivals aren't even aware that these strategies, as applied here, are being used against them. (For a summary of four types of curveball and a particular strategy that exemplifies each, see the sidebar "Curveball Strategy.")

Success in the marketplace is ultimately achieved by winning customers, not by defeating competitors. No matter how tough or clever you are, you have to deliver products or services that customers value. After all, competitors eventually will catch on to the curves you're throwing and adjust their moves in response. But while they're busy trying to get a bead on what is making you so effective, you can achieve a significant lead in winning customers' hearts and minds and wallets – thereby earning time to figure out the next curve to throw.

Draw Your Rival Out of the Profit Zone

Even the most unsophisticated strategist knows that some areas of a business are more profitable than others. It may come as a surprise, then, to find that you can sometimes lure a rival into *less* profitable areas. For example, you may be able to use clever pricing to get competitors to go after customers who, in the long run, will be the least profitable – while you lock up the most attractive ones.

Ecolab and Diversey competed head-to-head as the leading purveyors of cleaning chemicals in the United States. Their business involved selling to restaurants, hospitals, schools, and office buildings and maintaining the on-site dispensers that held the chemicals. Although Diversey was extremely profitable in many parts of the world, it struggled against Ecolab in the United States. In the late 1990s, losses in the U.S. led Diversey's parent, the Canadian brewer Molson, to sell the business to Unilever, which eventually got out of the cleaning chemicals business altogether. What happened?

Diversey's U.S. division had been under extreme pressure from its Toronto headquarters to improve its performance. A new U.S. division president, who had come up through finance, announced a strategy to enhance profitability there: By pursuing customers that would accept higher prices, Diversey would generate higher gross margins.

The problem was that this strategy didn't take into account the selling, service, and distribution costs related to those customers – this in a business in which the cost to serve customers represented half of total costs. (Most of the balance was the cost of materials.) The costs to serve individual customers varied greatly, based on a number of factors: drop size and mix (the amount and variety of products in a particular delivery), service needs (the maintenance required by dispensers, some of which were automated to control usage), and likelihood of contract renewal (because of the expense involved in installing and removing the dispensers). A customer's location also affected costs because of differences in overall sales volumes and delivery route densities.

Customers could be segmented on the basis of the cost to serve them. The two most useful segment characteristics were a customer's size, based on purchase volumes and purchase volumes per store, and whether it was independent or part of a chain. The least costly type of customer to serve was the large customer with large outlets – say, a restaurant or a hospital – that was part of a chain, which made its purchases through a central buyer and whose outlets could be serviced economically. Not surprisingly, the most costly type was the small, independent customer. But this segment, with less negotiating clout than the chains, could be charged higher prices, resulting in healthy gross margins for sales and service revenue.

In a classic curveball move, Ecolab adopted a pricing strategy that helped Diversey win – to its detriment – these seemingly attractive customers: It priced its bids to small independents high enough to lose to Diversey but low enough to keep pressure on Diversey's margins.

Meanwhile, Ecolab focused on big chain accounts, which, although they commanded lower prices and were more difficult to acquire, were cheaper to serve. The high volumes they purchased generated economies of scale, and the number of outlets involved meant they were less likely to switch suppliers. Ecolab priced aggressively to win this business. The result was gross margins that, if the prices were matched by Diversey, would wreak havoc on its high-margin strategy.

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Practices well-known in one industry can flummox people in another, especially those with long-established traditions and a stable set of players.

At first, Diversey managers thought its rival had given them a gift: The uncontested market of small independents looked like a big, fat pitch right down the middle, and top management swung with all its might. But the move was disastrous for Diversey. Even as gross margins steadily increased as it won more business from the independents and small chains, its bottom line continued to erode. Ecolab was enjoying a steady 20% return on sales, while Diversey was *losing* 15% on U.S. sales. By the time Diversey realized the importance of tying its gross-margin strategy to the costs of serving customers, the game was over.

Similar opportunities to draw rivals out of the profit zone exist in industries where the cost to serve customers is high and variable among different customers and among different products or services – and where industry pricing practices are relatively unsophisticated. These include office supplies and equipment, medical supplies and equipment, and consumer financial services.

Employ Unfamiliar Techniques

Practices well-known in one industry can flummox people in another, especially those with long-established traditions and a stable set of players. The competition will accuse you of destroying the industry with tawdry tactics. But it will be hard to sympathize with them – nor will it even be necessary to do so – from your new position as a category leader.

A decade ago, Britain's Halifax Building Society was a second-tier bank with respectable returns on equity but a diminishing share of its core home-mortgage market.

In 1999, the Halifax named to its retail division a new CEO, Andy Hornby, who had held positions at ASDA, a UK food and clothing superstore that had modeled itself in part after Wal-Mart (and that was subsequently acquired by Wal-Mart as its entry platform into the UK).

At the age of 34, Hornby had no intention of presiding over a sleepy building society. He set out to build a powerhouse purveyor of retail financial services that would be run like a world-class retailer instead of a stodgy bank. The time was ripe for such a move. Consumer financial service institutions in the UK were cushy businesses.

One way to throw competitors off balance is to mask high performance so rivals fail to see your success until it's too late.

Customers were inert, seldom changing banks. The financial institutions mainly sought to keep costs down while preserving their market share and margins. Their one area of major investment was in customer relationship management techniques and technologies, designed to load up existing customers with ever more complicated products and product extensions in the hope of squeezing the last bit of profit from their wallets. One industry wag said, "As long as we don't do anything stupid, we can ride the rising tide of increasing GDP per capita and not have to get out of bed too early in the morning."

Hornby used the brash marketing and merchandising tactics of a retailer to challenge the incumbents. Between 1999 and 2001, when the Halifax merged with the Bank of Scotland to become HBOS, the institution set for itself a goal of having the "best deal on the street" – an aim more reminiscent of Best Buy than Barclays Bank. It aggressively touted this image in its advertisements, which presented a jangling counterpoint to the gleaming steel-and-glass edifices and smart executives in sharp suits seen in the ads of other financial institutions. HBOS garnered the attention and business of consumers who normally did not entertain switching between seemingly identical institutions. It offered attractive deals – including interest-bearing checking accounts and aggressively priced credit cards and loans – that weren't tied to holding a mortgage with the bank.

The big banks were reluctant to respond to HBOS's stand-alone offerings with ones of their own because these would risk cannibalizing business that had been built up through cross selling. In fact, most were paralyzed by the moves, fearful that any action they took would destroy the profitability of their existing businesses.

HBOS also ran its branches as retail sales outlets. They were remodeled to resemble High Street retailers, and the conversion of the branches went beyond cosmetics. Managers exhorted the staff to close sales and rewarded them when they did. The aim was to have customers come to conclusions quickly, thus keeping acquisition costs low. Staff members focused on lead generation and on keeping their appointment diaries full. Incentive compensation, nearly unknown in the UK retail banking industry, further boosted lead generation and drove sales productivity to three times that of some rivals. In another parallel to the retail business, computer systems generated prompts for sales staff to use when interviewing prospective customers and provided back-office support from product specialists. Point-of-sale IT systems allowed salespeople to make immediate decisions on, say, a loan application and reduced the after-sales administrative burden of the sales team.

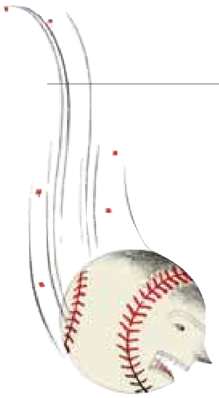
Today, HBOS is the largest and one of the most profitable retail banks in the UK, and it is growing at double-digit rates in overall revenue, revenue from new business, and profits. Some 40% of UK households use HBOS products, including personal mortgages, checking and savings accounts, and credit cards.

Competitive practices from another industry are most likely to succeed in slow-growing businesses with established supplier–customer relationships and stable market shares. In such cases, the industry participants are comfortable with their business models. Their cash flows are predictable and come from a core group of customers that they approach using sophisticated methods honed over time in well-defined ways. In such a setting, look around for strategies that have worked in other industries where this is the case and ask, "Why not try that here?"

Disguise Your Success

One way to throw competitors off balance is to mask high performance so rivals fail to see your success until it's too late. For example, you might drive sales through your service organization, making service technicians de facto sales representatives, effectively transforming a cost center into a profit center.

In the late 1990s, two companies – I'll call them MedicTec and DiaDevice – were in the business of designing, manufacturing, selling, and servicing a wide array of medical diagnostic equipment, ranging from $15,000 desktop devices to $6 million electronic behemoths that fill entire rooms. DiaDevice, the industry leader in



Curveball Strategy

Strategic hardball – playing rough and tough with competitors – employs smart strategies to defeat rivals. Strategic curveball – outfoxing competitors – can be just as effective in vanquishing the competition.

An effective curve will get rivals to:

Do something dumb that they otherwise wouldn't have – that is, swing at a pitch that appears to be in the strike zone but in fact isn't – or

Not do something smart that they otherwise would have – that is, fail to swing at a pitch that appears not to be in the strike zone but in fact is.

Here's how to throw four types of curveball:

Draw your rival out of the profit zone. Lure competitors into disadvantageous areas – for example, by competing for, but intentionally failing to win, the business of less profitable customers.

Employ unfamiliar techniques. Knock rivals off balance by importing a technique used in another industry – for example, employing the retailer's hard sell in the stodgy world of retail financial services.

Disguise your success. Veil your success by achieving an advantage through unlikely means – for example, generating product sales through your service operations.

Let rivals misinterpret your success. Allow rivals to act on a conventional but incomplete explanation for your success – for example, squeezing costs rather than aggressively utilizing assets.

Europe, was increasingly gaining market share in North America. MedicTec managers were convinced that DiaDevice was buying its way into the market with lowball prices and that the only way to meet the challenge was to out-hustle the newcomer on the sales front.

MedicTec's service chief – I'll call him Allan – decided to undertake his own evaluation of the problem. Breaking away from the demands of headquarters, he began a round of customer visits. At one site, the largest hospital in a midsize Midwestern city, Allan toured the facility with the hospital's head of engineering, stopping at each piece of MedicTec equipment to discuss its operating strengths and weaknesses. Allan realized that a fellow in a white coat was following them and, finding it hard to imagine that a doctor would be interested in this review, asked the engineering head about the interloper. The man turned out to be a service technician from DiaDevice, which had only a few pieces of equipment at the hospital. The real surprise, though: The technician was assigned to the site full time.

This didn't make sense, Allan said to himself. MedicTec had significantly more equipment at the hospital but could *never* afford to dedicate a service technician to a customer of this size. Granted, providing a rapid and effective response to equipment problems was particularly important for DiaDevice as it strove to gain customers in North America. But with service costs totaling between 15% and 20% of revenue at a company like MedicTec or DiaDevice, you didn't want to provide more service than was needed to keep a customer satisfied. Sophisticated algorithms for service scheduling, which took into account such things as the cost to customers of service interruptions, determined optimal service levels and guaranteed that "overservicing" wouldn't occur. Standard industry algorithms would certainly not have justified a full-time service rep at this hospital.

But Allan was curious. Back at the office, he pulled together data on customers for whom MedicTec did offer a dedicated service engineer. Those customers were typically in major cities with high customer and equipment density, places where the service algorithms had indicated that a full-time service technician was cost-effective. Allan's review initially uncovered no surprises. Although the sites with dedicated service technicians had lower equipment downtime rates and higher customer satisfaction scores, the differences weren't significant. The algorithm apparently was working, keeping service costs low across the company with no serious decline in customer satisfaction.

Digging deeper, though, Allan saw that service-contract renewal rates at these locations were roughly twice the national average for MedicTec customers – perhaps not surprising given customers' satisfaction with the service they received. But that wasn't all: New equipment sales at sites with a dedicated service technician were *also* about twice the national average for MedicTec customers. Subsequent conversations with these customers revealed that MedicTec's on-site service engineers didn't only generate customer satisfaction and goodwill – many engineers pitched in to repair rival suppliers' products when they went down – they also tended to boost new equipment sales by influencing a hospital's request-for-proposals process. Who better to provide input into the RFP, the hospital's purchasing team would reason, than an on-site technician who knew the strengths and weaknesses of all the equipment installed at the hospital – whichever the supplier – and who knew how best to fill gaps or extend the institution's capabilities to meet growing needs?

This clearly was what DiaDevice had set out to do – not in big hospitals where MedicTec already had dedicated service technicians but in the second-tier hospitals where MedicTec had determined that on-site service wasn't cost-effective. Here, DiaDevice was gaining share in both service-contract renewals and new equipment sales, virtually unopposed by MedicTec.

It wasn't easy for Allan to convince his colleagues that MedicTec should place full-time technicians at the sites of customers ripe for poaching by DiaDevice. MedicTec's investment criteria were heavily driven by cost-oriented savings. In the company's culture, it was better to place your bets on cost reduction, where you could control the game, than on growth or marketing, where the numbers were hypothetical and success depended on others. Only when Allan was able to predict accurately at which sites MedicTec would lose share in both service-contract renewals and new equipment sales did the company respond to DiaDevice's stealth sales moves.

Stealth sales can be exploited in industries where field service is an important element in customer satisfaction and is a large portion of a supplier's cost structure. Such industries include aircraft engines and components, mass storage devices, factory equipment, and process automation systems. The key is to determine the effect that more customer service will have on service-contract renewals and follow-on sales, particularly of new products where successful ramp-ups are critical to achieving deep customer satisfaction.

Let Rivals Misinterpret Your Success

We look at a successful company and we understand why it's successful – or at least we think we do. Buzz about the firm's innovative strategy spreads through the industry. Business media pick up the story and retell it from every angle. Before long, competitors and noncompetitors alike are trying to emulate the company's moves, which have taken on the mystique of media and business-school legends.

But often, the conventional assessment is wrong, or at least incomplete. A successful company can sit passively by as rivals overlook a key source – or even *the* key source – of its outstanding performance and stumble in trying to replicate it. A rival smart enough to see all elements of the strategy, though, can realize similar success, nailing the curveball for a home run.

Look at the recent history of low-cost airlines. To meet the competitive challenge posed by start-ups such as Southwest, major carriers launched their own low-cost operations. Most of those initiatives – think of Continental Lite, Delta's Song, US Airways' Metro, and United's Ted – have enjoyed less than stunning results. That's because most big carriers failed to appreciate and implement one of the key drivers of the newcomers' outstanding performance.

> A successful company can sit passively by as rivals overlook a key source – or even *the* key source – of its outstanding performance.

Most of the elements of Southwest's strategy are available for public scrutiny: one aircraft model for the fleet, low landing fees at out-of-the-way airports, low training and labor costs, no pension obligations, and – most conspicuously – minimal in-flight amenities provided by fun-loving flight attendants dressed in Bermuda shorts. This view of Southwest's sources of success is accurate but incomplete.

The curveball Southwest threw its competitors and ultimately the industry is a strategy of extreme asset utilization. The company uses a production-oriented approach to scheduling, with the goal of keeping planes in the air as much of the time as possible. Traditional carriers, on the other hand, typically have a customer-oriented approach to scheduling, one that will tolerate a plane remaining on the ground for, say, 20 extra minutes in order to pick up connecting passengers or accommodate business customers' preference for top-of-the hour departures.

Southwest structured its operations around being able to turn its planes at the gates within 20 minutes and get them flying again. This was a much faster turnaround time than legacy carriers' typical 60 to 90 minutes at the gate. By keeping its planes in the air 20% to 30% more hours, Southwest achieved higher asset utilization rates for both aircraft and employees.

Southwest's point-to-point route network also enhanced asset utilization. In the hub-and-spoke network of most traditional carriers, a plane arriving late to a hub typically results in three planes being late leaving the gate, with at least six pilots and nine to 12 cabin attendants experiencing unplanned downtime. A late plane arrival in a point-to-point network affects the utilization of just one plane, two pilots, and three cabin attendants.

The high asset utilization model is at least as important to Southwest's success as its reduced labor costs and barebones customer service. As asset turns increase, the prices required to maintain the return on assets can be reduced, which leads to lower fares, fuller planes, and, completing the virtuous circle, even greater asset utilization.

As Southwest knockoffs appeared around the world – AirTran and JetBlue in the United States, Ryanair and easyJet in Europe, Virgin Blue in Australia – most legacy carriers failed to see the significance of asset utilization to the effectiveness of Southwest's strategy or were unable to escape the traditional approaches of their base businesses to emulate it. Most, but not all.

In Australia, Qantas Airways had a typical customer-oriented model, and when low-cost rival Virgin Blue was launched in 2000, the newcomer quickly picked up 30% of the total passenger value in the domestic market, putting the profitability of Qantas's entire domestic route network at risk. But Qantas saw the pitch by Virgin Blue for what it was and responded vigorously. In 2004, it launched its own low-cost airline, Jetstar, which has successfully fended off Virgin Blue and flourished.

Jetstar followed the well-known low-cost strategy, avoiding the pay rates and work practices of its unionized parent and replacing traditional passenger amenities with friendly but spartan service. (Press coverage of Jetstar's launch put it this way: "No Leg Room, Warm Beer – But Everyone's Happy.") As the experience of low-cost spin-offs in the United States had shown, though, this wouldn't be enough.

So Qantas adopted for Jetstar the production-oriented approach that results in higher asset utilization rates for both aircraft and employees. Fast turnaround times at the gate kept its planes, pilots, and crew in the air for more hours each month than traditional rivals. Smart scheduling brought most planes and crews back to home base at day's end, further reducing costs and facilitating more effective scheduling of crews and planes.

This allowed Qantas to use its strengths against Virgin Blue, rather than struggle to match Virgin Blue's own production-oriented, asset-utilization model. Although operationally a stand-alone business, Jetstar benefited from Qantas's purchasing power and network scheduling flexibilities, further reducing its costs. Virgin Blue, faced with competition from a lower-cost Jetstar in combination with a higher-service Qantas, was caught in the middle. "They essentially surrounded us," Virgin Blue chairman Chris Corrigan said last year in a television interview. Following Jetstar's launch, Virgin Blue's growth slowed and its market value declined.

The benefits of high asset utilization are underappreciated in many industries. People fail to see that, by significantly cutting prices, you can generate more than enough business to make healthy returns not on sales but on capital. That is, instead of enjoying robust profit margins, you accept low margins but benefit from high asset productivity.

It takes guts to go down this road. You have to be willing to cut prices far enough to drive utilization rates well beyond the accepted industry norm. And while executives are generally courageous when it comes to cutting costs, most are utter chickens when it comes to betting on volume gains to improve profitability. This faintheartedness, along with a failure to understand the beneficial economics of high utilization rates, means that rivals typically remain frozen in their tracks when you follow this course. When they finally do respond, they face the additional costs associated with winning back your customers.

Extreme asset utilization won't work as a curveball in an industry where it's already the key strategy employed by industry players – in big box retailing, say, or chemical processing industries, in which very high break-even production loads are the norm. But it's something worth considering in any "occupancy" business, whether physical occupancy – of hotels, cruise ships, or airlines – or "mental occupancy" – for example, mind share or share of a customer's wallet in financial services.

Where Curveballs Come From

The opportunities to throw your competitor a curve are everywhere. We have described four in this article; there are many more. But how do you identify such opportunities? The best way is to look beyond the "averages."

We manage our lives and our businesses using averages. If we didn't, we'd be so overwhelmed with information that we couldn't manage at all. But this approach masks a gloriously rich world. As soon as we choose an average on which to make decisions, we cut ourselves off from more detailed information that could lead to insight affecting our decisions and our results.

The insights that led to the curveball strategies discussed here can be traced to looking beyond the averages:

Making marginal customers seem attractive. Income statements and balance sheets are infested with averages. Dig beyond the aggregation of accounts and look for outlying patterns in such areas as the cost to serve a customer or pricing by account size. When you do, you are likely to find new ways of looking at the business and its customers that were disguised by the aggregation of accounts. Chances are, if you have been misled by the aggregations your competitors have been, as well.

Importing best practices. The most egregious form of averaging is "industry practice." When confronted with this standard way of doing things, look for an industry or industries where the practices are different. Don't let yourself be discouraged when people point out that there are good reasons why effective practices from one industry won't work in yours; that attitude makes companies more susceptible to a curveball strategy.

Stealth sales. Ask an executive what his company's market share is and the answer will usually be an average. Drill deeper to determine the figure by, say, account or by different service and sales force deployment models and you will see the data begin to scatter. In the scatter pattern between the best and the average results, it is very likely you will be able to identify new strategies for increasing market share that you and your competitors have missed.

Extreme asset utilization. The relevant – but ultimately unasked – question over the past decade or so has been: "How can low-cost airlines charge so much less than the savings from cutting costs suggest possible and still be so much more profitable and faster growing?" If the executives of legacy airlines looked more closely at their performance data they would see situations – when ground time for aircraft and crews is minimized, when airplanes and crews consistently make it back to home base at the end of the day – in which asset utilization is much higher than average. By dissecting asset utilization as a function of variables that drive that utilization, one can begin to see the outlines of a new way to run a business.

Looking beyond the averages often yields new strategy and operational paradigms that help senior managers make better decisions and ensure they are acted upon on a day-to-day basis. By contrast, if competitors settle into managing the averages, they will not immediately – or even for an extended period – see the curveballs they are thrown.

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To order, see page 159.

JOHN CALDWELL

"I'd like a piece of gum, too. But I don't have a buck seventy-five in dog money."

The data, tools, and analytics that companies are increasingly using to improve their sales forces will not only help top performers shine, but they will also help drive sales force laggards to the middle of the curve.

The New Science of Sales Force Productivity

by Dianne Ledingham, Mark Kovac, and Heidi Locke Simon

Bob Brody leaned back in his chair, frowning. Corporate wanted another 8% increase in sales from his division this year, and guess whose shoulders that goal would fall on? Ah, for the good old days, when he could just announce a 10% target, spread it like peanut butter over all his territories, then count on the sales reps for each region or product line to deliver. Sure, some would fall short, but the real rainmakers would make up the difference. Today, the purchasing departments of Bob's customers used algorithms to choose vendors for routine buys; pure economics often trumped personal relationships. For more complex sales, purchasing wanted customized end-to-end solutions. There's no way one person could close those deals, no matter how much golf he or she played. Most of the time, you needed a team of product and industry experts, not to mention rich incentives and a lot of back-office support.

The fact was–he knew he'd have to face it sooner or later–Bob was overwhelmed. Nothing about the sales process was as simple or predictable as it used to be. Eight percent growth? He wasn't even sure where to start.

If this little fable sounds familiar, it's because managers often face similar problems. Over the past few years, we have worked through these sorts of challenges with dozens of senior executives in Brody's position. Even though the world around them was changing, they were still handing down targets from higher management and religiously putting more feet on the street, hoping that some of those new reps would once again save the day. Even arbiters of best practice such as General Electric can recall the wing-and-a-prayer style that, until recently, characterized their sales efforts. The company would give each individual his or her patch and say,

MICHELLE WILBY

"Good luck, and go get 'em," observes GE's Michael Pilot, who started his career 22 years ago as a salesperson at the organization and is now president of U.S. Equipment Financing, a unit of GE Commercial Finance.

Today, the savviest sales leaders are dramatically changing the way they run their groups. They are reinventing their sales approaches to respond to new market environments. They are expanding their lists of target customers beyond what anyone had previously considered. They are boosting their sales reps' productivity not by hiring the most-gifted individuals but by helping existing reps sell more. (See the exhibit "More Reps, or More Productivity?") As a result, their companies are growing at sometimes startling rates. Pilot's division – a large group in a mature industry – added $300 million in new business (about 10% organic growth) in 2005 alone, an improvement he attributes specifically to a reinvention of the operation's sales process. Similarly, SAP Americas, under president and CEO Bill McDermott, has more than doubled its software license business in three years, increasing its market share by 17 points.

What these leaders have in common might be called a scientific approach to sales force effectiveness. It's a method that puts systems around the art of selling, relying not just on gut feel and native sales talent – the traditional qualities of the rainmaker – but also on data, analysis, processes, and tools to redraw the boundaries of markets and increase a sales force's productivity. The goal isn't to replace rainmakers but to narrow the gap between the top 15% or 20% and the rest of the sales force. Companies that use the tactic well have found that, while even top sellers do better, reps in the lower quartiles show dramatic improvement, with productivity jumps of 200%. Such increases enhance the performance of the sales team as a whole and enable a company to reduce the expense of hiring new reps. Some firms using the approach have seen their average sales per rep increase by as much as 50% in two or three years, though most gains cluster around the 30% mark.

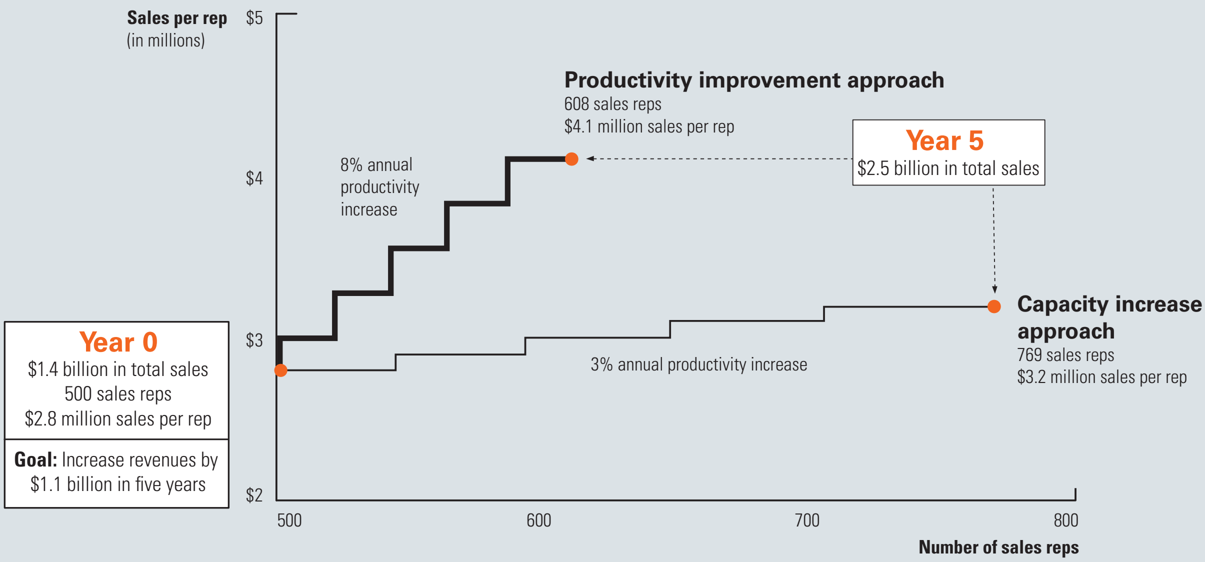
No latter-day Arthur Miller is likely to write a play about the practitioners of the new method; the drama is in the results, not the details. But if "the future of business is to do things by design, not by chance," as one sales leader put it, this new science may be what's required of the men and women charged with bringing in a company's revenue.

Putting Science into Sales

GE's Pilot understands how extensive a reinvention can be. As recently as the mid-1990s, the company was still

More Reps, or More Productivity?

Companies that choose to take a scientific approach to sales force effectiveness may want to evaluate the two options shown here. The growth target for this fictitious global manufacturer – in this case an increase in revenues of $1.1 billion over five years – can be attained through various combinations of productivity improvements and new hires. But the cheapest and most effective route is usually to increase productivity as much as possible through use of the four levers – targeted offerings; optimized automation, tools, and procedures; performance management; and sales force deployment – and only then to put more feet on the street. The management challenge is ensuring that you have put enough science into your sales organization to drive that productivity predictably.



expecting sales teams to assemble and prioritize their own database of prospects for their territories. The company's field sales managers even manually classified all the names in the division's database as either high priority or low priority. "We relied on telephone books," recalls Pilot. "And newspapers. And signs on trucks as they went by or signs on buildings." By 2004, says Pilot, he knew that GE Commercial Finance had to "put some science into it."

Pilot's first step was to revise the way he segmented customers – by using data that included records of past company transactions. The new database held information such as four-digit standard industrial classification codes, the type of equipment being leased, and so on. Then Pilot asked his field managers to create a list of prospective-customer characteristics, criteria that they believed would correlate with a customer's likelihood of doing business with GE. He took the 14 features they came up with, ran regression equations against the database of transactions, and identified six criteria that had high correlations. If a prospective customer tested well on those six criteria – such as predicted capital expenditures and number of filings for new business transactions – the probability that it would do business with GE was high.

The division scored its list of prospects based on the six attributes and then worked the new list for a while. Something interesting emerged. "We found that the top 30% of prospective customers were three times more likely to do a deal with us than the bottom 70%," says Pilot. In other words, that top group was made up of the new highest-priority prospects – and yet only about half of them had previously been classified as high priority by sales managers. The company had, in effect, identified 10,000 new high-priority prospects that it would otherwise have overlooked.

But it wasn't just the increase in sales acreage that made the difference; the new information also allowed Pilot to redesign his sales force. For example, he could take on the difficult job of restructuring territories, ensuring that each one contained plenty of opportunities.

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In some cases, that meant narrowing assigned areas based on the caliber of leads, reevaluating territories, or creating new territories entirely. "When you look at the market with that kind of scientific approach," Pilot says, "you'll never knowingly have territories that could intrinsically underdeliver."

On the performance management front, the data allowed Pilot to get new and less-experienced reps up to speed faster. "So much of the process of ramping up salespeople is just pointing them at the right targets," he says. "If you can do that, you'll get a big boost in productivity."

Pilot also used the information to support his sales force with new tools and processes for the field, such as targeted marketing campaigns that zeroed in on high-potential segments. Now every lead and piece of business generated gets tagged to a particular campaign. "It helps you think about what worked, what didn't, and where to double down and spend dollars for greater return on the marketing side," says Pilot.

The division's $300 million in new business for 2005 reflects both an increased sales pipeline and a 19% higher rate of conversion, or closings, in a market the company once believed was maturing. That revenue, Pilot notes, "is coming from customers that we know we wouldn't have been calling on" without the new approach. "At the end of the day," he says, "it's about building our business around customers and finding ways to help them grow."

Companies that use a scientific approach to sales force effectiveness have found that reps in the lower quartiles show dramatic improvement, with productivity jumps of 200%.

Setting Targets

Setting annual sales objectives is any company's first step in creating a sales plan. Like our fictional Bob Brody, sales leaders have traditionally set goals based on upper management's aspirations for the company. Since those ambitions typically reflect shareholder expectations, they can't be ignored. But sales leaders too often apply the targets across every region and segment, without gathering the market and competitive data that would make their goals more realistic. Since variations across regions and segments are probable, sales reps often end up with quotas that are unrealistically high or low – either of which can demoralize and demotivate a sales force.

To see how the new science of goal setting works, consider how Cisco Systems uses technology to forecast sales. The company created a site where managers could log in and see up-to-the-minute sales performance – listed by region, product line, and so on – all the way down to the level of individual account executives. The site also contains data about reps' pipelines, including the size of each opportunity, what kind of technology the customer requires, and who the competitors are. Managers hold regular pipeline calls and produce new forecasts derived from the data every week. They then roll up the numbers into weekly, monthly, and quarterly forecasts. "The forecast accuracy for our quarterly numbers tends to be within plus or minus 1% to 2%," says Inder Sidhu, Cisco's vice president for worldwide sales strategy and planning.

Like other best-practice companies, Cisco isn't sitting still. Last year it provided its reps with state-of-the-art PDAs, and it's building custom applications for the devices designed to boost productivity. One such program speeds up data entry; another lets reps check their customers' recent activity (such as whether they have ordered parts or remitted an invoice). Cisco has also jump-started its reps' motivation by developing an online personal compensation rate calculator. "People can actually go in and say, 'OK, here's where I'm at right now in the quarter,' " says Sidhu. "It tells them exactly what the deal will mean to them [financially]."

Two years ago, Aggreko North America, a division of UK-based equipment rental company Aggreko, adopted a scientific approach to goal setting with dramatic results: In 2005, sales rose by 29%, and sales force productivity rose by 90%. Company president George Walker says that the process begins from the top down. Executives gather regional data on critical industry-level drivers in each of the company's vertical markets – oil refining, home construction, and so on – and then they calculate the firm's share of each market to set goals for growth. Next comes the bottom-up element: Armed with the data, area sales managers develop a view of territories, accounts, and quotas for individual reps by multiplying potential market size by target shares for each market. An iterative process between the local reps and senior management ensures that the expectations for individual salespeople are in line with overall corporate objectives.

Stepping Up Productivity

Traditionally, sales managers assumed that if you wanted to see significant growth, you had to look at last year's performance and then try to gauge how many new salespeople you could add, given the potential market and the ramp-up time that each new rep would require before generating revenue.

Companies that follow a scientific approach take a much different course. They focus above all on increasing individual salesperson productivity. They can do so because the question of how to boost productivity is no longer a mystery to them. (See the sidebar "TOPSales: A Science-Driven Approach.") On the contrary, they have learned to use four levers that make productivity increases both predictable and manageable.

Targeted offerings. Most organizations already know how to gather the data that enables them to segment their customer base. But companies pursuing a scientific approach boost productivity by taking segmentation one step further. They systematically divide their customers according to factors such as potential value of the account, share of wallet, vertical market, type of product, and type of sale. They define roles and align incentives to help sales reps position and sell the offerings that are most appropriate to each customer segment. Sales reps at these companies must have a deep understanding of the segments they serve: No one package of products and services fits all. And because many sales today can't be closed by just one individual, these companies know how to support a team approach with a careful architecture and smart management.

No latter-day Arthur Miller is likely to write a play about the practitioners of the new method; the drama is in the results, not the details.

Targeted offerings aimed at individuals with a net worth of more than $25 million have made a big difference to Citigroup's private banking operation. That group serves business owners, real estate developers, lawyers, professional athletes, and other specialized segments, each with particular challenges and needs. "The industry has changed a lot in 15 years," says Todd Thomson, chairman and CEO of Citigroup's Global Wealth Management division. "It used to be about selling stocks and bonds and then mutual funds and other things. It was mostly transaction based." Today, Citigroup focuses less on selling investment products – commodities that can be bought and sold anywhere – and instead offers wealth management services and advice on how to reach short-, mid-, and long-term goals. The products, while still important, are secondary.

To make the transition, Citigroup stayed focused on two things. First, instead of simply growing its adviser and banker base, the firm made investments in the professional development of its people and platforms, such as by providing their private bankers with finance and business training taught by leading business school professors. Second, the company segmented its clients by type and created dedicated teams focused on supporting the needs of each client group. "We have a set of products, including risk management tools, that [have been crafted] and directed toward real estate developers," says Thomson. "When our private bankers and their teams show up to talk to a developer, we're smarter about what they need and how to deliver it than the competition is." The private bankers – the team coordinators – are encouraged to increase the reach of Citigroup's management expertise, which includes dealing with equities, fixed income, trust management, and even cash management for entrepreneurial businesses. "Over the past year, we've encouraged our people to think about how to solve [customers'] problems, and we've seen a massive increase in assets from those clients," Thomson says. The result: Citigroup's U.S. private bankers generate an average of $5.5 million per rep in revenue, compared with about $4 million average sales per rep in the rest of the industry.

Optimized automation, tools, and procedures. "Sales force automation" has become a buzz term in recent years,

TOPSales: A Science-Driven Approach

In today's selling environment, it's not enough to rely on your star reps and hope for the best. Any sales organization that wants to boost productivity should use a scientific approach to selling based on a set of four levers (which make up the abbreviation TOPSales).

Targeted offerings. Tailor your offerings to meet the needs of each segment, and make sure reps are selling the right wares to the right prospects.

Optimized automation, tools, and procedures. Bolster your technology tools with disciplined sales management processes, such as detailed pipeline discussions, systematic account and territory plan reviews based on standard guidelines, defined lead distribution processes with tracking throughout the sales cycle for both reps and partners, and electronic dashboards for reps and territories.

Performance management. Measure and manage inputs, such as pipeline metrics and competitive installations you want to target, but reward based on outputs. Calculate the time it will take new reps to begin generating revenue, and factor that in to your sales planning. Provide training and tools to reduce that time. Incorporate metrics, incentives, and skill development into compensation systems to reward high-performing reps.

Sales force deployment. Distribute your sales resources systematically, matching sales approaches and channels to the needs and challenges of each customer segment. Create teams for complex sales, and provide reps with support to help maximize their productivity.

and many companies are putting IT-based tools to work to improve sales force productivity. Aggreko North America uses CRM software with a "profitability predictor" that allows its reps to tweak an offering if margins aren't where they should be. GE Commercial Finance has Monday morning sales meetings that are facilitated by a "digital cockpit" that lets managers peer into reps' pipelines. Cisco, famed for its Web-based sales tools, knows that technology is effective only if it supplements and complements disciplined sales management processes (such as routine, detailed pipeline discussions based on a well-understood characterization of various stages in the pipeline and systematic channeling of leads to sales reps).

A dramatic transformation at SAP Americas, in particular, shows how important systematic processes can be. When McDermott took over in 2002, one of his first moves was to set standards for individual sales reps that reflected the market potential: $500,000 for the first quarter of the next year, $750,000 for the second quarter, and so on. The quarterly targets alone dramatically changed many people's thinking; traditionally, SAP reps had always counted on a big fourth quarter to pull themselves through the year. Instead of allowing reps to scramble to meet annual sales goals at the end of each year, McDermott set a pipeline standard. He expected reps to have three times their annual sales quotas in their pipeline of prospects on a rolling basis, quarter by quarter. To ensure that business partners (like IBM Global Services and Accenture, which implement the systems SAP sells) would be drawn into the selling effort, McDermott decided that at least half of each individual pipeline should be assigned to a business partner that would team up with SAP to close the deals.

Merely setting such goals, however, is not enough. Supporting them with management processes, selling materials, and automated tools for measuring leading indicators and results is what makes outcomes more predictable. For example, reps are regularly informed about key industry trends and about which of SAP's comprehensive product offerings will be most relevant and valuable that year for a target segment. When reps identify clients that could make better use of key SAP products to address an industry trend, "your whole marketing muscle and your pipeline muscle are really focused on letting those clients know that they're leaving

For a company to rely on the persuasive or relationship-building powers of a small group of talented individuals is simply insufficient.

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A New Role for Rainmakers

High-performing salespeople have always delivered the goods for their businesses. Can they be helpful in other ways as well? While we believe there is no substitute for the right segmentation strategy, processes, leadership, tools, and incentives, we also think that companies often fail to take full advantage of their top salespeople.

But that may be changing. Today, relationship sales consultants such as Andrew Sobel (coauthor of *Clients for Life*) and Tim Leishman (of consulting firm Leishman Performance Strategy) are taking a page from cognitive science and showing that it's possible to teach the underlying behaviors of top salespeople. In our experience, the best companies are aiming to do this instead of first searching for new stars. They are defining a new role for their rainmakers as collegial mentors who can impart what appear to be instinctual relationship-building skills. These firms are also having their rainmakers teach new hires how to break customer-winning behaviors down into actions they can adapt to their own personalities.

One pharmaceutical services company took just such an approach: It created a three-step training initiative that paired sales stars (who brought in about half the company's revenues) with new hires. During the "first steps" phase, the stars educated the newcomers about the market and took them on sales calls so they could observe firsthand how the high-performing veterans worked. During the "walking" phase, the newcomers made the calls – but the stars joined them, watched them, and offered tips and feedback. For the remainder of the year (the "running" phase), the stars met regularly with the newcomers to discuss progress and share ideas. The approach took about a year and capitalized not only on the high performers' desire to share their skills but also on their desire to earn: They received a 1% commission on all revenue brought in by the mentee during the yearlong program.

hundreds of millions of dollars of value on the table," says McDermott.

Performance management. Most organizations have an expected level of sales attrition based on whether reps make their quotas over time. But some have added deeper levels of performance analysis that make sales productivity more predictable and thus more manageable. For instance, for each customer segment (such as global accounts, large-company accounts, and so on), SAP has analyzed how long it takes for new reps to become productive and how their productivity increases after that. They can also determine the average productivity rate for seasoned reps. This helps managers staff their segment territory plan more effectively. And it helps them know more quickly when a new hire isn't meeting the standard. "People generally reach their productivity plateau at 12 months," McDermott explains. "If they are not there, they are not going to get there. And that's about 10% of our new hires."

The key to retention is to set people up to succeed. That shouldn't be a matter of good fortune; it should be a result of data-driven planning. Every successful company we studied measures inputs – a rep's pipeline, time spent prospecting, or specific sales calls completed – as well as outputs, thereby helping the reps stay on top of the process. "If you're not looking at the in-process measures and you're simply looking at the results," says McDermott, "you're missing the most important element, which is the future."

The best companies offer development opportunities to successful reps. Thus Citigroup's Thomson, who also oversees the wealth management business of Smith Barney, a division of the company, notes that successful financial advisers at his firm not only keep a higher percentage of the revenue they generate but also are rewarded with professional development that enables them to broaden and deepen their wealth management practices.

Data-driven companies also align incentives with the behaviors that are critical to a rep's financial success. That can entail adjusting metrics and commissions so that veteran reps can't simply coast on past sales. Or it can mean tailoring compensation systems to the type of sale. For example, one of Aggreko North America's business lines, called Aggreko Process Services, provides engineering services to supplement the temperature control equipment that the company rents to oil refineries (among other customers). Reps who sell these offerings – often involving a long and complex sales cycle – don't work on straight commission. Instead, they are paid a relatively high salary plus a bonus based on achieving targets. Meanwhile, reps who sell less-complex rentals, such as those to construction companies, earn a higher proportion of their compensation in commissions.

Sales force deployment. How a company goes to market – how it organizes and deploys not just its reps but its sales, support, marketing, and delivery resources – is a critical part of the sales process. Any company that has watched its territory-based sales reps migrate down-market toward easy sales rather than profitable ones is facing a deployment problem. Its resources simply aren't being put where they can generate the greatest return.

One simple way to fix a deployment issue is to create a demand map of the market using segmentation information and then to compare it with your deployment map. The point is to substitute data for gut feel to identify where the best prospects are and to synchronize that information with the companies that sales reps actually call on.

But an analytical approach to deployment goes well beyond simply matching up reps with particular prospects. Best-practice companies also typically benchmark themselves on whether approaches to sales are paired up with the right customers.

Most companies, for example, utilize a range of sales channels: enterprise or other direct sales, inside sales, the Internet, dealers or value-added resellers, and so on. Having access to detailed information about the behavior and profitability of customer segments and microsegments allows sales executives to decide how best to deploy these different resources. For instance, inquiries about Aggreko North America's commodity rentals are directed to the Internet or closed by telesales; inquiries about large consultative projects are sent to specialized sales reps. The ideal salesperson for the firm's construction-related business, says company president Walker, isn't necessarily a construction expert but a rep who "knows how to make 50 sales calls a week" and can close deals quickly. "The perfect rep for Aggreko's refinery business," Walker continues, "is someone who is comfortable with long sales cycles and complex, technology-intensive solutions."

Another question that leading sales organizations ask themselves is, Are the field reps spending as much time as possible selling? When we measure salespeople's "non-customer-facing time," we find that it often amounts to more than half of their total hours. If sales executives uncover that kind of problem, they have a variety of tools at their disposal. They may be able to channel some of the reps' administrative functions to support staff. They may want to reorganize territories to minimize time spent in transit. They also may simplify the systems that the reps are expected to deal with. Several years ago, sales executives at Cisco set a goal of reducing reps' nonselling time by a few hours a week and charged the IT department with making it happen. The improvement led to several hundred million dollars in additional revenue.

All four of the levers help increase sales force productivity. What's most interesting, however, is that they seem to have the greatest effect on lower-ranked performers and so narrow the gap between top performers and everyone else. When we studied the results of a systematic sales force effectiveness program launched in several branches of a large Korean financial services provider, we found that the branches experienced a 44% rise in weekly sales volume, compared with a 6% decline in other branches. The top quartile of customer-service reps increased their product sales by 6%, the second quartile by 59%, the third quartile by 77%, and the bottom quartile by an astonishing 149%. A study of a comparable program in the Korean offices of another global financial-services firm found similar, though not identical, results. Increases in assets under management ranged from 2% in the top quartile to 33% in the second quartile to 54% in the third quartile, with the lowest quartile registering a 44% increase.

Beyond Best Practice

Finding, attracting, and holding on to talented salespeople is more difficult than ever. And companies can no longer afford to depend on them the way they once did. "It's gotten incredibly expensive to hire stars from competitors," acknowledges Citigroup's Thomson. Relying on the persuasive or relationship-building powers of a small group of talented individuals is simply insufficient for predictable, sustainable growth. (See the sidebar "A New Role for Rainmakers.")

Fortunately, sales executives like Bob Brody don't need to depend exclusively on rainmakers to achieve their numbers. They can get much more out of their entire sales force by using a hard-nosed, scientific approach to sales force effectiveness. Like any science, of course, this one is evolving. The tools and processes we have described are today's best practice, but in a few years, they will almost certainly be standard operating procedure for any company that hopes to compete effectively in the global marketplace.

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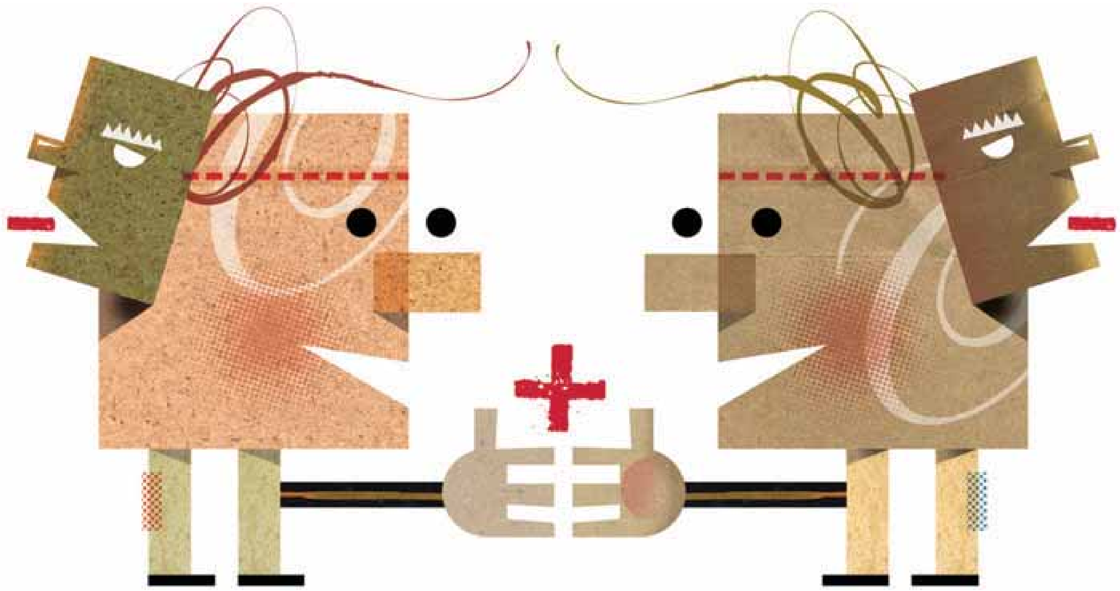

When Your Contract Manufacturer Becomes Your Competitor

by Benito Arruñada and Xosé H. Vázquez

Contract manufacturers cut OEMs' costs and free up capital. But the hungry ones are starting to bite the hand that feeds them. Smart OEMs know how to keep such hazards under control.

WALTER VASCONCELOS

IBM ESSENTIALLY CREATED the personal computer industry. It won't be long, however, before the company's nameplate disappears from PCs and IBM leaves the business, except for the joint venture it recently formed with PC maker Lenovo. Founded in 1984 as a distributor in China of equipment made by IBM and other companies, Lenovo will eventually affix its own logo to the PCs. Certainly, Lenovo has come a long way. So has Sanmina-SCI, the actual manufacturer of some IBM PCs in the United States: It recently acquired some of the factories where the computers are made. Like Lenovo, Sanmina assembles products for a variety of well-known brand owners. The company has expanded its role, however, and now also designs and engineers custom electronic components. These two firms are representative of a host of formerly anonymous makers of brand-name products that are stepping up and pushing the brands themselves aside. Indeed, the complexities of IBM's environment challenge the common view of contract manufacturing as no more or less than the anxious resort of large brand owners suffering from thinning profit margins.

Yes, outsourcing the entire manufacturing of a product allows original equipment manufacturers (OEMs) to reduce labor costs, free up capital, and improve worker productivity. OEMs can then concentrate on the things that most enhance a product's value – R&D, design, and marketing, for instance. Facilitating these gains are the contract manufacturer's (CM) special strengths, which may include location in a low-wage land, economies of scale, manufacturing prowess, and exposure to the engineering and development processes of products it handles for other OEMs. (Such exposure puts the CM in a position to propose improvements to different clients' products.)

As IBM and other companies have learned, however, contract manufacturing is a two-edged sword. For one thing, a CM is privy to an OEM's intellectual property (IP), which it can leak to other clients or arrogate. For another, an ambitious, upstart CM can claim for itself the very advantages it provides an OEM. Having manufactured an OEM's product in its entirety, the CM may decide to build its own brand and forge its own relationships with retailers and distributors – including those of the OEM. When these things happen, the OEM may find itself facing not only more dangerous incumbents but also a competitor of a new kind: the once-underestimated CM. Adding insult to injury, if the OEM had not given its business to the traitorous contract manufacturer, the CM's revenues and knowledge might have remained sufficiently meager to prevent it from entering its patron's market.

Although launching a brand would not be a trivial undertaking for any contract manufacturer, a brand identity rooted in the CM's production prowess would have immediate credibility. Moreover, a CM working for several OEMs has experience making a wider range of products than do most of its clients, permitting it to concentrate on producing the most profitable ones. And its cost structure does not necessarily bear the burden of investments in R&D.

In short, OEMs' humble attempts to realize operational improvements and cost savings can plunge them into a strategically treacherous realm in which partners quickly outgrow one another, spy more attractive opportunities elsewhere, and, in the most flagrant cases, bite the hand that has been nourishing them. Put simply, OEMs that retain contract manufacturers may unleash forces they find hard to control. It would be no exaggeration to say that the players soon find themselves immersed in a melodrama replete with promiscuity (CMs pursuing liaisons with a variety of OEMs), infidelity (retailers and distributors shifting their business to an OEM's CM), and betrayal (CMs transmitting an OEM's intellectual property to the OEM's rivals or keeping it for themselves).

OEMs and contract manufacturers can find themselves immersed in a melodrama replete with promiscuity, infidelity, and betrayal.

OEMs cannot evade this dilemma by terminating their outsourcing arrangements: Modularization, codification of manufacturing processes, and diminished transaction costs make contract manufacturing irresistible to less well-capitalized OEMs. But OEMs *can* manage their relationships with CMs so that the OEMs don't become weak or the CMs too strong. Doing so requires a few things: modesty about revealing one's secrets; caution about whom one consorts with; and a judicious degree of intimacy, loyalty, and generosity toward one's partners and customers. OEMs can also elude CMs' backbiting tendencies by using their surplus intellectual property to enter markets beyond those for their core products. Ironically, CMs' barrier-breaking abilities, otherwise used to invade OEMs' markets, can offer OEMs access to new markets – and sometimes a way out of the dilemma.

Heightened Competition

Few industrial companies still consider manufacturing an essential part of their businesses. Traditional brand owners – what we know today as OEMs – prefer to focus now on product research, design, and sales, leaving production to the new specialists: contract manufacturers.

Contract manufacturing involves outsourcing an entire manufacturing process to the point where, in many instances, none of an OEM's employees will have physically touched the product they're marketing and selling. The practice began in 1981, with the manufacture of the first IBM PCs, but a decade passed before it reached such everyday products as toys, clothing, footwear, beer, and pharmaceuticals. Today, even a few corners of the automobile industry have embraced it: Finland's Valmet Automotive assembles the Porsche Boxster, and Austria's Magna Steyr assembles cars for Mercedes, BMW, and Saab.

The diffusion of contract manufacturing has heightened competition in some industries in four ways.

The creation of new companies. Contract manufacturing facilitates the creation of new firms and divisions. Businesses that outsource don't have to raise, invest, and risk the capital necessary to develop their own production facilities. Thus, they can bypass the traditional deterrents to entering new markets. Indeed, any firm – even one selling low volumes – can decrease its unit costs simply by retaining the CM with the biggest scale. That's how Dell and Gateway have been able to venture beyond their PC roots and enter the domestic electronics markets for plasma and LCD

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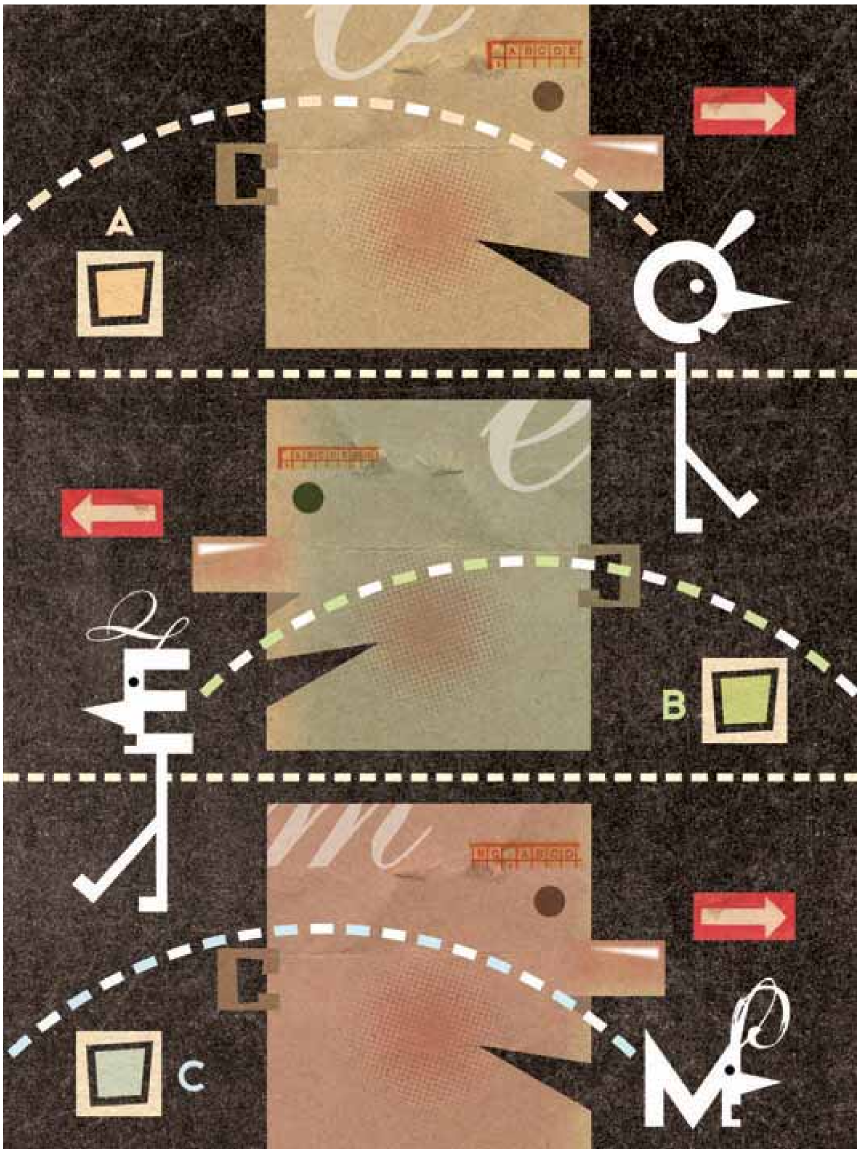
televisions, DVD players, and more than 50 other new products.

The creation of new brands. Contract manufacturers' evolving situation encourages them to develop their own brands. It happens as follows: As CMs reach efficient scale, their cost levels converge. At the same time, the products they make begin to commoditize. In response, CMs will attempt to regain a sustainable competitive advantage by undertaking the value-adding activities that their patrons had handled themselves, such as R&D and marketing. In a variant of the innovator's dilemma, OEMs cede particular functions to their CMs and, by doing so, give CMs room to develop the capabilities they may later use to threaten the OEMs. By that point, the CMs will have become OEMs themselves. Lenovo and China-based contract manufacturers Haier (household appliances) and TCL (televisions) have become three of the world's leading companies in their industries in just this way.

If CMs find they can't get from customers all the knowledge they need to sell and brand a new product, they can purchase entire divisions of OEMs. Taiwan-based BenQ did just that, buying Siemens's mobile phone business in 2005. By doing so, BenQ acquired not only Siemens's IP but also decades worth of Siemens's managerial experience, its highly developed talent pool, its widely known brand, and its global operations platform. Once they have achieved manufacturing mastery, CMs can begin innovating, something they have been doing for some time: The surging volume of Chinese patent applications filed under the European patent treaty – 26 in 1990 and 961 in 2000 – offers at least indirect proof of this. CMs can also buy R&D knowledge from OEMs. In 2004, Shanghai Automotive Industry Corporation (SAIC), which had done some manufacturing for Volkswagen and GM, acquired from bankrupt MG Rover the drawings needed to build the Rover 25, Rover 45, and Rover 75. SAIC plans to sell its own line of cars in China, Europe, and North America.

Movement up the value chain. The most powerful retailers and distributors can engage the largest, most efficient CMs to produce (under the retailers' or distributors' own nameplates) items equal in quality to those of the finest OEMs. These products share shelf space with the OEMs' products but ask half the price. Contract manufacturer Solectron developed its manufacturing expertise in the course of working for IBM, Hewlett-Packard, and Mitsubishi. Later, distributor Ingram Micro asked Solectron to custom build PCs, servers, and other computer equipment under its own and retailers' brands. Retailers, too, such as Best Buy, Carrefour, Sears, and Wal-Mart, are selling electronic products under their own brands, thereby diluting OEMs' marketing clout. Contract manufacturers that have established their own brands suffer as well, because their products have difficulty improving on the retailers' quality, innovativeness, and pricing. However, if an enterprising CM threatened to stop making items for a retailer, it would only drive its client into the arms of another CM – one that could translate the additional business into improved or even superior economies of scale.

Leakage of intellectual property. Contract manufacturing puts OEMs' proprietary intangible assets into play. A CM can exploit for the benefit of its own brands the knowledge it acquires in



the course of working for a given OEM; or the CM can transfer (legitimately or not) this knowledge to other client OEMs. Such leakage may occur even if the CM does no more than assemble components made by others: Three-dimensional scanning, computer-aided design, and computer-aided manufacturing allow companies to copy in a matter of hours components that may have taken years to design. The potential for abuse is high. CFM International, for example, a joint venture of General Electric and French manufacturer SNECMA, which makes parts for aircraft engines, has had to move against repair and overhaul shops in the United States that were purchasing counterfeit parts. Sure, OEMs can resort to lawsuits, banishment, or lobbying. None of these is a panacea, however. The results of litigation are uncertain and may arrive only after years of expensive proceedings. Meanwhile, profits keep falling. Persuading other members of one's industry to shun the offending CM also takes time, is certain to encounter resistance, and risks running afoul of antitrust laws. Finally, as globalization spreads, interventions from individual governments become less decisive. In any event, OEMs need CMs in order to keep specializing, adding value, and staying competitive.

What Kind of Relationship Do You Want to Have with Your Contract Manufacturer?

Organizational arrangements between original equipment manufacturers and contract manufacturers run the gamut – from one-off contracts to more interdependent pacts that may or may not be renewed. The chart below can help organizations determine the level of commitment – and, thus, the amount of risk – they're willing to assume when engaging outsourcing partners.

Type of relationship	Characteristics	Level of Commitment/ Cost of Control
Market agreement	Onetime engagement	Low
Renewable contract	Ongoing, but not open-ended, engagement	Moderate
Framework arrangement	Agreement in principle to produce several models in a given period; payment on basis of units produced or space utilized in manufacturing facility	Moderate-High
Strategic alliance	Long-term agreement; open sharing of processes and intellectual property; adaptiveness; frequent reciprocal communication	High

An Inevitable Relationship

Contract manufacturing is inevitable, though it entails inescapable hazards. First of all, OEMs that embrace contract manufacturing can reduce their direct costs even if the number of units they sell is well below the level otherwise required to achieve meaningful economies of scale. Consider Flextronics: The contract manufacturer's plant in Guadalajara, Mexico, can assemble for Royal Philips Electronics a device for connecting TV sets to the Internet at very low per-unit costs, because it is simultaneously producing a similar device for Sony on an adjacent production line. In turn, working for many OEMs gives CMs the revenues to keep making essential investments in factory automation. It would be more difficult for IBM, Hewlett-Packard, or contract manufacturer Sanmina to obtain equivalent economies of scale if their products were made in their own factories, and if those factories produced exclusively for their own brands.

Second, contract manufacturing allows OEMs to concentrate on their most profitable activities – R&D, for instance, or sales and marketing. IBM certainly had the money and the knowledge to invest in factory automation, and the company was glad that its relationship with Sanmina let it match Dell's prices. But IBM's points of differentiation are its outstanding engineering and services – forms of specialization that outsourcing has allowed it to concentrate on.

Third, firms can communicate and coordinate among themselves more efficiently than ever before. Consequently, the economic logic that once impelled OEMs to perform almost every specialized function in-house no longer applies. The Internet is driving most of these efficiencies, as are the standardized production methods, management procedures, electronic communication protocols, and digital design formats promoted by the International Organization for Standardization, a federation of national standards bodies. HP, for instance, can use technologies such as electronic data interchange to transmit specifications directly from its design departments to machines and robots at a contract manufacturer's plant. Such measures free OEMs to separate their innovation activities from their production activities.

Fourth, flexible manufacturing systems allow OEMs to replace one product with another on short notice. Valmet Automotive, for example, was able to start assembling the Porsche Boxster within seven months of landing the production deal with the automaker. And Ford makes three different chassis in its factories, each of which can accommodate nine different car models, allowing the company to shift production rapidly to the models generating the greatest market demand.

Finally, the combination of standardization and flexible manufacturing lets OEMs replace underachieving or uncooperative CMs about as easily as they can replace ebbing products. The reciprocal nature of these relationships–and, conversely, the ability of either party to withdraw at the first sign of a hold-up by its partner–makes them easy to embrace.

Leading OEMs cannot afford to retreat to the safety of vertical integration; the benefits of specialization are too great. The better alternative is to master the present stage of outsourcing's development while guarding against opportunistic, self-serving conduct by CMs and other partners.

How OEMs Can Cope

Clearly, OEMs have no choice but to coexist with contract manufacturing. Fortunately, a few defensive moves are available for coping with its dangers.

Be careful what you outsource. Processes that are part of an OEM's core competencies or that embody critical corporate assets should not be outsourced at all. Sony Ericsson, for example, outsources only the manufacturing of its aging, and therefore already copied, products. Cisco Systems retains an in-house manufacturing capacity for its cutting-edge routers and switches and their prototypes. Although Alcatel in 2000 began selling most of its 100 or so plants–some of them to CMs such as Solectron and Sanmina – it withheld half a dozen for the purpose of fabricating new products as well as high-tech items that can be made only on proprietary equipment.

In such cases, the risk of infringement–the dearest of transaction costs–is high. And sales volumes would not be so great that contract manufacturing could deliver important economies of scale; it would be too soon for the technology to have spread to competitors, whose additional business CMs could then translate into a lower cost per unit for everyone. Moreover, a company that has outsourced all its manufacturing will in time lose most of its manufacturing knowledge, which, if nothing else, it needs to oversee and inform the work of its CMs.

Hence, Porsche's venture into contract manufacturing didn't involve the automaker's 911 series, into which the firm customarily introduces its innovations. Instead, the venture involved the Boxster – a luxury car in the eyes of many, but, nevertheless, Porsche's low-end model. It is true that Porsche reclaimed in 2004 about one-third of the Boxster's production, but it did so in response to pressure from labor representatives on its board to repatriate good jobs that had been sent to Finland. Meanwhile, Porsche's plant in Leipzig, Germany, continues to assemble the newer and more sophisticated Cayenne SUV and Carrera GT.

One might expect that managers would be aware of the risk of externalizing core competencies. Why, then, do they seem so eager to outsource? The answer may be found in several countervailing influences. First is management's penchant for off-loading tangible assets in order to raise the company's return on assets and return on investment–and to be richly rewarded for doing so. Furthermore, by downsizing the workforce, managers can usually improve productivity ratios and avoid long and arduous negotiations with trade unions; changing suppliers is almost certainly much easier.

Suit the relationship to the circumstances. When an OEM's product is not novel and unique, its degree of innovativeness, complexity, and maturity in the marketplace should dictate the duration of the relationship between the CM and the OEM. If a product's novelty and complexity require a CM to devote time and other resources to mastering its manufacture, the CM will need the inducement of a long-term contract to make those investments. A long-term contract will also protect the OEM's own investments in the CM's mastery of the production process. In situations where the OEM's product is novel and complex, it becomes nearly impossible for the OEM to quickly find a replacement CM. Therefore, a long-term contract becomes valuable because it also hinders the CM from abandoning the OEM or extracting prohibitive terms as the price of remaining. An additional consideration for an OEM is what a CM will do with the OEM's intellectual property when the two parties are no longer legally bound to each other. The contracts that are drawn up to anticipate and deal with such eventualities cannot avoid being complex themselves, though the cost and difficulty of preparing them is justified by the seriousness of the stakes.

Conversely, if the OEM can easily switch CMs because the product is simple to make or has been around long enough to have become generic, a contract of shorter duration would be practical–even advantageous–for the OEM. In such cases, nothing should prevent an OEM from pursuing more attractive terms from a different CM, or vice versa.

In 1999, DaimlerChrysler (then doing business as Daimler-Benz) asked contract manufacturer Magna Steyr to assemble its Mercedes-Benz M-Class SUV. The first unit left the factory within only eight months of the initial venture agreement. In that case, a contract of limited duration was all both parties needed to protect their investments. When BMW asked Magna to assemble its X3s, however, the parties prepared and signed a lengthier contract. In that case, BMW wanted Magna's help in achieving advances in four-wheel-drive technology that would give the X3 some of the road feel for which BMW automobiles are noted.

Organizational arrangements between OEMs and CMs range from one-off contracts–known as market agreements–to more interdependent and ongoing pacts, such as framework arrangements, joint ventures, and other kinds of partnerships. A market agreement, which might or might not be renewable, would involve the manufacture of, say, a particular type of MP3 player, and the pact would contain very precise technical and design details. By contrast, a framework arrangement could require the CM to produce several models of an MP3 player in a given year. A partnership agreement, however, could commit the CM to being the long-term and exclusive supplier of an OEM's MP3 players.

There are two interesting varieties of short-term agreement. Elamex, a contract manufacturer of electronic components, lets customers choose either a turnkey contract or a shelter agreement. In the former arrangement, an Elamex customer shares the assembly line with other customers; each pays Elamex according to the number of units the company has produced for it. In the latter arrangement, a portion of the plant is dedicated to the production of a given customer's products, and the customer pays a proportional share of the overhead, even bringing in its own managers to oversee processes. Because Elamex lacks design capabilities, the firm enters into few long-term alliances. It follows that the company prefers to work with experienced manufacturers rather than start-ups.

Curiously, many strategic alliances end up devolving into temporary market-agreement relationships. This happens for three main reasons: First, many OEMs seem to lose track of the ultimate purpose of their long-term arrangements and start pressing CMs hard for savings. As a result, the CMs begin to feel that their investments in learning how to make and improve a specialized or unique product will not generate a return. Perhaps understandably, CMs under this kind of pressure shed whatever qualms they may have had about, for example, selling directly to the OEM's customers. This is an especially dangerous development for the OEM when it cannot easily find another capable CM – one of the main reasons for forming a long-term partnership in the first place.

If a contract manufacturer tries to persuade you to retain its services by offering to share other clients' trade secrets, assume that, somewhere down the road, it will do the same thing with your IP.

A second reason for the devolution of strategic alliances is the eventual devaluation of whatever was new and unique about the product. This problem is especially pronounced in the high-tech arena, where products have such short life spans. As products commodify, OEMs gain a wide choice of interchangeable suppliers. Take the case of PCs: Many were originally built by brand owners. Later, surface-mount technology, the increasing codification of knowledge, and the routinization of internal processes made the assembly of PCs easier and thus within the capabilities of external suppliers, to which the work was outsourced. Today, most PCs are generic products composed of motherboards, fans, and hard drives acquired by a local assembler according to an OEM's specifications.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The third reason strategic alliances weaken is the increasing modularization of components. Automation demands fewer judgment calls and less improvisation from workers. And assembly has become simpler for CMs now that OEMs are transferring ever-larger portions of manufacturing jobs from CMs to suppliers, which are responsible for turning parts into a single piece of equipment, such as the seat of a car. Both developments make it less important for CMs to have special skills and knowledge.

Give trustworthy partners their freedom. As mentioned above, in noncommodity situations, OEMs should seek close relationships with trustworthy contract manufacturers to minimize the risk of IP leaks and to protect their investments. Such closeness would have the incidental benefit of making CMs dependent on OEMs for funding and technical guidance. But such relationships should not be exclusive; otherwise, OEMs will become isolated from industry innovators or be denied the maximum feasible economies of scale CMs can achieve by serving many clients. OEMs that depend on CMs disengaged from developments in the industry will eventually find themselves marketing products whose cost and quality aren't competitive with those of rivals.

Accordingly, an OEM should enter into a close relationship with a CM that already has relationships with other OEMs. Indeed, some companies may expect and even encourage their CMs to find other clients. Contract manufacturer Flextronics in 1999 bought a plant from Swedish OEM Ericsson on the heels of winning a contract from that company. Only one-third of that factory's production capacity is dedicated to Ericsson's products; a bigger share is dedicated to fabricating Motorola wireless phones, two-way pagers, and other devices. By selling its factory to Flextronics, Ericsson has fostered a closer relationship between Flextronics and one of its leading competitors, from which it expects to benefit. It is also unlikely to be unhappy that Microsoft has established a wireless research center in Sweden in order to be near this node of manufacturing know-how. If Ericsson had wanted an exclusive relationship with its CM, it could surely have found one willing to agree to its terms – though probably a second-rate CM.

In noncommodity situations, OEMs and CMs should commit themselves to long-term relationships so their investments have enough time to pay off. Naturally, the greater the duration of a contract, the more contingencies there are that can arise over its course, and the less predictable those contingencies become. Consequently, such contracts must be highly detailed, with the meanings of terms fully elaborated. In the case of Magna Steyr and BMW, the assembly of the X3 entailed so many complex technical and commercial details that the contract ran to more than 5,000 pages. However, the enforceability of even a contract like that one would depend on the good faith of the parties.

How, then, does an OEM foster a CM's good faith and commitment to the alliance when the CM has other masters as well? An OEM might begin by trying to gain a sense of the prospects for long-term trust. The best way to do this is to examine a CM's past behavior; that might mean talking to other OEMs, trade association representatives, and the CM's suppliers. An OEM can also investigate the CM's record of commercial disputes. If a CM tries to persuade you to retain its services by offering to share other clients' trade secrets or intellectual property, it is a fair guess that, somewhere down the road, the CM will do the same thing with your IP.

Even if a CM candidate's good intentions have been established, an OEM must still determine its reliability. Before either Toyota or Honda retains a supplier, for instance, it scrutinizes the supplier's production process and cost structure. After the supplier has been selected, the automaker sends it a monthly questionnaire eliciting a performance history – quality and quantity of outputs, timeliness of delivery, the occurrence of any irregular incidents. Toyota's or Honda's engineers may then spend several months at the supplier's facilities using the information obtained to solve problems and improve processes.

And finally, an OEM needs to practice good communication. This involves more than just conducting surveillance and reacting to the responses it engenders. Both sides need to share their goals for the alliance and to agree on norms, values, and procedures. Exchanging personnel helps facilitate those things. OEMs not only can send their engineers to CMs' facilities but also can create, as Toyota and Honda have done, "guest engineer" programs, whereby first-tier suppliers send several of their design engineers to CMs' offices for two to three years.

An OEM whose product's commercial viability rests on proprietary technology and processes needs its CM to know its business well. The OEM must take steps, both at the inception of the partnership and throughout its course, to ensure the CM's competence, currency of knowledge, and good faith.

Fight CMs' disloyalty by deepening distributors' and customers' loyalty. It may be that CMs have certain advantages – superior manufacturing prowess, a broader variety of products to offer, and lower costs being the most important. But the rise of contract manufacturing has also brought with it some challenges for CMs that decide to retail the products they make. Among them is the proliferation of consumer choices and brands that the advent of contract manufacturing has spurred. There are as many as 20 global TV brands today, for example. Although CMs have by definition surmounted the barriers to entering the manufacturing business, OEMs' well-established brands and their marketing and selling expertise constitute barriers of another kind. Moreover, OEMs can deepen their existing, direct relationships with customers and distributors more easily than CMs can build such relationships from scratch.

OEMs can strengthen their ties with customers by offering rewards or special discounts to those that buy products

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frequently, by personalizing customer relationships, and by providing strong technical support. Some OEMs advertise professional products directly to end users in hopes that the end users will express a preference to the actual purchasers. Philips Medical Systems, for instance, has launched a massive TV campaign in several countries to publicize its Brilliance CT scanners, which are sold exclusively to hospitals.

Fundamentally, however, customer loyalty must rest on what distinguishes an OEM's product from those of its competitors. Loyalty cannot be based on low prices, since consumers looking for the best price will be perpetually ready to switch–and CMs are almost always in a better position than OEMs are to offer the best price. The same goes for quality, which CMs' operational excellence assures, and product range, which is a feature of CMs' scale. In fact, the products CMs provide to other brands will be similar in quality and cost precisely because they were made by the same company. By contrast, a CM that made unique products for a given OEM would be tied down by a long-term agreement, which would remove it as a competitive threat.

In IT, the assemblers of "clones" offer not only the best prices but also greater possibilities for customization than companies selling differentiated but fixed products. The assemblers' customers choose components of varying quality and are thus able to achieve made-to-measure PCs at their desired price points. Cars are likely to be assembled in just this fashion in the not-too-distant future: Flexible manufacturing and the ever-shrinking amount of time and money it takes to ship a car by sea (three weeks and $500 to travel between any two points in the world) argue for the rise of CM-branded cars in low-wage countries like China.

Consequently, companies wanting to adopt a differentiation strategy will have to focus on research, design, sales, time to market, or customer services. By doing so, they commit themselves to extensive outsourcing. Dell, of course, has dealt with the hardware commoditization problem by eliminating intermediaries – which permitted it to get closer to its customers–and by offering better service and support.

OEMs can also try to rebuild distributors' loyalties. Distributors may be unusually receptive to CMs' overtures because they resent being squeezed by OEMs seeking short-term savings. Even in cases where OEMs act generously, distributors' fears of disintermediation and ultimate replacement by electronic channels tempt them to embrace whichever companies promise fair treatment and long-lasting relationships. OEMs that make credible commitments to distributors, though these may entail higher costs, can help tie the distributors to the OEMs' brands and keep aggressive CMs at bay. These commitments may include paying to train a distributor's personnel in servicing and repairing the OEM's products; underwriting the cost of a processing system fitted to both parties' requirements; or incorporating the distributor's identity into an OEM's marketing campaigns. The last commitment in particular should help discourage the distributor from thinking about becoming a brand itself. OEMs might also want to consider granting a distributor territorial exclusivity, which would improve the distributor's revenues and encourage it to specialize in the OEM's products. If the distributor should nevertheless be tempted to shift its allegiance to a new OEM, it knows it would have to bear the expense of learning how to sell and service the new brand.

Look beyond the dangers of your own market. The strategic challenges posed by contract manufacturing call into question the truism that specialization trumps diversification. Traditionally, large companies have maintained portfolios of patents that are much more diverse than their portfolios of production activities. In other words, a good OEM will probably have intellectual property relating to more than just its core products. A maker of car doors, for instance, needs to be knowledgeable about the plastics, airbags, electronics, and glass that go into them and might even hold patents for devices that it invented in the course of researching and developing improvements in its core technologies. OEMs may want to exploit this surplus or incidental knowledge by entering new product markets. Such entry could be facilitated by the CMs that OEMs hire – just as competitors use contract manufacturing to enter OEMs' original markets. Here OEMs would be turning to their own advantage the very resource that was used to torment them. OEMs would accomplish this by doing the same thing to the incumbents in some other market that had previously been done to them – at low cost and low risk, thanks to the features of contract manufacturing. These new products would rest advantageously on novel, proprietary technologies. For example, Royal Philips, an electronics company, already designs and sells a range of products – computers, photography equipment, Discmans, refrigerators. Similarly, auto companies would have the brand credibility and technological capabilities to diversify into fuel cells, alloys, batteries, filters, mirrors, glass coating, electric engines, security devices, and safety systems. With eager CMs waiting in the wings, all that such companies and others would need to begin is sufficient production expertise to assemble prototypes and high-quality, limited-run products. Toyota has already diversified into telecommunications, prefabricated housing, and recreational boating – which it did opportunistically, not because any CM put the company's margins under pressure.

OEMs should implement this strategy to enter markets outside but related to their core offerings, where their brands may have some influence. For OEMs, directly exploiting their patents – with help from their CMs – is a better alternative for coping with an accumulation of dormant IP than out-licensing would be. Without contract manufacturing, most OEMs would probably never attempt direct market entry.

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As long as technological innovation keeps increasing the benefits of specialization, contract manufacturing will be an oft-exercised choice for OEMs. Unfortunately, managers' incentives encourage a wholesale, uncritical approach to decisions about whether to outsource, which products to outsource, which CMs to engage, and in what form – a market agreement, a strategic alliance, or something in between. When OEMs share sensitive intellectual property with CMs, it is important that the relationship be trusting and close – but not so close that CMs lose touch with the market and other OEMs' contributions. Since these techniques are not infallible, OEMs should treat their customers and distributors well enough that they become immune to the appeals of upstart CMs, and they should spread their risk by diversifying their portfolio of products.

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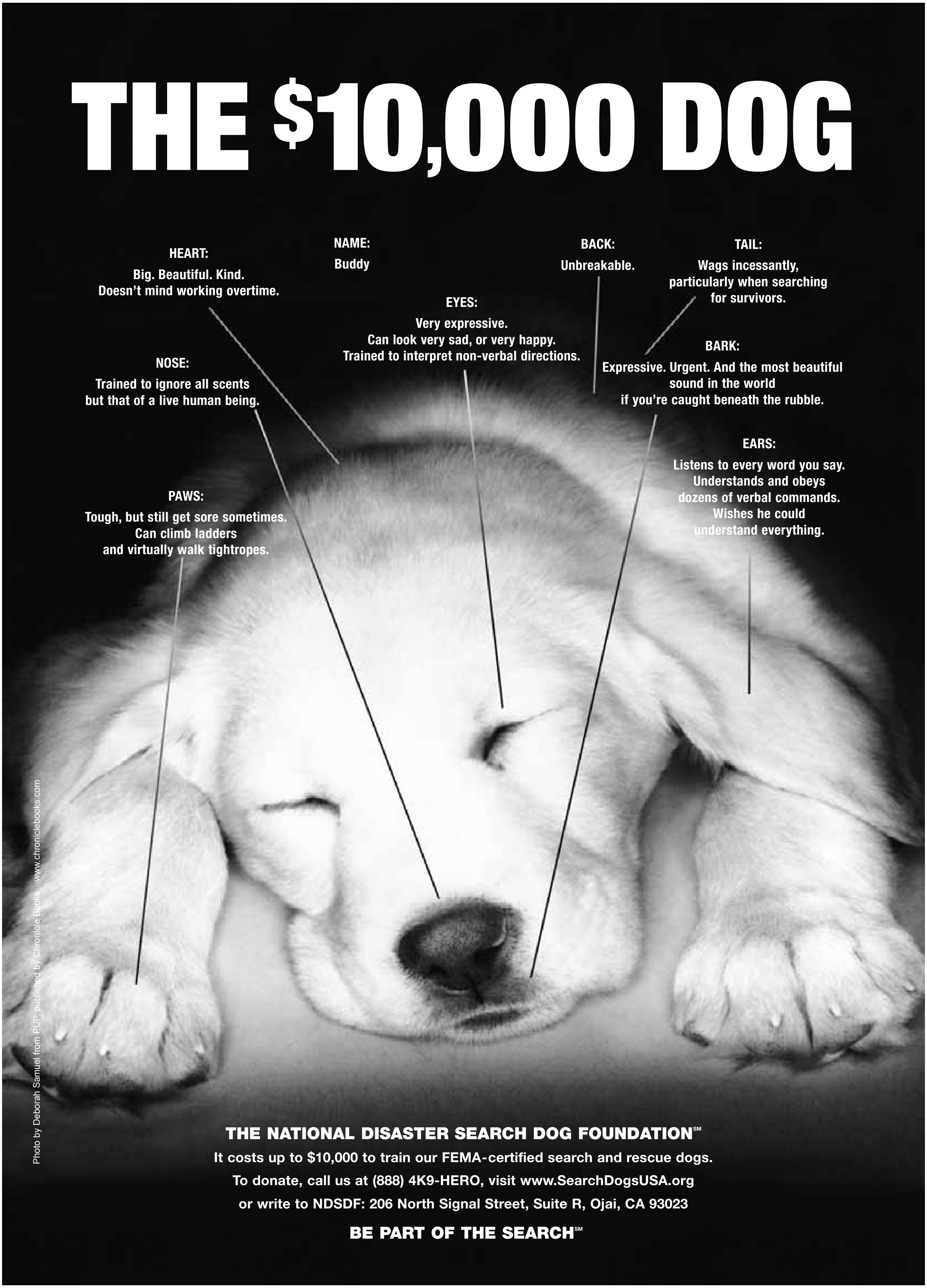
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Mapping Your Innovation Strategy

The May 2006 article "Mapping Your Innovation Strategy" by Scott D. Anthony, Matt Eyring, and Lib Gibson is a well-thought-out attempt to synthesize a formal innovation process from Clayton Christensen's excellent analytical work on disruptive innovation. The article will no doubt help some companies take a few steps forward in their attempts to innovate, but its ability to drive firms to pursue truly competitive levels of innovation is limited.

Toward the end of the article, for instance, the authors postulate that innovation will eventually become a formal

By describing the landscape of unmet customer needs and analyzing where new offerings have worked before, you can chart a path that will produce successful innovations time after time.

Mapping Your Innovation Strategy

by Scott D. Anthony, Matt Eyring, and Lib Gibson

To a casual observer, American football seems pretty simple: You run, you pass, you kick, you pause an inordinate number of times for car commercials. However, any aficionado knows that football is, in reality, dizzyingly complex. A professional team's playbook looks about as thick as the Manhattan phone book. On any given down, the coach selects a formation and a specific play to run from that formation. All the players know their precise assignments for each play and how to adjust them if necessary.

SIMON PEMBERTON

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process yielding predictable decisions once we learn the patterns. I can see why they might suggest such an outcome: Over the past few decades, advances in management science have chiefly come from organizations' efforts to systematically drive out variability and waste and emphasize consistency. (Think TQM and lean manufacturing.) The act of innovating, however, is fundamentally different from other organizational activities. The essence of innovation is variability and adventure, neither of which can ever be completely formalized in any analytical process.

As one of the leaders of Pennsylvania's Ben Franklin Technology Partners, the granddaddy of state-run entrepreneurial development programs, I have worked with hundreds of innovative entrepreneurs over the past 20 years. I've found that entrepreneurs succeed at bringing their innovations to market not so much because of their brilliant business strategies but because they are adaptable. They understand the value proposition of their products or services, and they have an uncanny ability to discern and adapt until they find the right positioning for their offering and the greatest opportunity for success. This observation reinforces the common notion that execution is more important than strategy. But many excellent leaders and consultants fail to understand that the unique features that make it possible to execute for innovation must be reflected in people's behaviors and attitudes.

Traditionally, though, companies have used tools of coercion to drive execution – linking employees' bonuses to their ability to meet corporate objectives, for instance, or holding the threat of job loss over employees' heads. For the most part, these techniques have proved effective at getting people to do what the hierarchy wants them to. Nevertheless, employees inevitably focus inward on "working the system"–that is, doing whatever is necessary to avoid penalties and earn rewards. This both limits their performance and stifles the level of corporate innovation needed to sustain competitive advantage in today's global markets. Trying to add "adaptation" as the last step in a linear process, as the authors suggest, sounds

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THEODORE LEVITT (1925–2006)

Theodore Levitt served as one of this magazine's most distinguished chief editors from 1985 to 1989. He transformed the *Harvard Business Review* from an academic periodical into a potent and accessible publication dedicated to exploring the challenges facing business leaders. Professor Levitt added *New Yorker*–style cartoons to HBR, and he favored shorter, pithy articles. He advised prospective authors to focus on "important issues that are important to important people."

Professor Levitt wrote 26 articles for HBR, a number surpassed only by Peter Drucker. His third piece, however, was perhaps the most notable: "Marketing Myopia" appeared in 1960 and has since sold almost a million reprints. Indeed, it's the rare B-school student who hasn't learned to ask himself or herself, "What business are you in?" The article made the railroads notorious for defining their business too narrowly. Perhaps most important, it elevated the stature of the marketing function in the eyes of business leaders. Marketing was no longer to be equated with selling; it became the essential link between customer insight and corporate strategy.

Professor Levitt championed customers' interests, telling his students that customers didn't need quarter-inch drills; they needed quarter-inch holes. The benefits that customers could derive from a product had to drive that product's attributes. Customers valued differentiation and the choice and competition it spawned. In Professor Levitt's marketing lexicon, the word "commodity" did not exist. The most mundane product could be differentiated – if not by its features then by its accompanying support services and the total customer experience it offered. And for managers who were marketing services rather than products, Professor Levitt's advice was to make the intangible tangible, to provide physical and visual cues that would reassure customers of the service provider's stability and trustworthiness.

Perhaps Professor Levitt's second most important HBR article, based on the controversy it provoked, was "The Globalization of Markets," published in 1983. He popularized the term "globalization" and claimed, in the face of then-customary obeisance to national cultural differences, that consumers worldwide were becoming more and more alike because of changing technology and communications. All markets have one great thing in common, he wrote – "an overwhelming desire for dependable, world-standard modernity in all things, at aggressively low prices."

Few academics could get away with such sweeping generalizations; Professor Levitt could. His observations were grounded in an acute and perceptive understanding of management practice and the forces of change that constantly shape consumer behavior and marketing insight. Professor Levitt was also a master of prose, often putting an article through five or six drafts, not so much to alter the content as to change the pace of the argument, the rhythm of the provocation.

Professor Levitt was, simply, the most influential and imaginative thinker in marketing history.

John A. Quelch
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good but rarely works in hierarchical, risk-averse organizations.

For a company to get to a competitive level of innovation – where existing employees come up with more and better ideas and successfully bring them to life – its culture must encourage and support innovative behaviors. These include continually questioning and learning, sharing information openly, fostering mutual respect across the hierarchy, building trust, focusing on customers, and taking risks within boundaries. These behaviors can never be coerced, nor can the outcomes be completely planned.

Innovative results flow from innovative behaviors; behaviors are driven primarily by culture; and culture is shaped by what senior leaders really do, not by what they say. In my experience, however, most leaders don't even recognize that the organization's innovation goals and strategies are at odds with employees' actual behaviors, much less understand the causes of this disconnect. Fortunately, innovative behaviors can be habit forming and motivating – but only if a company's senior executives recognize the need for a new leadership paradigm rather than another extension of management science.

Mark Lang
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Anthony, Eyring, and Gibson respond: We strongly agree with Mr. Lang that senior leadership plays a pivotal role in successful innovation. Leadership's most critical role is to create context – that is, allocating and protecting a company's resources and shaping the firm's innovation agenda and approach. In many ways, culture is a lagging, not leading, indicator of successful innovation. The culture changes when people solve problems in new ways.

To stimulate new growth, senior managers first need to pinpoint the organizational barriers to innovation. Maybe there aren't any creative sparks. We have great faith, however, in the collective creativity of managers in incumbent companies to come up with great ideas. More likely, the problem is that internal forces are dousing those sparks. Companies need to build the systems, structures, and, yes, processes that will shelter and sustain the creative sparks and turn them into roaring growth businesses.

Innovation is never entirely mechanistic, of course, and we strongly agree that new ventures require flexibility. In fact, there is a 90% chance that the first strategy for bringing a new innovation to market will be wrong in some fundamental way. In those cases, it's important to have a rigorous but quick way to isolate central assumptions, run experiments, and adapt. Historical patterns of success can provide guidelines to expedite this adaptation.

Innovation may never be as predictable as, say, product manufacturing, but it can be made significantly more predictable than it is today. Combining the right context with a more structured approach to spotting and shaping specific opportunities can lead to very robust results.

Manage Customer-Centric Innovation – Systematically

Larry Selden and Ian C. MacMillan rehash an old and well-known concept in their April 2006 article, "Manage Customer-Centric Innovation – Systematically." Organizations in general, and R&D divisions in particular, have been pursuing customer centricity for years. Selden and MacMillan correctly point out that companies should create products that customers want rather than creating products in search of customers. But the authors fail to point out the critical reason most firms are unable to do just that – namely, the difficulty organizations have operationalizing customer centricity.

The first challenge in becoming a customer-centric organization is to recognize that you are not one currently: Too many companies believe they are customer centric even though their policies and practices reinforce a one-size-fits-all mentality. Another challenge comes from your R&D group: Engineers are great at creating innovative products, but, traditionally, they are less talented at handling customers' requests. Ever the artists, engineers pride themselves on creating something new – even if it's not necessarily what customers asked for. Selden and MacMillan suggest it's possible for companies and R&D groups to make a major shift – in both culture and mind-set – toward getting closer to customers earlier in the process without losing R&D expertise. Given the proclivities of R&D talent, however, this would seem to be a much more painstaking transition than the authors suggest.

To become more customer centric, organizations need to uproot their false convictions that they're already focusing on customers; win over the people in R&D; link the customer-centric model to employee compensation; and create customer-centric education programs. All are equally critical to ensuring customer centricity.

Finally, the authors' model suggests that companies need to choose either customer-centric (incremental) innovation or customer-leading (breakthrough) innovation rather than seek a balance of the two. Consider the fact that many successful products originally were rejected by customers and that customers are typically more comfortable with incremental change than with radical, breakthrough change. If all innovation followed the authors' model, technological, sociological, and economic progress in the world would be slow.

The authors' customer-centric model works well when competitors aren't using the same model; when they are, all the players in the market end up chasing the same idea. Customer centricity may bring those companies to parity but not to competitive advantage.

Lior Arussy
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Selden and MacMillan respond: How can the letter writer claim that "organizations in general, and R&D divisions in particular, have been pursuing customer centricity for years"? We began the article with our empirical observations about companies' widespread failure to gain even average financial returns from R&D. In one of the sidebars, we stressed that many CEOs face a growth gap between their business plans and Wall Street's expectations. Firms certainly *aren't* pursuing the customer centricity we propose – the kind that drove spectacular share price improvements at Best Buy and Royal Bank of Canada. Not a word in the letter addresses how to make R&D pay off, either for customers or for investors.

The letter writer's accusation that we fail to point out the difficulty firms have operationalizing customer centricity is false. We state clearly that customer-centric innovation requires "sustained and focused effort and – perhaps hardest of all – a willingness to break through existing mind-sets." And we offer a proven process for operationalizing customer centricity. The successes that firms have realized with our process have been highlighted in the *Wall Street Journal, Fortune,* and other leading publications.

Finally, the letter writer states that organizations need to uproot their false convictions of being customer centric; win over the people in R&D; link the customer-centric model to employee compensation; and create customer-centric education programs. Precisely because we so often encounter such high-level and non-operational statements, we articulated the five-step process for creating sustained competitive advantage (not just parity) in the section titled "Beyond Customer R&D." That is, we suggest understanding customer profitability; segmenting customers according to their needs and wants; developing for and delivering to those customers competitively superior value propositions and filling the company's competency voids; organizing the company around customer segments; and driving innovation from headquarters to the field.

Very practically, unless companies are reorganized around customer-segment business units and led by individuals empowered to innovate but held accountable for customer-segment growth and profitability, any investments in education will fare even worse than current investments in conventional R&D.

Home Depot's Blueprint for Culture Change

Ram Charan's "Home Depot's Blueprint for Culture Change" (April 2006) looks like an effort to paint a failure as a success. Home Depot's transition from the wildly successful organization it was to the mediocre-performing operation it is today appears to be a result of mistakes that most leaders learn to avoid in Change Management 101.

Robert Nardelli failed to create and communicate an effective platform for change at the outset. The article points out that leadership didn't adequately address significant opposition to change until a year and a half into the transition. As CFO Carol Tomé points out: "People never had time to grieve for the company Home Depot once was [and] we didn't do a very good job of explaining the *why.*"

On top of this, Nardelli tried to force-feed changes to the organization in order to speed the transformation, but he "put the brake" on his plans and started over. He must have missed the change management class that dictates that change happens fast and efficiently when people close to the work not only embrace the change but also participate in its implementation.

Finally, it seems that in their zeal to change Home Depot, senior managers neglected to pay enough attention to preserving what made the company great in the first place. Instead, Charan explains at every step how radical change was necessary. In more instances than not, it seems like the baby went out with the bathwater.

Effective leaders communicate and socialize a new direction at the outset of change, not years into it. Moreover, they involve seasoned leaders up and down the organization in designing and implementing the tactical initiatives (like changing inventory control systems). Finally, they create change by building on the company's good points – of which Home Depot had plenty.

It's no wonder Home Depot hit more than a few major bumps in its transition. It's no wonder the company's performance and stock price lag competitors'. And it's no wonder that the Dallas-based Investors for Director Accountability Foundation has targeted Nardelli as one of about a dozen corporate executives who are paid too much. If Charan's article is to be taken at its face, five years into the transition the headstrong CEO finally seems to be getting the organization behind him. That's five years too late.

Bob Matha
Macy Boehm
Principals
Basics 3
Chicago

The night before reading *Harvard Business Review*'s article on Home Depot's culture change, I was pacing the aisles of Brooklyn's Home Depot in near total frustration. This may well have been my 200th visit to one of the company's superstores, and I swore again it would be my last. A deep, meaningful, ten-year relationship with the big orange box had been steadily souring. As I searched in vain for someone capable or interested enough to cut a piece of steel pipe for me, it seemed obvious that no one cared.

In my former life as a design-build architect, Home Depot offered me easy access to locally relevant materials in both large and small quantities at prices that rivaled trade discounts and bulk orders. Home Depot had always been a trusted resource, with a rare mix of product diversity, reliability, and shop-floor expertise as part of the consumer experience – all of which made my recent frustrating visits so incomprehensible.

Ram Charan's article solved the mystery for me and, I suspect, for many other bewildered Home Depot customers. It also did something far more significant. It illuminated an alarming trend in management and leadership thinking that is radically reshaping the American landscape: the confusion of "culture" with "technique." Both are means for channeling behavior, but they are based on entirely different foundations, producing immensely different outcomes.

Culture is a framework of values and meaning; simply put, it's "the way we do things around here." By contrast, technique is a system of specified processes geared toward efficiency and predetermined results. Despite this polarity, the willful confusion and potential interchangeability of these terms have proved highly seductive to business leaders. Charan's depiction of the new Home Depot reveals the inner workings of the current managerial mind-set, in which decisive words like "metrics" and "data" and "information" are used to describe Home Depot's supposed new culture. Home Depot's managers and employees – not to mention HBR's readers – are expected to nod approvingly as they watch a robust entrepreneurial network once characterized by individual commitment and autonomy converted into a system of centralized control, where knowledge and intuition must surrender to standardized information and procedures.

Ironically, Charan's April article is only pages away from Laurence Prusak's Forethought essay "The World Is Round," which warns organizations against confusing culture and technique. "Knowledge, not information, is the key to prosperity," Prusak reminds us. And this knowledge is "embedded in organizations in ways that have largely evaded codification." Nonetheless, the codification continues – technique replacing culture across the global landscape. But looking out at the landscape, we can quickly see that changing or *using* culture is not the same as *building* it.

We shouldn't confuse what happened at Home Depot with the creation of a new culture. If culture is a system of shared values and meaning, it must be formed by groups with convictions, ideals, and compelling rhetoric. It is a cycle of individual expression and collective agreements that must be cultivated. When it's incrementally planted, pruned, and harvested, culture develops into a dense and fertile system that yields more than any one leader could have ever imagined alone. And because culture is a system that is principled *and* subjective, it offers and sustains the kind of diverse, textured environment that most people actually want to live in. In business terms, this means robust markets, coherent organizational relationships, solid foundations for innovation, and, finally, sales associates who know how to interact with customers and cut steel pipe.

Technique cannot be sustained as a business foundation. Business needs culture to undergird the complex relationships, responsibilities, and contextual knowledge that constitute any vital organizational structure. It needs culture to create contexts in which products and services have meaning. It needs culture to fertilize innovation, which comes as a result of productive, sustained tension between social structures and personal freedom. In short, business needs culture because it needs people, and people cannot exist without it.

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Knowing What to Sell

V. Kumar, Rajkumar Venkatesan, and Werner Reinartz describe how companies that use the right mathematical models can increase their odds of successfully predicting specific purchases by specific customers at specific times ("Knowing What to Sell, When, and to Whom," March 2006). Their forecasting method relies on historical customer and company data and special software. But does that mean accuracy in predicting behavior depends solely on the richness of an organization's past data and the strength of its computing power? Are the marketers who use the authors' prediction method more likely to succeed than the marketers who don't?

The answer in both cases has to be no. First, the authors' forecasting model excludes several critical variables, such as external market influences and competitive activities. What if your product is threatened by a niche player's more aggressively priced product? Or what if a rival launches a big advertising campaign? Second, the authors' model (like most mathematical models) captures only quantitative information about customers. Intangibles such as customer satisfaction or the relationships among vendors, business partners, and end users are not accounted for.

I trust the authors when they say their Bayesian estimation model is more accurate than the traditional forecasting methods most companies use, and there is nothing wrong with using historical data and applying them in a model to forecast revenue. But such tools constitute a relatively small part of an overall CRM strategy. Like the rearview mirror of a car, they're important for seeing what's behind you but not essential for moving the car forward.

Marketers want forecasting methods that take into account and analyze *all* customer contacts and interactions with a company – for instance, when and how often the customer calls the support desk, goes to specific company Web sites, sends e-mails to the billing or customer service departments, attends marketing events, tests and returns a product (and why), and then, yes, what and when the customer buys. A 360-degree approach like this would make historical customer data a real asset, maybe even one that could be sold. Most companies have all these data available in some format. Their challenge is to retrieve the information from various sources (data warehouses or cubes) and formats (e-mails, images, MS Word documents) and turn it into usable content that allows senior management to make smart business decisions. When that happens, CRM will become a real asset to organizations.

Until then, keep it simple: Listen to your customers. You'll find out more about your business by asking your clients directly rather than by indirectly studying their buying behaviors.

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Kumar, Venkatesan, and Reinartz respond: If, as Mr. Schweizer suggests, managers were to include in their forecasting models factors such as external market influences and competitive activities, they could certainly improve their ability to predict which products their customers will buy. However, the mathematical model we describe in our article is focused on customers, not products. In our field experiments with B2B and B2C companies, we didn't include these factors in our predictive models for the test and control groups for two reasons. First, such information wasn't always available. Second, we wouldn't expect that incorporating information regarding external market influences, competitive activities, customer satisfaction, or strength of vendor, partner, and end-user relationships would improve *customer-focused* purchase predictions in the control group any more than they would improve forecasting in the test group; such factors would influence both groups equally. The model we used with the test group was based on our Bayesian estimation methodology, and the model we used with the control group reflected traditional forecasting methods. The results of our field experiments strongly suggest that a predictive model that uses information regarding a company's marketing activities and past customer transactions to forecast future purchasing behavior can result in higher profits and ROI.

To build our predictive models, we analyzed the influence of customer-initiated points of contact in the companies we studied. The low reliability of the customer-initiated contact information (in the instances where we analyzed those data) is one of the reasons that variables such as the number of times a customer attends a company's marketing events don't have a stronger influence on predicting future end users' behavior. However, one of the critical factors in our model is the number of previous company-initiated contacts customers have had with a salesperson; another is the number of company-initiated direct-mail and telesales contacts the customers have had.

Companies need to augment their current processes for "listening to customers" with predictive models that are focused on customers and that extract trends from customers' past purchasing behavior to predict future purchasing activity. Certainly, intuition and experience are invaluable for making smart marketing decisions. But well-executed quantitative analysis provides the leverage that marketers need in competitive environments.

The High Cost of Cheap Chinese Labor

Paul W. Beamish's June 2006 Forethought article "The High Cost of Cheap Chinese Labor" correctly points out that recruiting and retaining white-collar workers in China is difficult. But his analysis of China's HR problem is far too simplistic. Indeed, the issue of retaining talent in China is not so much the fault of multinational corporations like GE and L'Oréal as of workers themselves and general market conditions.

Consider the following: Organizations in China – the small and midsize enterprises as well as the *Fortune* 500 companies – are actually overpaying university graduates right now. The first job out of university for many Chinese grads is with a multinational. That's because the graduates' parents, most of whom were raised in the state-run era, want their kids to find stable, prestigious work in big companies. When the grads leave their first big jobs, they become more independent; they do more of what they want and thus join smaller firms. To get the right talent for their teams, foreign companies are regularly doling out 20% increases in salaries to junior workers to poach them from other companies.

The Chinese markets are obviously electric. A few years ago, it took earnings of only $6 million for an individual to make it on the *Forbes* "China's 100 Richest" list; now a person needs nearly $100 million in total assets. Many graduates from Chinese universities see and hear about people making fortunes running their own businesses. They feel left behind if they stay in stable but stodgy MNCs. Moreover, it's almost passé for 20- and 30-year-olds in China to stay with the same firm for more than a few years. Peer pressure to change jobs is huge; if you don't, it's almost as if there is something wrong with you.

MNCs shouldn't be blamed for being too cheap to pay good salaries. They just haven't established good retention programs and practices. Multinationals should launch more training programs and clarify the paths for promotion and advancement. Many MNCs don't want to do this, however. They're afraid that once they train their employees, they'll jump ship. It is a catch-22: Train now, and hopefully keep your best employees – but understand that you also run the risk that your current trainees will eventually become your future competitors.

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Managing Middlescence

In their article "Managing Middlescence" (March 2006), Robert Morison, Tamara Erickson, and Ken Dychtwald call attention to a costly and largely hidden business problem, but their six strategies for revitalizing careers miss a vital opportunity.

If companies want to make a substantial commitment to dealing with middlescence, they should start by enabling each worker to craft a personal vision for the future. Investing in a worker's personal vision costs companies relatively little, particularly if all workers share the costs, and the return is likely to be significant. Employees who are willing to stake a personal claim by advocating what they want and sharing in the outlay for their future are the company's best investment in "rekindling."

The notion that middlescence is largely a career problem is false. Midcareer workers have matured in a world of ideas and experiences that go far beyond their occupations; they know that they are not just their work. Thus, any attempt to support employees in developing a personal vision must be more than a career-planning exercise. It must be a whole-life endeavor.

Steve Edelstein
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Morison, Erickson, and Dychtwald respond: Individual employee situations, preferences, and ambitions are essential for customizing the employment deal, opening new career opportunities, and managing middlescence. We also see the potential value of encouraging and enabling employees to craft personal visions of the future for both work and the rest of life. But we add a caveat: Such visions must include realistic goals – not wish lists – to find winning moves for both employer and employee.

The Nice Guy

The commentators for Russ Edelman and Tim Hiltabiddle's case study, "The Nice Guy" (February 2006), make some valid points, and they are most likely right that Paul Kennedy is not tough enough for the job. However, if they stopped pounding on Paul for not dealing with the problem of Lisa's diminishing performance, they could learn something from him about listening.

Paul does not blow it during the 7:14 AM phone conversation with Lisa. He understands that leadership is about people. By listening to Lisa and considering the situation from her point of view, he exudes a depth of character and compassion that are too rare in C-suites. Paul does not overlook Lisa's slipping performance; he makes a clear mental note to think of ways to rectify the situation.

Addressing a serious problem in the heat of the moment is the wrong approach. Instead, a manager should come back in a collected way to teach, develop the employee, and remedy the problem. Had Paul demanded that Lisa stop talking and come in to the office, the result would have been a disaster.

Tommy Weir
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What Executives Should Remember

Thank you for publishing the selection of excerpts from articles by Peter F. Drucker in "What Executives Should Remember" (February 2006). It must have been hard to choose among the dozens of articles he published in HBR. Of them, I remember best "The New Productivity Challenge" (November–December 1991), which addressed the changes needed to improve knowledge workers' productivity. It led me to commute to California to take his class on the knowledge worker.

Drucker's class, like his publications, had us all wrestling with how to put his ideas into action. Several students were frustrated with upper management because, they said, "Our bosses don't understand us when we explain what knowledge workers need to be productive." Drucker told us, "It's your job to make your bosses understand." Still frustrated, one student asked him, "But how do we do that?" Drucker gave her the same answer the taxi driver gave when a musician asked him how to get to Carnegie Hall. Drucker said, "Practice, practice, practice. After all, where do you think best practices come from?"

It's a simple answer but a difficult task. It will take a great deal of practice to master the art of making knowledge workers productive in the information age. I wish Professor Drucker were still here to help us.

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COVER STORY

66 | Ten Ways to Create Shareholder Value

Alfred Rappaport

Executives have developed tunnel vision in their pursuit of shareholder value, focusing on short-term performance at the expense of investing in long-term growth. It's time to broaden that perspective and begin shaping business strategies in light of the competitive landscape, not the shareholder list.

In this article, Alfred Rappaport offers ten basic principles to help executives create lasting shareholder value. For starters, companies should not manage earnings or provide earnings guidance; those that fail to embrace this first principle of shareholder value will almost certainly be unable to follow the rest.

Additionally, leaders should make strategic decisions and acquisitions and carry assets that maximize expected value, even if near-term earnings are negatively affected as a result. During times when there are no credible value-creating opportunities to invest in the business, companies should avoid using excess cash to make investments that look good on the surface but might end up destroying value, such as ill-advised, overpriced acquisitions. It would be better to return the cash to shareholders in the form of dividends and buybacks.

Rappaport also offers guidelines for establishing effective pay incentives at every level of management; emphasizes that senior executives need to lay their wealth on the line just as shareholders do; and urges companies to embrace full disclosure, an antidote to short-term earnings obsession that serves to lessen investor uncertainty, which could reduce the cost of capital and increase the share price.

The author notes that a few types of companies – high-tech start-ups, for example, and severely capital-constrained organizations – cannot afford to ignore market pressures for short-term performance. Most companies with a sound, well-executed business model, however, could better realize their potential for creating shareholder value by adopting the ten principles.

Reprint R0609C; HBR OnPoint 1069

IDEAS & TRENDS

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20 | When Crowds Aren't Wise Predictions made by large groups often turn out to be right, but sometimes they're dead wrong. Here's when *not* to trust the majority. **Reprint F0609A**

Cutting the Cost of HIV By approaching HIV infection among Russian and Botswanan miners as a financial problem, a Deloitte consultant and a mine executive created programs that improved employees' health and reduced the costs to the mines. **Reprint F0609B**

Smart Product Design Dan Williams, known for his work on mobile phones when he was at Motorola, talks about evolution in design. **Reprint F0609C**

Procurement as Strategy Procurement has increasingly become central to companies' strategy – and even drives innovation. **Reprint F0609D**

Energy-Credit Buyers Beware Companies are buying millions of dollars' worth of renewable energy credits (RECs) to offset the carbon produced by the electricity they use. But RECs have little effect on the environment, the author says. **Reprint F0609E**

What Men Think They Know About Executive Women According to surveys conducted in 1965, 1985, and 2005, attitudes about executive women have improved, but not as much as men think. **Reprint F0609F**

Marketing in an Unpredictable World Predicting entertainment megahits is a risky proposition. Instead, marketers can adopt five strategies to exploit consumers' social influence as it emerges. **Reprint F0609G**

How to Fix HR HR departments should be held responsible for their companies' performance, not just for programs that provide services and support to staff. **Reprint F0609H**

Book Reviews Featuring *Mind Your X's and Y's: Satisfying the 10 Cravings of a New Generation of Consumers,* by Lisa Johnson, and reviews of three other books.

LEADERSHIP

HBR CASE STUDY

37 | Indispensable

John Beeson

Edward Bennett has done wonders at Astar Enterprises. In the 15 years he's been CEO, the company has more than tripled in size through product-line extension and disciplined acquisitions and is now distributing its cleaning, personal hygiene, and skin care products nationwide.

But Astar's chief executive is 64 years old, and while all his attention is taken up with a new strategy to expand into international markets, board members are becoming increasingly worried about the issue of succession. Bennett wants none of it, arguing that if he were to die suddenly, his second in command, Tom Terrell, could take over. Besides, after much prodding, Bennett, former vice chairman Vincent Dalton, and longtime HR head Gail Thompson have already come up with a list of four possibilities. "When will these guys back off?" Bennett complains to Thompson. "I've told them who the candidates are. Why do we need to talk about it?"

Thompson knows, however, that the board chairman, Tom Calloway, considers Terrell a nonstarter without the requisite skills to take over in anything more than an interim capacity. As for the other three candidates, only one is even known to the board, and none has any significant international experience.

Calloway is well aware of how critical Bennett is to Astar. But he's equally certain that the board risks failing in its fiduciary responsibilities if it doesn't create a viable succession plan. What should Calloway and the board do if Bennett refuses to cooperate?

Commenting on this fictional case study are John W. Rowe, the executive chairman of Aetna; Edward Reilly, the president and CEO of the American Management Association; Jay A. Conger, a professor at Claremont McKenna College and London Business School, and Douglas A. Ready, a visiting professor at London Business School; and Michael Jordan, the CEO of EDS.

Reprint R0609A
Reprint R0609X: Case only
Reprint R0609Z: Commentary only

ORGANIZATION & CULTURE

55 | The Decision to Trust

Robert F. Hurley

Surveys have shown that 80% of Americans don't trust corporate executives and – worse – that roughly half of all managers don't trust their own leaders. Mergers, downsizing, and globalization have accelerated the pace of change in organizations, creating a crisis of trust that didn't exist a generation ago.

Leaders who understand how trust is built can actively influence its development, resulting in a more supportive and productive work environment and, not incidentally, a competitive advantage in the war for talent. Building on research in social psychology, and on his 15 years of experience consulting on trust, the author has developed a model for predicting whether trust or distrust will be chosen in a given situation. It helps managers analyze ten factors at play in the decision-making process. Hundreds of top executives have used it to diagnose and address the root causes of distrust in their work relationships.

Some of the factors in the model relate to the decision maker: How tolerant of risk, how well-adjusted, and how relatively powerful is he or she? Others relate to the specific situation: How closely aligned are the interests of the parties concerned? Does the person who is asking to be trusted demonstrate competence? Predictability and integrity? Frequent and honest communication?

Sue, a relatively new VP of sales, used the trust model to manage her relationship with Joe, an employee nearing retirement who was not performing well in a new sales role. Fearing for his job, Joe wasn't initially inclined to trust her. Sue took concrete steps to communicate openly with Joe, explore other options for him, and show concern for his well-being. When Joe was transferred, he let his former colleagues know how pleased he was with Sue's handling of the situation. As a result, the level of trust increased in Sue's department, even though it was experiencing major change.

Reprint R0609B; HBR OnPoint 1056; OnPoint collection "Winning Your Employees' Trust" 1052

ORGANIZATION & CULTURE

78 | Rethinking Political Correctness

Robin J. Ely, Debra E. Meyerson, and Martin N. Davidson

Legal and cultural changes over the past 40 years ushered unprecedented numbers of women and people of color into companies' professional ranks. Laws now protect these traditionally underrepresented groups from blatant forms of discrimination in hiring and promotion. Meanwhile, political correctness has reset the standards for civility and respect in people's day-to-day interactions.

Despite this obvious progress, the authors' research has shown that political correctness is a double-edged sword. While it has helped many employees feel unlimited by their race, gender, or religion, the PC rule book can hinder people's ability to develop effective relationships across race, gender, and religious lines. Companies need to equip workers with skills – not rules – for building these relationships.

The authors offer the following five principles for healthy resolution of the tensions that commonly arise over difference: *Pause* to short-circuit the emotion and reflect; *connect* with others, affirming the importance of relationships; *question yourself* to identify blind spots and discover what makes you defensive; *get genuine support* that helps you gain a broader perspective; and *shift your mind-set* from one that says, "You need to change," to one that asks, "What can I change?"

When people treat their cultural differences – and related conflicts and tensions – as opportunities to gain a more accurate view of themselves, one another, and the situation, trust builds and relationships become stronger. Leaders should put aside the PC rule book and instead model and encourage risk taking in the service of building the organization's relational capacity. The benefits will reverberate through every dimension of the company's work.

Reprint R0609D; HBR OnPoint 1068

STRATEGY & COMPETITION

88 | With Friends Like These: The Art of Managing Complementors

David B. Yoffie and Mary Kwak

Intel and Microsoft neither buy from nor sell to each other directly, but they are undeniably in business together. They are probably the world's most widely known pair of *complementors* – companies that independently provide complementary products or services to mutual customers. Complementors increase the value of each other's offerings and the size of the total market. So it's not surprising that so many just assume that their interests are aligned. Nothing could be further from the truth.

Discord can develop in many areas, such as pricing, technology, standards, and control of the market – both in terms of which company has the most influence over customers and which one gets the biggest slice of the pie. The issue of pricing perfectly captures this tension. Ideally, you'd like to price your goods high while your complementors price theirs low. Airlines, for instance, would be happy to see vacation lodgings go for a song, while destination resorts could raise rates and still fill their rooms if customers could fly there for free.

The first step in managing relationships with complementors is to develop a deep understanding of their economics, their strategies and goals, their existing capabilities, their incentives for cooperation, and any potential areas of conflict. Then, to gain the upper hand, companies can use a variety of tools that fall into two main categories: hard power (inducements or coercion to get what you want) and soft power (persuasion through indirect means to get others to want what you want). The authors explain how to build both hard power and soft, illustrate the strengths and limits of each, and offer guidelines for choosing one over the other. Conflict among complementors is inevitable, but together, hard and soft power can help companies manage the dark side of complementor relationships and take full advantage of the opportunities that cooperation should create.

Reprint R0609E; HBR OnPoint 1085; OnPoint collection "Don't Innovate Alone" 1049

HUMAN RESOURCES

104 | How to Keep A Players Productive

Steven Berglas

After graduating from Harvard Business School with highest honors, Jane rapidly moved up the corporate ladder at a large advertising firm, racking up promotions and responsibilities along the way. By the time she became the company's creative director, she was, in everyone's estimation, an A player – one of the organization's most gifted and productive employees. But although she received an extraordinarily generous pay package and had what some people considered to be one of the most stimulating jobs in the company, Jane felt underappreciated and was talking to headhunters. Eventually, she was lured away to a competing company that, by her own admission, offered less-challenging work. Both Jane and the advertising firm she left behind lost out.

Of course, not all A players are as vulnerable as Jane. Some superstars soar to stunning heights, needing little or no special attention, and have the natural self-confidence and brilliance to stay at the top of their game with elegance and grace. But as every manager knows, megastars with manageable egos are rare. Far more common are people like Jane who are striving to satisfy an inner need for recognition that is often a sign of irrationally low self-esteem.

According to the author – an executive coach, management consultant, and former faculty member of the department of psychiatry at Harvard Medical School – if you do not carefully manage the often unconscious need A players have for kudos and appreciation, they will burn out in a way that is damaging to them and unproductive for you. The key is understanding what makes your A players tick. The author suggests that you assist your stars by offering them authentic praise, helping them set boundaries, and teaching them to play nicely with subordinates. In the process, you can turn these high performers into even more effective players.

Reprint R0609F

STRATEGY & COMPETITION

114 | Curveball: Strategies to Fool the Competition

George Stalk, Jr.

In this follow-on piece to his article "Hardball: Five Killer Strategies for Trouncing the Competition" (HBR April 2004), George Stalk of the Boston Consulting Group offers another approach for prevailing over rivals. Strategic hardball is about playing rough and tough with competitors; strategic curveball is about outfoxing them. It involves getting rivals to *do something dumb* that they otherwise wouldn't (that is, swing at a pitch that appears to be in the strike zone but isn't) or *not do something smart* that they otherwise would (that is, fail to swing at a pitch that's in the strike zone but appears not to be).

Stalk describes four types of curveball:

• **Draw your rival out of the profit zone.** Lure competitors into disadvantageous areas – for example, by competing for, but intentionally failing to win, the business of less profitable customers.

• **Borrow techniques from unexpected places.** Using the hardball tactic of plagiarizing good ideas, put rivals off balance by importing techniques from other industries – for example, employing the retailer's hard sell in the stodgy world of retail financial services.

• **Disguise how you attain your success.** Veil your methods by achieving an advantage through unlikely means – for example, generating product sales through your service operations.

• **Let rivals misinterpret the reasons for your success.** Allow them to act on conventional but incomplete explanations for your success – for example, squeezing costs rather than aggressively utilizing assets.

The author provides extended examples of these curveball strategies in action, at companies such as the industrial-cleaning chemical supplier Ecolab and the Australian airline Jetstar.

Reprint R0609G; HBR OnPoint 1055; OnPoint collection "Hardball Strategies, 2nd edition" 1050

SALES

124 | The New Science of Sales Force Productivity

Dianne Ledingham, Mark Kovac, and Heidi Locke Simon

For years, sales managers at many companies have relied on top performers and sheer numbers of sales reps to stay competitive. But while they may have squeaked by on this wing-and-a-prayer technique, their sales teams haven't thrived the way they once did.

Today's most successful sales leaders are taking a more scientific approach. Savvy managers are reshaping their tactics in response to changing markets. They are reaching out to new customers in innovative ways. And they are increasing productivity by helping the reps they already have make the most of their skills and resources.

Leaders who take a scientific approach to sales force effectiveness have learned to use four levers to boost their reps' productivity in a predictable and manageable way. First, they systematically target their firms' offerings, matching the right products with the right customers. Second, they optimize the automation, tools, and procedures at their disposal, providing reps with the support they need to boost sales. Third, they analyze and manage their reps' performance, measuring both internal processes and results to determine where their teams' strengths and weaknesses are. Fourth, they pay close attention to sales force deployment – how well sales, support, marketing, and delivery resources are matched to customers.

These four levers can help sales leaders increase productivity across the board, the authors say, though they have the greatest impact on lower-ranked performers. The overall effect of increasing the average sales per employee can be exponential; it means a company won't have to rely on just a few talented individuals to stay competitive. This is especially important because finding and keeping star salespeople is more difficult than ever. What's more, managers who optimize the sales forces they already have can see returns they never thought possible.

Reprint R0609H

STRATEGY & COMPETITION

135 | When Your Contract Manufacturer Becomes Your Competitor

Benito Arruñada and Xosé H. Vázquez

PC maker Lenovo started out as a distributor of equipment made by IBM and other companies; now it has formed a joint venture with IBM and will eventually affix its own logo to its computers. Shanghai Automotive Industry Corporation (SAIC) started out manufacturing vehicles for Volkswagen and GM; now it's preparing to sell its own cars in China, Europe, and North America. Lenovo and SAIC represent a host of formerly anonymous makers of brand-name products that are breaking out of their defined roles and pushing the brands themselves aside.

In this article, the authors explore the double-edged relationships original equipment manufacturers (OEMs) forge with their contract manufacturers (CMs). On the one hand, an OEM can reduce its labor costs, free up capital, and improve worker productivity by outsourcing all the manufacturing of a product. The company can then concentrate on value-adding activities – research and development, product design, and marketing, for instance. On the other hand, an OEM that retains a contract manufacturer may find itself immersed in a melodrama replete with promiscuity (the ambitious CM pursues liaisons with other OEMs), infidelity (the OEM's retailers and distributors shift their business to the upstart CM), and betrayal (the brazen CM transmits the OEM's intellectual property to the OEM's rivals or keeps it for itself when the contract is up).

OEMs cannot simply terminate their outsourcing arrangements – they need contract manufacturers in order to keep specializing, adding value, and staying competitive. But OEMs *can* manage these relationships so that they don't become weak or the CMs too strong. Doing so requires modesty about revealing trade secrets; caution about whom one consorts with; and a judicious degree of intimacy, loyalty, and generosity toward partners and customers.

Reprint R0609J

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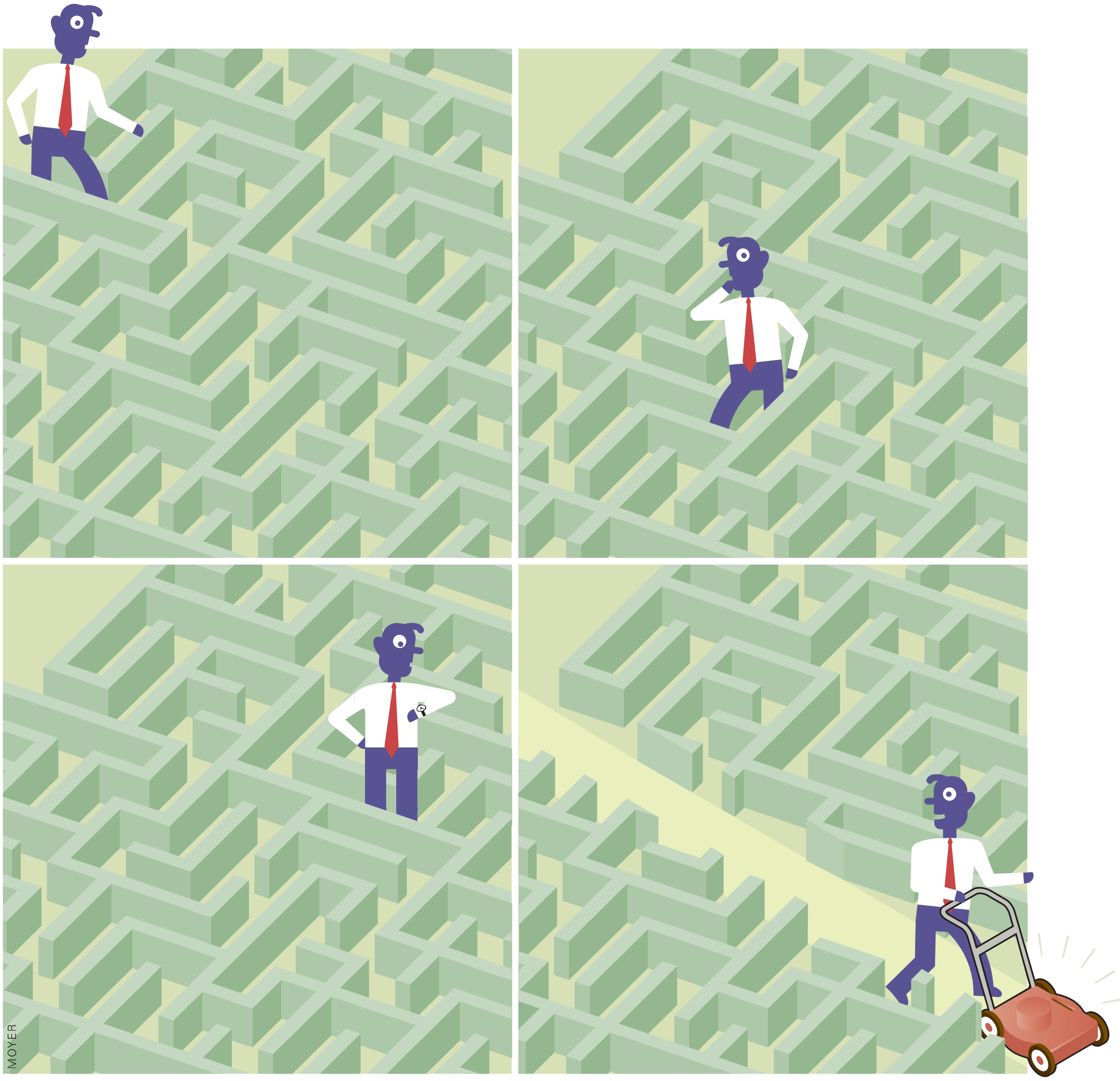

Shortcut

The way we see our problems has a profound effect on the way we arrive at solutions – and ultimately on the solutions themselves. Problem solvers are trained to choose one of two approaches: work and work to find the best solution, or spend less time on the problem and settle for an adequate fix. In *The Art of Problem Solving,* Russell Ackoff reminds us of a third path.

Ackoff defines a puzzle as "a problem that one cannot solve because of a self-imposed constraint." That is, we can become enmeshed in seemingly unsolvable problems when our view is too narrow. Ackoff thinks more flops come from failing to see the nature of the problem accurately than from failing to solve the problem we see. Thus, the third type of problem solver can be a wise guy – redefining and effectively eliminating the problem by thinking beyond the apparent constraints.

The catch? The better you get at seeing and solving problems conventionally, the harder it becomes to envision a shortcut. So take a breath. And before you invest a lot in finding the optimal solution, give at least a little thought to how to make the whole problem go away.

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