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Excerpt

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**I** | *Bases of strategic management*

# 1 | *The strategic management field*

## Historical origins of the term “strategy”

Strategy as a term was coined in Athens around 508–7 BC, where ten *strategoí* comprised the Athenian war council and yielded both political and military power. Etymologically, *strategos*, or general, derives from *stratos* (the army) and *agein* (to lead). So, in this original sense, “strategy” is “the art of leading the army.” Concerns of early writers on strategy such as Aenias Tacticus, Pericles, and Xenophon included the qualities of effective *strategoí*, principles of employing the troops, and wider strategic goals such as Pericles’ admonition about the “need to limit risk while holding fast to essential points and principles.” According to Xenophon, moreover, a commander “must be ingenious, energetic, careful, full of stamina and presence of mind, loving and tough, straightforward and crafty, alert and deceptive, ready to gamble everything and wishing to have everything, generous and greedy, trusting and suspicious.” An essential attribute of aspiring *strategoí* was “knowing the business which [they] propose to carry out.” A general was expected not only to plan for battle, but also to lead the troops into battle himself (Cummings 1993).

Parallel developments in Asia included Sun Tzu’s *Art of War*, dated to around the 5th century BC (Sawyer 1996). Sun Tzu emphasized meticulous planning, the ideal of vanquishing the enemy indirectly without the need to fight, the qualities of effective generals, advice on managing the troops, and general principles and tactics of engaging with the enemy.

While strategy has originated in the military sphere, since the 1960s it has risen into prominence in the business world. Top executives of multidivisional corporations such as Chester Barnard of AT&T (1938) and Alfred Sloan of General Motors (1963) were among the first to draw attention to the need for strategy within a business context. Drucker (1954) argued for an active approach to management which entailed

planning and actions intended to shape a firm's environment as opposed to simply reacting passively to it. The sociologist Philip Selznick (1957) at around the same time proposed the notion of an organization's "distinctive competence," which would become a central concept of the resource-based view of the firm (Wernerfelt 1984).

There are indeed good reasons for positing effective strategy as a cornerstone of high-performing organizations. Research has shown that a firm's strategy is the most important determinant of its performance; industry context is important to performance, but not as important as firm strategy (Bowman and Helfat 1998; McGahan and Porter 1997; Rumelt 1991). Some companies in very tough industries consistently deliver higher performance than their competitors, and this is because of the particular strategies they adopt at the global, corporate, business, and functional levels.

### Classic authors on strategy

In 1912, the Harvard Business School began offering a course in "Business Policy," intended to be a capstone course integrating the functional knowledge that the students had gained in earlier study. Alfred Chandler of the Harvard Business School, in his classic *Strategy and Structure* (1962), explored how large businesses adapted their administrative structures to accommodate strategies of growth. In this work he gave a basic definition of strategy and structure which would have long-lasting resonance in the field: "strategy can be defined as the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals... Structure can be defined as the design of organization through which the enterprise is administered" (1962: 15–16). Chandler also suggested, based on his data, that "structure follows from strategy and that the most complex type of structure is the result of the concatenation of several basic strategies" (1962: 16).

Learned *et al.*, also at Harvard, in their *Business Policy: Text and Cases* (1965–9) echoed Chandler when they defined strategy as "the pattern of objectives, purposes, or goals and major policies and plans for achieving these goals, stated in such a way as to define what business the company is in, or is to be in and the kind of company it is or is to be" (1965–9: 15). They viewed strategy formulation as a process

interrelated but practically distinct from strategy implementation, a distinction that has been questioned by strategy scholars, even those aligned with industrial organization economics such as Michael Porter, who has asserted that “there is no meaningful distinction between strategy and implementation, because strategy involves fine-grained choices about how to configure particular activities and the overall value chain” (1999: 25). In formulating strategy, Learned *et al.* proposed that managers should balance external market opportunity with internal firm competence and resources, managers’ personal values and aspirations, and obligations to stakeholders other than the stockholders. Strategy could then be implemented through mobilizing resources, exhibiting leadership, and configuring the appropriate organization structure, incentives, and control systems. This broad approach was consistent with that of Chandler, and incorporated Selznick’s concept of “distinctive competence” as well as the idea of an uncertain environment.

Also in the mid-1960s, Igor Ansoff, in his *Corporate Strategy* (1965) argued that strategy provided a “common thread” for five interrelated issues – (1) product-market scope, (2) growth vector, (3) competitive advantage, (4) internally generated synergy, and (5) make or buy decisions – and stressed the need for mutual reinforcement among these choices. Ansoff proposed the well-known product – mission matrix as a way for firms to define the common thread of their own strategy. This framework has nevertheless been popular as a means of identifying avenues for growth (figure 1.1).

	<i>Present product</i>	<i>New product</i>
<i>Present mission</i>	<b>Market penetration</b>	<b>Product development</b>
<i>New mission</i>	<b>Market development</b>	<b>Diversification</b>

**Figure 1.1** Ansoff’s product/mission matrix

*Source:* Ansoff (1965).

The major pedagogical approach to the study of strategy at Harvard consisted of case studies combined with industry notes, an approach followed later by most other business schools. This approach reinforced the notion that strategy had to be determined inductively on a case-by-case basis, depending on both the specific internal capabilities of each company and its particular external environment. This approach assumed that the complexity of strategic decisions meant that it would be difficult if not impossible to establish useful generalizations.

Strategic decisions such as divestments, new product launches, acquisitions, and overseas expansions do involve what has been referred to as “wicked” problems (Mason and Mitroff 1981). Strategic decisions involve issues that are inherently ambiguous and unstructured, complex, have organization-wide implications and interconnections, are fundamental to the welfare of the organization, and often involve significant organizational change. By comparison, operational decisions are routinized, operationally specific, and may involve smaller-scale change.

Work by these early authors established the main parameters for how the subject of strategy would be understood and researched in the next few decades. These parameters included the link between strategy and performance, the importance of internal capabilities and resources as well as external environment, the distinction between formulation and implementation, and the active role of managers in setting and realizing strategy.

### **The entry of consulting firms**

While academics determined how strategy was to be taught in business schools, their insistence that strategy was idiosyncratic to each individual firm, meant that the growing business demand for standardized strategic frameworks could be addressed by consulting firms, who used this opportunity to exercise substantial influence on the practice of strategy.

The Boston Consulting Group (BCG), founded in 1963, for example, was a pioneering consultancy that introduced influential concepts such as the “experience curve” and the “growth-share matrix” (Stern and Stalk 1998). The experience curve concept held that total costs would decline by a certain percentage every time cumulative production doubled. This idea spurred corporations to expand aggressively their

capacity, focus on cost minimization, and seek higher demand, often by keen price competition. However, when inevitable market downturns occurred or innovative products were introduced, the flaws of this approach became apparent. Companies found themselves with excess capacity and outdated product designs, as well as reduced capacity for innovation given their previous focus on cost-cutting. More criticism ensued. According to Ghemawat (2000: 9), “the concept of the experience curve was also criticized for treating cost reductions as automatic rather than something to be managed, for assuming that most experience could be kept proprietary instead of spilling over to competitors, for mixing up different sources of cost reduction with very different strategic implications (e.g., learning vs. scale vs. exogenous technical progress), and for leading to stalemates as more than one competitor pursued the same generic success factor.”

The growth-share matrix viewed companies as a portfolio of businesses and was intended to help senior managers identify the cash-flow requirements of different businesses and take resource allocation decisions about them. When using the growth-share matrix, businesses are grouped in strategic business units (SBUs) (a term introduced at a later stage by the CEO of General Electric for use in their own portfolio analysis tools) and are mapped on a matrix along two dimensions: industry growth rate and relative market share. The SBUs are then divided into “stars,” “question marks,” “cash cows,” and “dogs” (figure 1.2).

BCG assumed that competitors with larger market shares would have the lowest costs and highest profits, and that in growing markets

	<i>High share</i>	<i>Low share</i>
<i>High growth</i>	<b>Star</b>	<b>Question mark</b>
<i>Low growth</i>	<b>Cash cow</b>	<b>Dog</b>

**Figure 1.2** Boston Consulting Group’s growth-share matrix

*Source:* Boston Consulting Group.

a company should try to capture most of the growth by growing faster than its competitors, so that when growth slowed down, it would emerge as the highest-share competitor. Based on these assumptions, the strategic implications of the BCG matrix were that cash from “cash cows” should be used to support selected “question marks” and to strengthen emerging “stars,” the weakest “question marks” should be divested or liquidated, the company should exit from “dog” industries, and that the company should have a balanced portfolio of “stars,” “cash cows,” and “question marks.”

Companies that followed these recommendations blindly made important strategic errors. One reason is that it is too simplistic to take important investment decisions based on just two, historically oriented dimensions. The historical performance of business or the historical growth pattern of markets were not guaranteed to continue along the same trajectory in future. Secondly, the relationship between market share and cost savings is not as straightforward as assumed by the growth-share matrix, for example in industries using low-share technologies such as mini-mills or micro-breweries, and in industries benefiting from computer-assisted manufacturing (CAM). Thirdly, even “cash cows” may require substantial investment to be kept competitive; for example, the motor vehicle industry is indeed low-growth and relatively consolidated, but it is also characterized by cut-throat competition. If the leading competitors reduce their investment in new vehicle designs, and product or process innovations in general, they are likely to be quickly overtaken by other more capable competitors. Lastly, portfolio planning techniques tend to view businesses as free-standing entities, and thus ignore any potential or actual synergies between them.

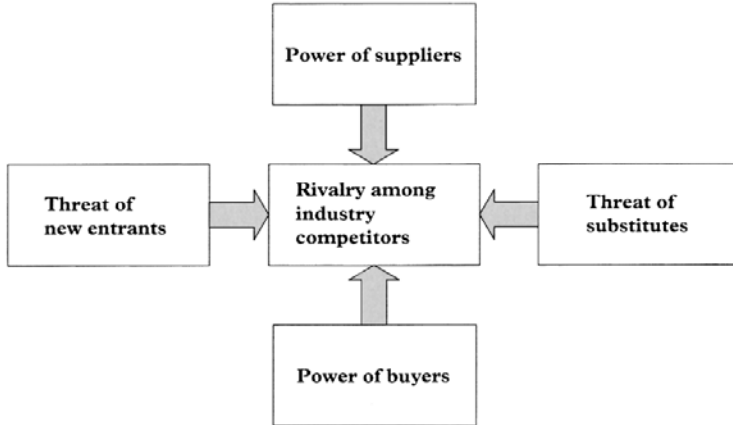
Improved models of portfolio planning techniques have been developed, which address some of the above flaws, one example being the McKinsey/GE matrix. Even though such models are definite improvements over the BCG matrix, in that they address a much higher number of relevant dimensions of industry attractiveness and business strength, they still have some drawbacks. They still tend to regard businesses as independent, downplay diversification as a strategy for creating value since they focus on existing businesses, and undervalue the need to leverage distinctive competencies and resources across business units to achieve synergies.

A significant alternative approach is Hamel and Prahalad's view of the corporation as a portfolio of *core competencies* as opposed to a portfolio of businesses (Hamel and Prahalad 1994). Building on the resource-based view of the firm (Wernerfelt 1984), this view has important implications for investment decisions that are quite different from the implications arising from using portfolio tools such as the BCG matrix. The aim shifts from strict maximization of financial performance of SBUs in the short term, to longer-term investment in the nurturing and creation of core competencies across SBUs that can enable the company to be a winner in the future; they thus focus on "opportunity share" rather than simply market share.

### **The industrial organization model**

Meanwhile, developments in the academic sphere continued. Two streams of strategy research are particularly worth noting because of their significant influence on the field: the industrial organization model, and the resource-based model. The industrial organization (IO) model focuses on the industry structure or attractiveness of the external environment, suggesting that the performance of any firm is largely determined by market characteristics (Porter 1980). Economists have traditionally assumed a situation of perfect competition, where several equally capable competitors would gradually eliminate super-normal profits, and the choice of competing firms would be either to produce efficiently and price at cost, or exit the industry. This emphasis has downplayed the empirically differential internal capabilities of firms, and focused on market structure, leading to the Structure-Conduct-Performance (S-C-P) paradigm (that market structure would determine firm conduct which would determine performance). This was based on research by Edward Mason (1939) and Joe Bain (1951, 1956), two Harvard economists. Bain (1956) identified three main barriers to entry to an industry as a means of explaining why some industries are more profitable than others: absolute cost advantages, product differentiation, and economies of scale. These entry barriers are linked with two out of three "generic" strategies subsequently proposed by Michael Porter, then a joint economics/business doctoral researcher at Harvard: cost leadership, differentiation, and focus (Porter 1980). Michael Porter proposed his well-known "five





**Figure 1.3** Porter's five forces framework for industry analysis

*Source:* Porter (1980).

forces” framework for industry analysis as a more structured way to evaluate industry attractiveness and to explain the differential performance of industries (figure 1.3). Porter's model was an advance over existing understandings of the market in that it emphasized extended competition rather than simply current competitors, in the form of threat from substitute products, as well as offering a memorable, structured framework that could be easily applied.

One subsequent development is the introduction of the concept of “complementors” (Brandenburger and Nalebuff 1996), firms from which customers buy, or suppliers sell, complementary products or services. Porter, however, believes that the relationship of complementors to industry profitability is not “monotonic,” and that it has to be analyzed not as a force in its own right but through its effects on the five forces. He made similar arguments for the role of government, that some have proposed as a sixth force (Porter 2002).

This early research set the foundations for the IO paradigm of strategic management; this includes using the industry as the unit of analysis, addressing the content rather than the process of strategies, methodologically employing archival data longitudinally, and posing the dominant inference pattern that industry structure sets limits on firm performance (Jemison 1981).

The realization that profitability differences within industries can be even greater than across industries, led to research on strategic groups

(Hunt 1972) that aimed to explain this differential. Companies within the same strategic group follow the same or similar strategies along certain dimensions (Porter 1980: 129), and movement from one strategic group to another is hindered by so-called “mobility barriers” (Caves and Porter 1977), a similar concept to “barriers to entry.”

Another aspect of industries highlighted by IO research is that they can be fragmented or consolidated to various degrees. Fragmented industries are often characterized by low entry barriers and commodity-like products. Consolidated industries, on the other hand, have higher entry barriers and are composed of interdependent firms. Industry structure is dynamic; industries can move from being fragmented to more consolidated after an industry shakeout; or they can become fragmented after the entry of new competitors enabled by environmental shifts such as deregulation or the availability of new technologies or new distribution channels.

### **Porter’s value chain and generic strategies**

Michael Porter also developed the value chain as a tool for analyzing an organization’s internal activities. This represents the flow of activities that results in a product or service of value to the customer. “Primary” activities relate to manufacturing, marketing, sales, and service, and “support” activities relate to infrastructure (structure and leadership), human resources, research and development, and materials management. Use of the value chain can enable a company gain a deeper understanding of where its distinctive value-adding competencies lie, or identify problems with its functioning. Porter has shown how successful strategies involve clear choices as well as mutual reinforcement among a firm’s internal activities (Porter 1996). For example, a successful strategy of cost leadership involves cost control in all of a firm’s activities which are mutually reinforcing to deliver a product or service of sufficient quality at a lower cost than most or all competitors.

With regard to generic strategies, Porter argues that “the fundamental basis of above-average performance in the long run is sustainable competitive advantage... there are two basic types of competitive advantage a firm can possess: low cost or differentiation... combined with the scope of activities for which a firm seeks to achieve them lead to three generic strategies... Each of the generic strategies involves a