



Michael Porter Asks, and Answers: Why Do Good Managers Set Bad Strategies?

Published : November 01, 2006 in [Knowledge@Wharton](#)

Errors in corporate strategy are often self-inflicted, and a singular focus on shareholder value is the "Bermuda Triangle" of strategy, according to Michael E. Porter, director of Harvard's Institute for Strategy and Competitiveness.

These were two of the takeaways from a recent talk by Porter -- titled "Why Do Good Managers Set Bad Strategies?" -- offered as part of Wharton's SEI Center Distinguished Lecture Series. During his remarks, Porter stressed that managers get into trouble when they attempt to compete head-on with other companies. No one wins that kind of struggle, he said. Instead, managers need to develop a clear strategy around their company's unique place in the market.

When Porter started out studying strategy, he believed most strategic errors were caused by external factors, such as consumer trends or technological change. "But I have come to the realization after 25 to 30 years that many, if not most, strategic errors come from within. The company does it to itself."

Destructive Competition

Bad strategy often stems from the way managers think about competition, he noted. Many companies set out to be the best in their industry, and then the best in every aspect of business, from marketing to supply chain to product development. The problem with that way of thinking is there is no best company in any industry. "What is the best car?" he asked. "It depends on who is using it. It depends on what it's being used for. It depends on the budget."

Managers who think there is one best company and one best set of processes set themselves up for destructive competition. "The worst error is to compete with your competition on the same things," Porter said. "That only leads to escalation, which leads to lower prices or higher costs unless the competitor is inept." Companies should strive to be unique, he added. Managers should be asking, "How can you deliver a unique value to meet an important set of needs for an important set of customers?"

Another mistake managers make is relying on a flawed definition of strategy, said Porter. "'Strategy' is a word that gets used in so many ways with so many meanings that" it can end up being meaningless. Often corporate executives will confuse strategy with aspiration. For example, a company that proclaims its strategy is to become a technological leader or to consolidate the industry has not described a strategy, but a goal. "Strategy has to do with what will make you unique," Porter noted. Companies also make the mistake of confusing strategy with an action, such as a merger or outsourcing. "Is that a strategy? No. It doesn't tell what unique position you will occupy."

A company's definition of strategy is important, he said, because it predefines choices that will shape decisions and actions the company takes. Vision statements and mission statements should not be confused with strategy. Companies may spend months negotiating every word, and the results may be valuable as a corporate statement of purpose, but they do not substitute for strategy.

In the last 10 years or so, Porter added, companies have become increasingly confused about corporate goals. The only goal that makes sense is for companies to earn a superior return on invested capital because that is the only goal that aligns with economic value.

Recently, companies have developed "flaky metrics of profitability," he said, pointing to amortization of



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

good will as an example. Some of these measures began as a way for managers to stay a step ahead of the demands of Wall Street. "What starts as a game for capital markets then starts to confuse the managers themselves. They [then] make decisions that are not based on fundamental economics."

Porter said the "Bermuda Triangle of strategy" is confusion over economic performance and shareholder value. "We have had this horrendous decade where people thought the goal of a company is shareholder value. Shareholder value is a result. Shareholder value comes from creating superior economic performance."

To think that stock price on any one day, or at any one minute, is an accurate reflection of true economic value is dangerous, he noted. Research shows companies can be undervalued for years. Conversely, during the Internet bubble, managers whose motivation and compensation were tied to stock price began to believe and act as if the share price determined the value of the company. Managers are now beginning to understand the goal of their companies is to create superior economic performance that will be reflected in financial results and eventually the stock price. "We know there's a lag and it's ugly. But it's important that a good manager understands what the real goal is -- not spend time pleasing the shareholders."

Corporate strategy cannot be done without strong quantitative analysis, said Porter, adding that each year students take his strategy course thinking they will have at least one class in which they don't have to worry about numbers. Not true. "Any good strategy choice makes the connection between the income and the balance sheet."

Right Time, Right Price

Companies hoping to build a successful strategy need to define the right industry and the right products and services. Bad strategy often flows from a bad definition of the business, said Porter.

He pointed to Sysco Corp., the number-one foodservice supplier in North America. Defining Sysco simply as a food distribution firm would eventually lead to a failed strategy. The industry is actually two distinct sectors. One delivers food to small restaurants and institutions that need help with finance and product selection. The other has large, fast food franchise customers, like McDonald's, that are not interested in any additional services. McDonald's just wants industrial-size containers delivered on time at the best price. Sysco has developed two separate strategies for its two customers.

Geographic focus is another type of business definition that can trip up strategy. He gave the example of a U.S. lawn care company that developed a plan to grow through international expansion. The business, however, was not suited to operating on a global scale. The products were bulky and expensive to ship, and the company had to deal with different retail channels in different regions.

One more mistake managers make is confusing operational effectiveness with strategy. Operational effectiveness is, in essence, extending best practices. Good operations can drive performance, Porter said, but added: "The trouble with that is it's hard to sustain. If it's a best practice, everybody will do it, too."

None of this is easy, he conceded. "The real challenge of management is you have to do these things together at the same time. You have to keep up with best practices while solidifying, clarifying and enhancing your unique positions."

Managers often tend to let incremental improvements in operations crowd out the larger strategy of building a unique business that will retain its competitive advantage, Porter noted. To bypass this problem, managers must keep the competitive strategy in mind at all times. "Every day, every meeting, every decision, has to be clear.... Is this an operational best practice or is this something that's improving on my strategic distinction?"

He went on to describe key principles of strategic positioning, including a unique value proposition, a tailored value chain, clear tradeoffs in choosing what not to do, and strategic continuation, or ongoing improvement. The underpinnings of strategy are "activities that fit together and reinvigorate each other."

Enterprise Rent-A-Car is an example of a company that stumbled onto its strategy more or less by luck, according to Porter. The company started as an auto-leasing firm, but customers frequently asked if they

could rent cars for short periods. The rental car industry was completely geared toward travelers, with pick-ups at airports and a price structure suited to expense accounts or vacationers willing to splurge.

It is difficult to sustain the kind of strategic advantage Enterprise enjoys without a patent, Porter pointed out. Hertz has tried to connect with this business but remains geared toward the traveler and cannot compete with Enterprise in its specific market.

Porter stressed that continuity is critical to successful strategy. "If you don't do it often, it's not strategy," said Porter. "If you don't pursue a direction for two or three years, it's meaningless." Many companies start out with a good strategy, but then grow their way into failure, Porter continued. Research shows that among companies that fade in 10 years, many enjoyed phenomenal growth in the beginning, but then put growth ahead of sticking to their strategy.

Dividends are one way to avoid the pressure to boost stock price with rapid growth, Porter said. Dividends also return capital to all investors, not just short-term investors who benefit from trading on gains in share price.

Leadership and Strategy

Porter cited some capital market biases that result in barriers to strategy. First, Wall Street tends to create pressure for companies to emulate their peers. He said analysts often anoint a star performer in each industry, which encourages others to follow that company's game plan. Again, this leads to the no-win approach of companies competing on the same dimensions, not on unique strategies.

Analysts also tend to choose metrics that are not necessarily aligned with true value or meaningful for all strategies, said Porter, noting that analysts apply pressure to grow fast and have a strong bias toward deals, which lead to a quick bump in the stock early on. Managers are made to feel like "Neanderthals" if they resist mergers and acquisitions or other financial market tactics, he added. "What happened in a lot of companies was that the equity compensation was [tied to share price] and people became crazed and very attentive to these biases. All the corporate scandals came from pressure to do things that were stupid."

Other barriers to strategy include industry conventional wisdom; labor agreements or regulations that constrain choice; inappropriate cost allocation to products or services, and rapid turnover of leadership. Increasingly, he is struck by how important leadership is to strategy. "Strategy is not something that is done in a bottom-up consensus process. The companies with really good strategy almost universally have a very strong CEO, somebody who is not afraid to lead, to make choices, to make decisions." Strategy is challenged every day, and only a strong leader can remain on course when confronted with well-intentioned ideas that would deviate from the company's strategy. "You need a leader with a lot of confidence, a lot of conviction and a leader who is really good at communication."

Years ago, corporate strategy was considered a secret known only by top executives for fear competitors might use the information to their advantage, said Porter. Now it is important for everyone in the organization to understand the strategy and align everything they do with that strategy every day. Openness and clarity even help when coping with competition. "It's good for a competitor to know what the strategy is. The chances are better that the competitor will find something else to be unique at, instead of creating a zero-sum competition."