



Strategic business cycle management and organizational performance: a great unexplored research stream

Philip Bromiley University of California-Irvine, USA

Peter Navarro University of California-Irvine, USA

Pedro Sottile University of California-Irvine, USA

Introduction

... the impact of the business cycle on firm strategy has been neglected in strategy research. (Mascarenhas and Aaker, 1989: 199)

This lament is as true today as it was almost 20 years ago. Indeed, most scholars continue to ignore one of the most important, but least developed, research streams in all of management strategy and organizational science – strategic business cycle management (BCM).

BCM involves the application of a set of typically countercyclical prescriptive behaviors that, when applied in a timely way over the course of the business cycle, can improve the performance of an organization relative to rivals. For example, countercyclical advertising in a recession may help increase market share and build brand identity (Dhalla, 1980), countercyclical hiring during a recession may help build a lower-cost, higher-quality workforce (Greer, 1984) and an organization that cuts production and inventories in anticipation of a recession may cut costs relative to rivals that do not (Navarro, 2004).

Despite the performance claims of the prescriptive BCM literature, BCM research remains relatively rare, Balkanized in its treatment by functional silo, significantly lacking in empirical testing and considerably hampered by the lack of any unified general theory that explains observed BCM heterogeneity across organizations. After more than five years of case work and empirical study in which we have identified and tested potential causal links between prescriptive BCM and organizational performance (Navarro, 2004, 2005, 2006; Navarro et al., 2006), we find this lack of scholarly attention to BCM both puzzling and exciting. It is puzzling because BCM involves all functions of the organization; thus, it should

interest scholars in areas ranging from organizational theory, business strategy and human resources to marketing, managerial cognition, operations management and origination theory. It is exciting because the evidence to date, scant though it may be, strongly suggests that BCM behaviors related to staffing, production levels, supply chain management, acquisitions, capital expenditures, capital structure, finance, advertising and pricing may all influence organizational performance.

Our own research likewise indicates that many organizations appear deficient in handling BCM. Only a minority of organizations appear to use BCM-sensitive practices. Surprisingly, even organizations that successfully practice BCM in some functional areas, e.g. marketing or capital finance, may not adopt related BCM practices in other functional areas, e.g. staffing or inventory control.

This essay introduces the broader research community to the state of, and current findings in, BCM research and proposes a research agenda. Our goal is to motivate management scholars to further develop this largely overlooked but incredibly fecund research stream.

The business cycle defined

The prescriptive BCM literature seeks to exploit movements of the economy to gain competitive advantage over rivals, typically through the application of countercyclical behaviors in anticipation of (or reaction to) key business cycle turning points.

Economists generally measure the business cycle by changes in 'real gross domestic product', GDP adjusted for inflation. Figure 1 illustrates the four distinct phases of the business cycle: expansion as the economy grows, a turning point 'peak' where the expansion stops, a downward movement as the GDP growth rate begins to decline, another turning point 'trough' that marks the end of the contraction and a 'recovery' or upturn in which the economy once again expands toward full employment. The figure also illustrates that in some cycles the economy grows extremely quickly (a 'boom') and in some it may decline precipitously (a 'bust').

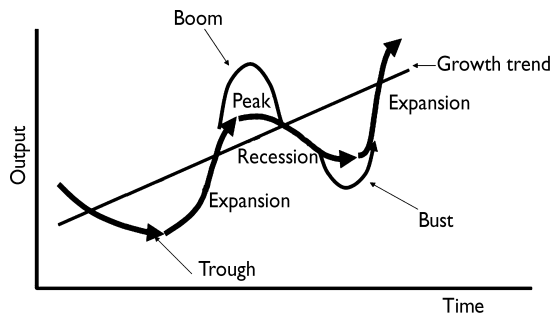


Figure 1 The typical business cycle and its turning points

It is essential to note that 'the business cycle' does not imply a cycle with consistent periodicity. Both the duration and amplitude of each cycle and its movements vary substantially. In fact, some say business cycles are like fingerprints – no two are alike. This is illustrated in Table 1, which documents the US business cycle since the Second World War.

Columns 2 and 4 document the considerable variability in the duration of expansions and contractions while Columns 3 and 6 indicate significant variability in amplitude. For example, since the Second World War, the shortest contraction lasted just six months (January–July 1980) while the longest spanned 16 months (November 1973–March 1975 and July 1981–November 1982). With respect to amplitude, the maximum smallest quarterly negative growth rate during a contraction has been a relatively mild –1.6 percent (March 2001–November 2001). In contrast, the largest maximum quarterly negative growth was a painful –10.3 percent in the 1957–8 deep recession.

In light of this variability, some scholars have argued that firms cannot accurately forecast the business cycle so they cannot circumnavigate its movements. Consider, for example, this statement, which captures a relatively common belief among management scholars: 'recessions cannot be exclusively and systematically predicted with any reasonable accuracy' (Kane et al., 1994: 22).

The rejection of BCM based on this claim does not, however, pass investigation for two reasons. First, effective BCM need not require that a firm anticipate recessionary and expansionary turning points. Rather, firms may benefit simply by reacting more quickly and appropriately than rivals once a new 'state of economic nature' arrives, e.g. a recession or economic recovery. (As a useful

Table 1 The US business cycle since the Second World War

Dates of contractions	Duration (months)	Maximum negative quarterly growth rate (%)	Dates of expansion	Duration (months)	Maximum positive quarterly growth rate (%)
Nov. 48–Oct. 49	11	–5.5	Oct. 49–Jul. 53	45	17.6
Jul. 53–May. 54	10	–6.3	May. 54–Aug. 57	39	11.9
Aug. 57–Apr. 58	8	–10.3	Apr. 58–Apr. 60	24	10.9
Apr. 60–Feb. 61	10	–5.0	Feb. 61–Dec. 69	106	10.3
Dec. 69–Nov. 70	11	–4.2	Nov. 70–Nov. 73	36	11.6
Nov. 73–Mar. 75	16	–5.0	Mar. 75–Jan. 80	58	16.3
Jan. 80–Jul. 80	6	–7.9	Jul. 80–Jul. 81	12	8.0
Jul. 81–Nov. 82	16	–6.5	Nov. 82–Jul. 90	92	9.8
Jul. 90–Mar. 91	8	–3.2	Mar. 91–Mar. 01	120	7.1
Mar. 01–Nov. 01	8	–1.6			

Sources: National Bureau of Economic Research (NBER) and Federal Reserve Board.

analogy, effective medical treatment does not demand that physicians predict who will fall ill or get injured, but those who obtain timely and appropriate treatment after falling ill or being injured usually have better outcomes than those who do not.)

Second, there have been significant econometric developments in the business cycle forecasting literature whereby researchers have demonstrated an increasing ability to predict movements in the business cycle, albeit with only modest accuracy (e.g. Chauvet and Piger, 2003; Estrella and Mishkin, 1998; Hamilton, 1989; Harvey, 1989; Laurent, 1988).

It follows that any hypothesized inability to forecast business cycles does not stand as a legitimate objection to studying BCM practices. Organizations that either forecast and act in a preemptory manner or simply react appropriately to business cycle changes as they occur may gain an advantage over rivals who do not.

A catalogue of prescriptive BCM behaviors

Table 2 and the text that follows provide a summary of the various prescriptive behaviors by functional silo, as they have been argued or suggested in the literature. Remarkably – and regrettably – few of the studies have offered up any empirical tests of these behaviors and how they might relate to firm performance.

Countercyclical advertising and the product mix

During recessions, most firms cut their advertising budgets. This results in less ‘congestion’ or noise in the marketplace and typically lower advertising rates. Firms that countercyclically increase their advertising during recessions to take advantage of lower rates and reduced congestion are better able to build brand and move product and/or services.

Regarding product mix, consumers tend to be more cautious and risk-averse and tend to put more emphasis on value than style during recessions. In contrast, during expansions, consumers will be more ebullient and less risk-averse and more open to style-oriented marketing and products. Because consumer sentiment changes with the ‘business cycle seasons’, firms can benefit by tailoring their product mix and advertising messages to these changing seasons. For example, during recessions, firms can increase sales by emphasizing products with fewer expensive options and more value.

Countercyclical staffing

Rising unemployment that accompanies a recession deepens the pool of qualified labor and reduces wage pressures. Therefore, countercyclical hiring allows organizations to staff a higher quality workforce at lower wages. In contrast,

firms that continue to hire at premium wages in the late stages of an expansion may increase their cost structure relative to firms that stop hiring or cut back on their workforce in anticipation of a recession.

Why don't workers simply switch jobs after being hired during a recession once the recovery ensues? The literature on labor market inertia acknowledges a 'status quo tendency' in decision-making (e.g. Samuelson and Zeckhauser, 1988; Silver and Mitchell, 1990), while March and Simon (1958) argue that satisfied workers do not search for information on other employment.

Countercyclical production and inventory control

Firms that reduce raw materials purchases, cut production and trim inventories in anticipation of a recession (or as a recession ensues) will reduce their inventory holding costs, costs associated with increased breakage and pilferage, and the incidences of inventory write-downs relative to slower acting rivals. Symmetrically, firms that increase production, increase input purchases and build inventories in anticipation of, or at the beginning of, an economic recovery can meet increased demand with the latest products and styles, as consumer purchases increase and thereby gain revenue opportunities and market share relative to rivals that act or react less quickly.

Countercyclical capital expenditures

Countercyclical investment during a recession can help a firm increase market share and revenues by positioning the firm with adequate capacity as the economy recovers. Firms may also benefit by having the most technologically advanced products ready to ship to market. In contrast, if many firms procyclically invest late in the expansion, a 'bandwagon effect' can create excess capacity and pricing pressures. This is particularly true in highly cyclical industries like semiconductors, petrochemicals and steel. In addition, adding capacity late in an expansion can expose a firm to liquidity problems when a recession ensues, cash flow falls, and the firm is saddled with heavy debt.

Acquisitions and divestitures

Companies acquire other companies for many reasons – to eliminate a rival and boost pricing power, to secure an important factor input, to achieve economies of scale in production or marketing, and so on. Regardless of the purpose of an acquisition, its performance depends on the purchase price. If stock price relative to firm value varies over the course of the business cycle (as co-movements of the stock market and business cycle suggest), firms that acquire when price to value is low should benefit relative to those that buy when price to value is high. Symmetrically, firms that divest during expansionary times when prices are high relative to value may outperform rivals that do not.

Accounts receivable and credit management

The risk of default or late payments on accounts receivable increases during recessions and falls as an expansion approaches, while bankruptcies increase during recessions and decline during expansions. Thus, a firm that tightens credit and aggressively collects accounts receivable in anticipation of a recession may reduce credit losses relative to firms that do not. Symmetrically, a firm may gain sales without undue risk by loosening credit standards in anticipation of an expansion.

Procyclical pricing

Introductory economics courses teach students that the price elasticity of demand measures the proportionate change in the sales of a product from a unit change in price and that when price is highly elastic, a small change in price causes a relatively large change in the quantity demanded. It follows that when firms raise prices when price is elastic (> 1), total revenues (price \times quantity) will fall.

What most introductory economics courses do not teach is that price elasticities can vary over the business cycle. In particular, price elasticities tend to fall during economic booms and rise during recessions (e.g. Harrod, 1936). Accordingly, firms that raise prices during recessions to offset falling revenues and earnings may worsen both problems while losing market share to rivals that procyclically price. On the other hand, firms that procyclically raise prices during expansions as short-run demand price elasticities fall may increase revenues and improve profitability relative to slower acting rivals.

A BCM–performance empirical link?

Our study (Navarro et al., 2006) is the only study we know of that has empirically tested this set of behaviors across functional areas. The analysis used a sample of 70 firms matched in 35 pairs from the S&P 500 Index. We collected the data from an administered questionnaire conducted by MBA students based on detailed questions designed to identify the application – or lack thereof – of the various prescriptive behaviors identified in Table 2 by firms in the sample.

We chose to sample from the population of firms in the S&P 500 Index because they meet the most stringent reporting requirements and have extensive press coverage, making detailed data available. These firms account for approximately three-quarters of the capitalization of the US stock market.

The data extended from February 1999 to December 2003. The interval begins two years prior to the onset of the 2001 recession and extends two years past the official end of that recession, as declared by the National Bureau of Economic Research. Given its length and specific years, this period allows observation of firm performance and BCM behaviors across all business cycle phases.

Table 2 Prescriptive BCM behaviors

BCM functional areas	Key references by functional area	Key BCM activities by functional area
Advertising and product mix	Cundiff (1975) Shama (1978, 1981) Dhalla (1980) Picard (2001) Kypriotakis (2002) Joseph and Richardson (2002) Sorrell (2003) Krishnamurthy (2005) Srinivasan et al. (2005)	Increase advertising during a recession to build brand in a less congested market at lower unit costs Change product mix and advertising messages with business cycle seasons
Staffing	Bright (1976) Greer (1984) Greer et al. (1989) Greer and Stedham (1989) Greer and Ireland (1992) Greer et al. (2001)	Hire during recessions from a deeper labor pool at lower wages Don't hire at premium wages in late stages of an expansion
Production and inventory	Bils & Kahn (1998) McCarthy and Zakrajšek (2003) Navarro (2004, 2006)	Cut raw materials purchases and production and trim inventories in anticipation of a recession and conversely
Capital expenditures	Bromiley (1986) Mascarenhas and Aaker (1989) Ghemawat (1993) Dugal and Morbey (1995) Henderson and Cool (2003)	Countercyclically invest during a recession to ensure adequate capacity and most technologically advanced products upon recovery
Acquisitions and divestitures	Ghemawat (1993) Harford (1999) Rigby and Rogers (2000)	Acquire firms during recessionary times when stock price to value is low. Divest during expansionary times when it is high
Accounts receivable and credit management	Churchill and Lewis (1984) Isberg (2004) Navarro (2005)	Tighten credit/aggressively collect accounts receivable in anticipation of a recession. Loosen credit standards in anticipation of an expansion
Pricing	Harrod (1936) Field and Pagoulatos (1997) Navarro (2006)	Procyclically cut prices during recessions and raise prices during expansions as short-run demand price elasticities rise and fall

We constructed a matched sample using the method of 'polar extremes' (e.g. Hair et al., 1987). The sample included firms selected from subindustries in the S&P 500 Index that have shown the highest and lowest total shareholder's return over the sampling period. This matched sample approach also controls partially for the possibility that cycles influence all companies in a particular industry in somewhat the same manner.

To test the statistical significance of the association of performance and BCM behaviors for the sample, we used two statistically similar but interpretatively different analytical techniques, discriminant analysis and conditional logit analysis. The discriminant analysis provided strong evidence that BCM behaviors such as countercyclical hiring and investment associate positively with firm performance. In addition, the factor analysis suggests firms tend to adopt subsets of the behaviors related to the dimensions of supply, capital management or demand, rather than coherently using the practices across all corporate functions.

Despite the potential practical importance of BCM, our study also suggests that only a minority of firms use BCM-sensitive practices. Perhaps most interesting from an organizational theorist's perspective, even firms that successfully practice BCM in some functional areas, e.g. marketing or capital finance, may not adopt related BCM practices in other functional areas, e.g. human resources or inventory control. That is, just as many firms exist in a Balkanized structure by function, so, too, does the practice of BCM across functions. How might this be explained from an organization-theoretic perspective?

One theory begins with the observation that BCM demands a multidisciplinary and integrative approach in a world in which many firms, both by culture and by structure, are functional silo oriented. A second very practical problem is that the planning horizons for the effective application of BCM behaviors vary markedly across functional areas.

For example, countercyclical BCM in the areas of marketing, production and staffing tend to take place in a two- to three-quarter planning horizon. In contrast, countercyclical capital expenditures may take place over a six- to eight-quarter planning horizon. These differing planning horizons vastly complicate proper BCM timing.

A third issue is that the application of BCM is marked by high uncertainty. The economic forecasting upon which BCM inevitably must be based is marked by a high degree of uncertainty. Complicating matters further is that the deployment of forecasting resources can be an expensive endeavor which small- to mid-size firms may not want to shoulder.

Still a fourth issue that follows from our earlier observations that the business cycle lacks periodicity and that expansions tend to last significantly longer than recessions is that effective BCM may be difficult to learn because business cycle movements are infrequent. Consider the recent economic history from 1992 to 2006. During this period, the US economy experienced only one, relatively brief economic recession; and management executives have had less

opportunity to hone BCM skills than in previous, far more turbulent, times such as the stagflationary 1970s and the Great Depression of the 1930s.

The broader point is that the failure of many firms to effectively apply BCM raises a number of very interesting organizational-theoretic issues – with collateral and very interesting theoretical and empirical implications.

Research challenges in BCM

Our research to date supports the conclusions that firms differ in BCM behaviors and that BCM behaviors influence firm performance. These conclusions open three major directions for future research: (1) to understand further the ties between BCM and performance; (2) to explain why many firms use BCM in some areas but not others; and (3) to explain why some firms use BCM and others do not. In exploring these major directions, empiricists may want to:

- Study whether there are additional BCM behaviors not identified in the prescriptive literature that might allow firms to take advantage of business cycle effects.
- Conduct more sophisticated tests of the impact of BCM activities on performance with a sharper, more definitive focus on causality.
- Test the impact of BCM behaviors on performance using larger samples and historical data across multiple recessions and expansions.
- Conduct functional studies to improve BCM activities, e.g., what constitutes optimal inventory management over a recession?
- Examine BCM tradeoffs. For example, extremely high sensitivity to potential recessions may cause the firm to make changes for anticipated recessions that do not occur. Extremely low sensitivity may cause the firm to ignore recessions and suffer the consequences.

Looking at the BCM literature more broadly, almost no research to date has examined what determines whether a firm uses BCM or not. This, however, is an extremely important question. In this regard, the organizations literature offers a variety of more general theories to explain the use, or lack thereof, of BCM. Four possible theories include (but are not limited to):

1. *Simple randomness*: Firms that may be observed to engage in BCM behaviors may do so simply by chance rather than strategic intent.
2. *Founding date*: Typically, firms founded in any given era tend to have similar fundamental policies; for example, whether they employ union or non-union labor or put salespeople on commission or salary. In this regard, Stinchcombe (1965) finds many of a firm's fundamental policies become established in their early years. Potentially, therefore, firms founded in a recessionary era may have better BCM rules than other firms founded in more expansionary times.
3. *A theory of routines*: The behavioral theory of the firm (BTOF; Cyert and March, 1963; March and Simon, 1958) argues that firms operate largely

through routines, and these routines adapt incrementally to the competitive environment. Because firms differ in their routines, these differences can result in differences in outcomes as the business cycle moves from peak to trough and back to peak. Firms may also adapt their routines to feedback at different rates. During an expansion, one firm may rapidly tune its routines to assume an expansion while another may not.

4. *Management insight and knowledge:* Different firms employ managers of different ages, with different education attainments and different levels of economic training and financial market literacy. Drawing from different experiential bases, firms can be expected to have different beliefs or understandings of the world. In this regard, cognitive work on top management teams (TMTs) demonstrates that TMTs collectively differ in their beliefs across firms and that differences in managerial beliefs do influence strategic choices. Potentially, managers may have different beliefs about the benefits of BCM in a particular area of application, and some may not even have considered the issue.

These four briefly sketched theories notwithstanding, we are quick to note here that the development of a more general and unified theory of BCM should be high on the list of organizational and strategy theorists seeking to legitimize BCM as a research stream.

Concluding comments

How firms pursue strategies that take advantage of time-specific opportunities, such as whether to enter an industry during an upturn or downturn, is one of the great unexplored themes of strategic organization. (Mathews, 2006: 97)

This essay has reflected upon the current state of BCM research and organizational practice. In doing so, we have largely focused on a general set of questions that may be of interest to different management disciplines. Nonetheless, it should also be obvious that much of the research conducted in the area of BCM will necessarily be both multidisciplinary and integrative – particularly if a more general theory of business cycle management is to be developed and formalized.

This multidisciplinary imperative poses obvious challenges for a traditional research paradigm that is dominated by specialization and functional silo inquiry. If, however, heterogeneity in firm-specific BCM capabilities does indeed represent an important discriminator in firm performance, it is essential that researchers overcome these obstacles and broaden and deepen what, as Mathews (2006) suggests, is arguably one of the ‘great unexplored’ research streams in all of management.

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Philip Bromley is a Dean's Professor in Strategic Management at the Merage School of University of California, Irvine. Previously he held the Curtis L. Carlson Chair in Strategic

Management and chaired the Department of Strategic Management and Organization at the University of Minnesota. He has published widely on organizational decision-making and strategic risk-taking. He has served on the editorial boards of *Academy of Management Journal*, *Organization Science*, *Strategic Organization* and the *Journal of Management* and as associate editor for *Management Science*. He currently serves on the board of *Strategic Management Journal* and edits the Blackwell series on 'Theories of Strategic Management'. His current research examines strategic decision-making, the microstructure of competition, the behavioral foundations of strategic management research and corporate risk-taking. His most recent book, *Behavioral Foundations for Strategic Management* (Blackwell, 2004) argues for a behavioral basis for scholarly theory in strategic management. Address: University of California-Irvine, Merage School of Business, Irvine, CA 92697, USA. [email: bromiley@uci.edu]

Peter Navarro is a business professor at the University of California-Irvine, a regular CNBC contributor and author of *The Coming China Wars*. Professor Navarro's other books include *The Well-Timed Strategy* (Wharton School Publishing, 2006) and *If It's Raining in Brazil, Buy Starbucks* (McGraw-Hill, 2002). Navarro's expertise lies in his 'big picture' application of a highly sophisticated but easily accessible macroeconomic analysis of the business environment and financial markets for investors and corporate executives. His articles have appeared in a wide range of publications, including the *Journal of Economic Perspectives*, *Harvard Business Review*, the *Sloan Management Review* and the *Journal of Business*. Address: University of California-Irvine, Merage School of Business, Irvine, CA 92697, USA. [email: pn@peternavarro.com]

Pedro Sottile is a PhD candidate in the area of finance at the Paul Merage School of Business, University of California at Irvine. His main areas of interest are international and corporate finance. His current work spans empirical and strategic analysis about the relationship among international and domestic players, and political determinants of sovereign distress and default. Address: University of California-Irvine, Merage School of Business, Irvine, CA 92697, USA. [email: psottile02@merage.uci.edu]
