Essentials of Strategic Management

Effective Formulation and Execution of Strategy

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1 Strategic Management Foundations

Learning Objectives

After studying this chapter, you should be able to

- explain triggering events for companies to rethink their strategic orientation.
- understand the roots of strategy and their relevance for management today.
- describe different business views of strategy and how they can be linked.
- explain the six principles of strategy and their relevance for strategic management.
- explain ways for measuring competitive advantage and company performance.
- outline foundations of decision making and apply them to strategic situations.
- understand the impact of cognitive biases and recommend how to deal with them.
- explain the evolution, schools of thought and paradigms of strategic management.
- describe the wheel of strategy framework and explain its interrelated components.
- explain how to make strategic management effective and describe its resulting benefits.

1.1 What Is Strategy?

Outperforming competitors and long lasting survival

How does a company outperform its competitors and win in the market? How can it perform well for a prolonged period of time and ensure long-lasting company survival? These are definitely not easy questions to answer. Only few companies have remained in the market and been successful forever and a day. An example is the Bavarian state brewery Weihenstephan, which celebrated its 970th birthday in 2010 and is the oldest company in Germany. Another long-term performer is the Merck Group. Founded in 1668, it is not only the oldest pharmaceutical and chemical company in the world but also ranks among the world's leading firms in this industry today. Other multinational companies like Bosch, Daimler, Henkel or Siemens have been writing their success stories for more than 100 years. On the other hand, firms such as AEG, Chrysler, Nixdorf Computers, Kodak, and Agfa that used to be famous for their innovative products in times past have gone out of business, were swallowed up by others or had to sell major divisions.

Strategic Snapshot 1.1

"Few large corporations live even half as long as a person"

"Few large corporations live even half as long as a person. In 1983, a Royal Dutch/Shell survey found that one third of the firms in the Fortune '500' in 1970 had vanished (de Geus 1988). Shell estimated that the average lifetime of the largest industrial enterprises is less than forty years, roughly half the lifetime of a human being! The chances are fifty-fifty that readers of this book will see their present firm disappear during their working career. In most companies that fail, there is abundant evidence in advance that the firm is in trouble. This evidence goes unheeded, however, even when individual managers are aware of it. The organization as a whole cannot recognize impending threats, understand the implications of those threats, or come up with alternatives."
(Source: Senge 1990: 17)

Average life span of companies

Looking at the average life span of major companies actually reveals a sobering picture. For example, less than 15 % of the largest companies in the US listed in 1917 in Forbes Magazine still exist today. The rest vanished from the business landscape because they either have been taken over by other companies or gone out of business. Looking at even so-called world-class companies identified by Peters and Waterman or by Collins and Porras in their bestselling books "In Search of Excellence" or "Built to Last" reveals a similar picture. Only a minor portion of all companies perform well over several decades (Watson 2012: 287; Foster/Kaplan 2001: 7 f.). The average life span of companies in Europe is about 12 years, 28 years if they are publicly listed on a stock exchange, and 48 years if they are large corporations with more than 10,000 employees or $5 billion market capitalization (Stadler/Wältermann 2012: 10). Most companies that were high performers at a certain time are not able to remain superior in the long run, for example, for 10 years or more (Wiggins/Ruefli 2005 and 2002). Why did so many prominent companies vanish from the business landscape or lose the superior performance level they had at a certain time? They have failed to adapt their *strategy* to the changing environment and had to learn that past performance is no guarantee of future success.

Triggering events to rethink strategy

When do companies typically rethink their strategic orientation and engage in a (re-)definition of their strategy? Some triggering events that may act as stimuli for changes in strategy are (Wheelen/Hunger 2010: 24):

- **Performance gap (unmet performance expectations):** Many companies with revenues or profits that are no longer increasing, falling behind major competitors or even decreasing, rethink their strategic orientation to get back on course in the long term. This may also be the case for anticipated future performance issues caused by, for example, advancing competitors or disruptive technologies.
- **Changes in ownership:** New shareholders may alter financial and strategic expectations of the company and require a new strategic orientation. For example, family-owned companies differ significantly from private equity firms when it comes to risk aversion, short- and long-term profit orientation or the desire for appreciation in the community.
- **New anticipated trends:** New trends such as new technologies or changes in customer preferences may make existing strategies ineffective and require new strategic approaches. For example, Nokia underestimated the trend from cell phones

Strategy Practice Example 1.1

CEO Eras and Strategy at Daimler

Diversification was one of the key corporate strategic thrusts of Edzard Reuter in his era of being CEO of Daimler from 1987 to 1995. He wanted to transform the company into an "integrated technology corporation" and diversified Daimler with acquisitions in the aerospace and electrical industries such as MBB, MTU, Dornier, and AEG. His successor, Jürgen Schrempp, changed this diversification strategy and refocused the group onto the automobile business during his 10 years as CEO. He wanted to refocus the corporation and create a world auto giant with a strong shareholder value orientation. Under his leadership, the Daimler-Benz AG merged with the US corporation Chrysler in 1998. Due to unsatisfactory results the era DaimlerChrysler was finished in 2007 by Dieter Zetsche who has become CEO in January 2006. The company was renamed to its current name Daimler AG.

to smart phones and was forced to rethink its strategic position once companies like Apple introduced their new innovations such as the iPhone.

- **New CEO or executive leadership team:** New executives at the helm of companies usually bring in new strategic ideas and approaches (see Strategy Practice Example 1.1). This is similar to what frequently happens in sports when a new coach or manager comes in and fundamentally changes the strategic thrust.
- **Intervention from other external stakeholders:** Interventions from other external stakeholders than customers and competitors such as governments, non-governmental organizations, banks, etc. may have a significant impact on the company. For example, recent decisions of the German government to exit nuclear energy until 2022 and increase the share of renewable energy sources for supply in Germany to 80% by 2050 triggered significant changes in corporate strategy at some German energy corporations such as E.On.
- **More unstable environment:** More and more companies are facing unstable environments with a high degree for volatility. For example, some firms are required to advance their strategic agility and adapt their strategies more frequently than they used to. Other companies such as ZEISS (see 3.2.2.2) may foster diversification to get a balanced risk profile of their businesses portfolio with regard to turbulence in the global economy (see chapter 3.2.2.2).

1.1.1 Origins and Views of Strategy

Multiple applications of the strategy term

Nowadays, the term "strategy" is used in all kind of areas ranging from computer gaming, gardening, Poker as well as food to sports, dating or even housecleaning. This variety of applications makes it hard to develop a common and shared understanding. The same is true in a business context. The range of strategy interpretations reaches from anecdotal statements like "strategy is what makes money"—a perspective of the CEO of a Fortune 500 company in a strategy workshop—to more philosophical understandings like "strategy is revolution; everything else is tactics" (Hamel 1996: 70). Furthermore, the strategy term is frequently related to its origin in military history.

How relevant this might be for tackling today's management challenges will be discussed first followed by a brief overview of some actual views of strategy that can be applied to company practice today.

1.1.1.1 Roots of Strategy

"Stratos" and "agein"

The etymological roots of the term "strategy" go back to ancient Greek (6th/5th century BC) where—based on the terms stratos (army, military force) and agein (to lead)—stratégos was an expression for an army leader or military general. Later on in history, various military leaders referred to militarily motivated strategies in their renowned publications, such as:

- "The Art of War" written by the Chinese military strategist and mathematician Sun Tzu (544–496 BC). Nowadays it is considered the first strategy book in history. One of his important strategy principles is the idea of victory without fight.
- "The Prince" and "About the Art of War" written by the Italian Renaissance political philosopher and historian Niccoló Machiavelli (1496–1527).
- "The Book of Five Rings" written by Miyamoto Musashi (1584–1645), a Japanese swordsman and samurai. One of the important strategy principles he refers to in his famous publication is the importance of situation assessment from a bird's eye perspective.
- "On War" written by the German-Prussian General and military theorist Carl von Clausewitz (1780–1831). He defined strategy as the use of combat for the purpose of war.

Relevance of military strategy principles for business

Figure 1-1 provides some fundamental principles of historic military strategies that seem to be timeless and relevant also for business management today (Kotler/Berger/Bickhoff 2010: 7): Concentration of resources strongly relates to one of the key challenges in management, that is the effective allocation of limited resources. The element of surprise is leveraged by companies in a variety of ways such as establishing a first mover advantage with their products in certain markets or by unexpected mergers, acquisitions, etc. Furthermore, companies elaborate very carefully on which competitive arenas they are playing in, based on their strengths and core competencies. Communication between the top leadership team and the employee base is a key pillar of any modern strategy execution system. The precise coordination of strategic objectives and resources relates to the management approach of strategy and organizational alignment which is vital for making strategies happen effectively. Finally, how companies can gain a substantial advantage through innovation can be seen over and over again by innovative companies launching new technologies, products or business models.

Limitations of military principles for business management

Anecdotally speaking, strategy "arranges strengths, means, time, space and methods in a guiding principle of action. It is, therefore, nothing else but an efficient success plan, whose fundamental elements *What do I want?—What can I do?* and *What do I do?* have not been changed since Seneca's "Want—Can—Dare" *(Note: Roman philosopher, 4 BC–65 AD)*" (Werle 2005: 197). Historical insights from warlords may provide simple and highly generic inspirations for staying on target and capturing new perspectives—that might be useful in, for example, dynamic situations or when

Fig. 1-1

Applicability of military strategy principles for business management

Source: Kotler/Berger/Bickhoff 2010: 7

competing in multiple markets. However, based on a more critical evaluation, those principles provide hardly any answers for solving strategic challenges today. Although many ideas are timeless and valid, they lack uniqueness. The insights are revolutionary for its time but self-evident for most managers today. Most historic strategy ideas are on a high level. They particularly lack precise recommendations for one of the biggest challenges in strategic management, that is execution. Furthermore, "big names" are frequently used for marketing purposes (see Strategic Snapshot 1.2).

Strategic Snapshot 1.2

Return of the "Warlords"

Although the relevance of military principles for solving today's business challenges can be questioned, there are a number of popularized business publications of the last 20 years leveraging historical strategy perspectives. Examples are:

- "Miyamoto Musashis Book of Five Rings. 52 Brilliant Ideas for Your Business" (2012; published in German)
- "Sun Tzu and The Art of Business. Six strategic principles for Managers" (2011)
- "Sun Tzu. The Art of War for Managers. 50 Strategic Rules Updated for Today's Business" (2010)
- "Clausewitz on Strategy. Inspiration and Insight from a Master Strategist" (2001), a publication of the Strategy Institute of the Boston Consulting Group
- "The New Machiavelli. The Art of Politics in Business" (1999).

Practitioners might be inclined to use the supposed credibility of historic military leaders for reducing complexity in strategic decision-making situations. One of the key limitations of military strategies for business is its traditional focus on opponents which is equivalent to focusing only on competitors in markets. Not only does this neglect cooperative strategies for the most part, but also the customer as most important stakeholder for business is not addressed at all. And finally, translating certain rules of war into business is inappropriate today if the recommendations are not compliant with law or ethical principles (Werle 2005).

1.1.1.2 Business Views of Strategy: the 5 P's

To better understand what strategy means in a business context, it is helpful to recognize different interrelated views of strategy that can be found in management practice and science alike (Mintzberg 2000: 23–29, 1987 and 1978). Understanding and integrating those different views is supposed to reduce some of the confusion that comes with the strategy term and establish a foundational terminological framework that will be applied in this book:

- Most practitioners are likely to define strategy as a **plan** that specifies what the company intends to do and when. It is made purposely in advance of the actions to which it applies.
- Others may understand strategy more as a specific competitive move or **ploy** to preempt an opponent's response in a head-on competitive situation. In this understanding it is also a plan but more in a sense of outmaneuvering an opponent in a 1:1 business setting.
- Another understanding of strategy is specifically related to the **position** in the environment that allows an organization to generate sufficient "rent". In practical terms this might be a particular industry or the financially most promising product-market combination within the competitive arena a company focuses its resources on.
- Whereas the position is outside the organization, the understanding of strategy can also be based on a more internal view. Here, strategy is seen as a collective **perspective** in people's minds. It is a kind of shared mental model that builds the strategic orientation of the company.
- A final understanding of strategy as a **pattern** is not related to the intention of people but to the resulting behavior of an organization. Here the key is consistency in behavior, whether intended or not. Successfully realized strategies are not always planned in advance and planned strategies are not always realized (see also chapter 1.1.1.5).

Integrating the 5 P's of strategy

Figure 1-2 provides an attempt to integrate the different views of strategy in a hierarchical order following the strategic planning logic of this book. Strategic guideposts are established by a company's vision, mission and values. They provide a high-level normative direction and strategic context. This is a view of strategy as *perspective*. Framed by the strategic guideposts the company has to decide where and how it wants to compete based on industry and market attractiveness and dynamics as well as its own resources and capabilities. This is the core of formulating corporate and

Fig. 1-2

5 P's of strategy and strategic planning logic

Source: following Simons 18; adapted

business strategies and reflects a view of strategy as *position*. Once certain strategy options have been decided on and strategy is set, it is refined with strategic goals, quantified with metrics and targets, and translated into strategic action programs as well as corresponding budgets and incentives. This is related to the view of strategy as *plan*. Some of those goals or actions may capture certain moves to outwit rivals or fight competitive threats, that is viewing strategy as *ploy*. Finally, strategy is what really happens. The strategic behavior of an organization may have been planned according to the process described or it may emerge unplanned through learning and trial and error. In any case, it is a consistent stream of actions and decisions. This is strategy as *pattern*. By describing how companies like Ikea, Starbucks, Apple or others present themselves in the market, key strategic elements can be clearly identified as they reflect consistency in behavior of those companies. Cornerstones of their strategies are visible for everybody without knowing whether they were ever planned in formal strategy sessions or just emerged over time.

1.1.2 Understanding Strategy with Six Principles

Strategy is a multifaceted phenomenon about how to compete.

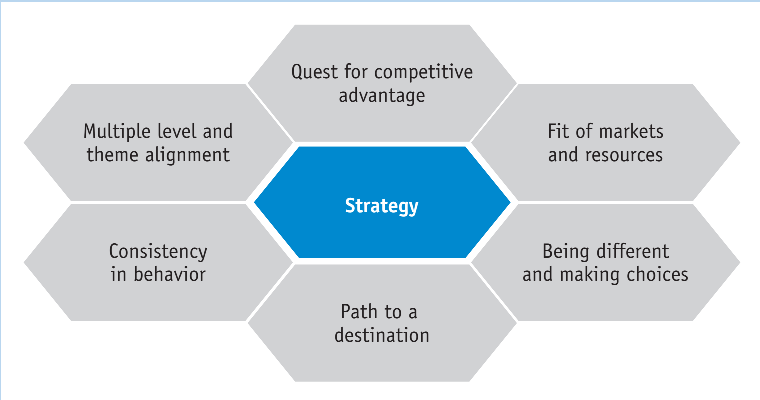
Strategy is a multifaceted phenomenon that can hardly be described with a single definition. The 5 P's described before are a practical and a frequently used consolidation of various views of strategy. Different authors emphasize different elements when they provide their understanding of strategy. A common theme that can be found in most strategy definitions is the idea of competition. Consequently, strategy can be seen as an approach of how to compete. To shed additional light on what strategy is, selected aspects from various understandings of strategy are pointed out. According to certain authors, strategy is about

- the creation of competitive advantage (Ohmae 1982: 36)
- the determination and pursuit of basic long-term goals (Chandler 1962: 13)
- the idea of being different and choosing what to do and what not (Porter 1996: 70)
- the description of a "path" from a current to a targeted future state (Kirsch 1991: 301)
- the integration of an organization and its environment based on consistent patterns of organizational decisions over time (Mintzberg 1978)
- the definition of businesses in which to compete on a corporate level and how to compete on a business level (Andrews 1980: 18 f.).

Instead of trying to formally define what strategy is, these elements are used to derive the six principles shown in figure 1-3. They are supposed to sharpen the strategy concept that is relevant for moving forward and will be explained next.

Fig. 1-3

Six principles of strategy



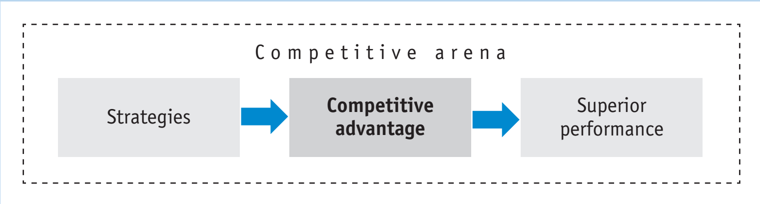
1.1.2.1 Quest for Competitive Advantage

Strategy is about gaining, sustaining and renewing competitive advantage

Most people will agree that strategy makes a major difference between winning and losing in any competitive situation whether it is in business, sports, politics, or others. In business, it helps a company to establish some sort of advantage relative to its competitors that is crucial for outperforming them. As illustrated in figure 1-4, the strategy a company pursues is supposed to lead to competitive advantage, and thus, ultimately to superior performance in a given competitive arena. Strategy is about gaining, sustaining and renewing competitive advantage as a base for superior per-

Fig. 1-4

Relation of strategy, competitive advantage and performance



formance. The question what "superior" performance means is discussed more in detail in chapter 1.1.3.

Gaining competitive advantage—the strategic triangle

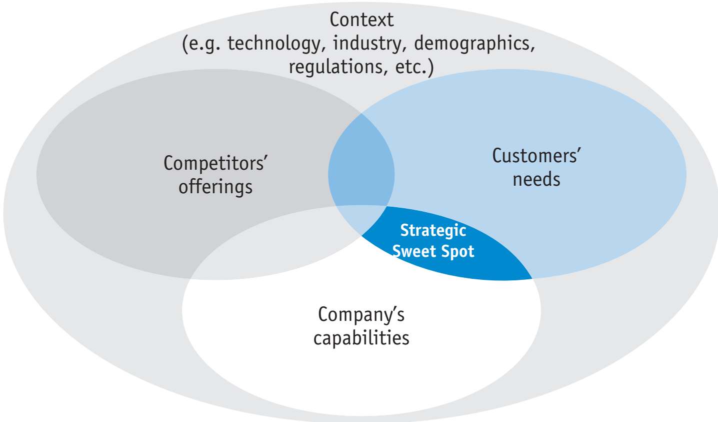
Firms that are capable of providing their customers goods and services that are better, cheaper or delivered faster than those of their competitors are generally more likely to outperform their rivals and win in the market. Companies take strategies to achieve such a competitive advantage, and thus, ultimately superior performance compared to their competitors in the same industry or to the industry average. The competitive advantage a company wants to realize always needs to be assessed relative to other companies competing in the same—clearly defined—competitive arena or market and with respect to the needs and wants of the customer. Simply put, competitive advantage can be created when companies are able to utilize their resources and capabilities for meeting customer needs and delivering customer value in a way their competitors cannot, given the specific context in which they compete. This can also be referred to as the "strategic sweet spot" (Collis/Rukstad 2008: 89). A key principle of any business strategy is to consider these three main players—the so-called "strategic three C's" or "strategic triangle" (Ohmae 1982: 91 f.)—and identify the strategic sweet spot as illustrated in figure 1-5.

Sustaining competitive advantage

Companies typically try to keep their advantage relative to their rivals over a prolonged period of time. In those cases, the companies would have a **sustainable competitive advantage** (Porter 1985: 11). This can be pursued, for example, by making the advantage difficult to understand and hard to imitate by rivals through, for example, a unique business model (see chapter 3.4.4) or by protecting it from imitation with patents, for example. However, a company can typically sustain its competitive advantage only for a certain period of time. As rivals work hard to imitate and neutralize it, protection might only last for a while and then expire. Furthermore, changes and discontinuities in the environment such as technological leaps might erode the advantage. For example, Leica Camera has been renowned for its high quality cameras over a long time. The firm ignored the trend of digital photography technology in the 1990s and tried to compete with high-class analog cameras. This strategy did not work out and lead to a competitive disadvantage. The company—meanwhile recovered—faced a severe crisis, had to look for investors and realized losses of more than €15 million in 2005.

Fig. 1-5

The strategic sweet spot



Source: Collis/Rukstad 2008: 89; adapted

Renewing competitive advantage

Given today's highly volatile and dynamic environment, companies might not be able to or do not strive to sustain competitive advantage for a long time. They focus on continuously building **temporary competitive advantage**—that is a competitive advantage that lasts only for a very short period of time—based on speed, organizational agility and innovation. For example, in the food industry only a few companies focus on radical (breakthrough) innovation based on new to the world products that are proprietary and become blockbusters. Most companies have to work hard to continuously establish temporary advantage based on incremental innovation or so-called renovations, that is slight changes in taste, packaging, or size, for example (Wunder/Bausch 2014a). Also, some companies seek new products or technologies through acquisition strategies as they lack own capabilities to develop true breakthroughs. Firms may even purposely avoid long-lasting competitive advantage or alter their competitive advantage after a while. They do not strive to sustain competitive advantage as it makes them predictable and vulnerable from the perspective of their aggressive competitors. Instead there are pursuing strategies directed toward continuously renewing their competitive advantage (D'Aveni 1994; see also Strategic Snapshot 1.3).

Outside-in versus inside-out

1.1.2.2 Fit of Markets and Resources

In the quest for competitive advantage, a company has two key options for elaborating on strategies. First, it can take an outside-in perspective and try to identify sources for competitive advantage in the industry or market. Hereby, the market a firm decides to compete in and its strategic positioning in this competitive arena are

Strategic Snapshot 1.3

Competitive Advantage—Illustrated With Soccer

In the 2012/13 European soccer season, FC Bayern Munich became the first German team that won the so-called “Triple”, that is the National Championship, the National Cup and the European UEFA Champions League. This means that—in this season—Bayern Munich gained a **competitive advantage** over its rivals based on different sources such as individual players, the total team composition, the coach, as well as effective alignment of what the coach wanted and what the team delivered. The club was able to execute a strategy that led to this competitive advantage, and thus, to superior performance. However, one can also say that the club has been able to realize **sustainable competitive advantage** as they won the National Championship 24 times in 51 years since the foundation of the “Bundesliga” in 1963. The second best teams in this ranking won only five times. Although the players and coaches of Bayern Munich have been continuously changing over the past 51 years, the club was able to outperform its competitors for such a prolonged period of time. In the 2013/14 German soccer season, FC Bayern Munich—now with a new coach named Josep (“Pep”) Guardiola—won the German Championship at the earliest time ever in German Bundesliga history, that is with 77 points at the 27th of 34 games. The new coach did not try to merely sustain the competitive advantage the team gained in the previous season. He changed the strategic system fundamentally in a way that there seem to be no fixed positions for the players anymore. In and between matches, players that used to be excellent in certain positions and play well in “traditional” formations have now been changed continuously. Based on this new agility of the team and an outstanding squad, the coach continuously creates **temporary competitive advantage** that makes it very hard for competitors to anticipate their ploys and come up with an effective game plan.

considered key determinants for success. Second, the company can focus on its resources and develop strategies following an inside-out perspective. Hereby the key drivers of success are seen in the company’s resources, capabilities and competencies. These two perspectives are expressed in the market-based view of strategy and the resource-based view of strategy. They are traditionally used for explaining differences in competitive advantage, and thus, the ultimate performance of companies.

Market-based view of strategy

The market-based view of strategy has its origins in the 1980s and is strongly linked to the work of Michael Porter (Porter 1985 and 1980; see also Porter 2008). It is theoretically grounded in industrial economics. Following the so-called structure-conduct-performance paradigm (SCP-paradigm), the success of a company (performance) is primarily determined or limited by the characteristics of an industry (structure), which strongly determine the company’s behavior (conduct). According to the market-based view of strategy, the firms operating environment is considered the most important factor for achieving competitive advantage, and thus, superior performance. Consequently, the company is well advised to identify and focus its business activities on the most attractive industries and markets. Furthermore, it needs to have a strong position in those industries to achieve above normal profits. This position can be analyzed and measured relative to competitive forces that are used to characterize the industry: bargaining power of buyers, bargaining power of suppliers, threat of new entrants, threat of substitutes, and the rivalry among established firms (competitors). The application of an enhanced framework of those competitive forces to analyze an industry structure is explained more in detail in chapter 2.2.2.2. Based on their evaluation, the company decides to remain in or enter an industry. If the company is part of the industry, it leverages competitive strategies to establish an optimal shield against those competitive forces as a foundation for realizing competitive advantage. Some companies may be in a position to even influence and shape the industry structure in a way that provides them with new sources of competitive advantage. Cost leadership, differentiation or focusing on market niches are examples of generic strategies for positioning a firm in a specific industry or market and realizing competitive advantage (see chapter 3.4.2).

Although the market-based view provides a wealth of insights and guidelines for strategy formulation, it also has its limitations (Chandler/Werther 2014: 52):

- **Narrow view on only three stakeholders:** Only the firm's customers (buyers), suppliers and competitors are focused on. However, there are many other stakeholders that may influence the competitive environment and can squeeze the performance of a company. Thus, the requirements and relative power of other stakeholders such as governments, nongovernmental organizations (NGOs), local communities, unions, creditors, etc. need to be thoroughly considered as well.
- **Confrontational perspective on stakeholder relationships:** The general relationship with particularly buyers and suppliers is considered primarily combative. In order to gain competitive advantage and survive, it is suggested that a firm needs to analyze the power of buyers and suppliers and ultimately "beat" its stakeholders. More cooperative strategic approaches such as collaboration between business competitors (coopetition) or creating shared value with suppliers are not considered.
- **Neglecting internal organizational characteristics of companies:** Internal resources and capabilities of a company that are likely to predict how a firm is able to compete are neglected. Competitive advantage, and thus, performance is primarily related to the external industry structure. Strengths and weaknesses of a company and its corresponding strategic behavior are considered only of minor relevance.

Resource-based view of strategy

Based on criticism of the strong outside-in success logic in the market-based view, a different perspective on strategy emphasizes the role of an individual firm's resources, capabilities and competencies for gaining and sustaining competitive advantage (Barney 2001 and 1991; Hamel/Prahalad 1994; Wernerfeldt 1984; Peteraf 1993). Anecdotally speaking, whereas the market-based view is suggesting to establish a market position, and thus, answers the question of "where to be", the resource-based perspective is suggesting to leverage resources and capabilities, and thus, answers the question of "what to be". This does not mean that the importance of understanding the industry is neglected in the resource-based perspective. However, companies within an industry are advised to exploit their individual resources and capabilities—or core competencies (Prahalad/Hamel 1990)—to make a difference in competition when compared with other firms. According to this view, it is not the general availability of resources and capabilities that provide competitive advantage but their combination in a way that is a particular strength or competence relative to rivals. To provide such a competitive edge in the long run, a firm's competence (i. e. the combination of resources and capabilities) needs to fulfill the following criteria (Barney 1991: 105–114; Barney/Hesterly 2010: 68–83; see also chapter 2.3.2):

- **Value:** It must enable a firm to exploit an opportunity or neutralize a threat in its environment.
- **Rarity:** It must be available for and controlled by only a small number of competitors.
- **Imitability:** It must be expensive and a cost disadvantage for another firm that lacks and wants to obtain it.
- **Substitutability:** There must be no strategic equivalent available, that is no substitute competence that allows implementing the same strategies.
- **Organization:** The firm's organization must be designed in a way that enables exploiting the resources and capabilities for competitive advantage. For example, even when firms are competing with similar product and service offerings, one may have a competitive advantage because it is able to put together marketing and sales programs, technology such as billing systems, incentives, and training in a way other firms struggle with.

According to the resource-based view of strategy, a company can expect to enjoy a sustainable competitive advantage when it has particular resources and capabilities that are valuable, rare, in-imitable and non-substitutable, and when it is organized in a way to exploit these resources. A more detailed description of what resources, capabilities and competencies are and how to apply the corresponding framework (VRIN) is provided in chapter 2.3. When applying a resource-based view of strategy in company practice, it needs to be considered that there are also some fundamental limitations of this approach:

- **Neglecting a firm's operating environment:** Competitive advantage is primarily related to a unique combination of resources and capabilities and the resulting customer and economic value. Changing industry conditions and market dynamics are mainly ignored although they are likely to have a strong impact on a company's ability to develop and exploit competencies for competitive advantage (Chandler/Werther 2014: 48 f.). A more situational perspective emphasizes the role of a specific company context on performance and suggests a basic "fit" between the firm's internal configuration and its external environment.
- **Lack of core competences:** In company practice, combinations of resources and capabilities that fulfill all the criteria for being a source of sustainable competitive advantage are hard to find. For many firms it is simply not possible to develop competencies that are valuable, rare, not imitable and non-substitutable. They are not able to combine their resources and capabilities in such a way that is difficult to replicate. There are a number of practitioners left disillusioned after a failed attempt to find core competencies in their companies based on those criteria.

Integrating market and resource-based view

Conceptually, the market-based and resource-based views of strategy are competing. In company practice, though, they are more a question of sequence in the strategic planning process than a question of which approach to follow and which not. Both views provide a valuable perspective on strategy for company practice, and thus, need to be considered within the strategic management process. This can be practically achieved by leveraging the SWOT framework (see chapter 2.4.1). Hereby, the company's external environment is analyzed to identify **o**pportunities and **t**hreats, which can be related to a market-based view of strategy. The results are combined with an internal perspective that represents a resource-based view in which **s**trengths and **w**eaknesses are analyzed. To expand the strategic ideation process beyond the boundaries of today's operating environment (e.g., industries and product/market combinations), it is suggested to supplement the identification of strengths and weaknesses with a particular analysis of (core) competencies along with the criteria provided by the resource-based view of strategy (see chapter 2.3.2. Tools for elaborating on alternative strategy options based on the identified opportunities, threats, strengths, and weaknesses such as the TOWS-matrix (Weihrich 1982; see chapter 2.4.3) are essentially based on the idea of integrating a market-based with a resource-based perspective on strategy.

Dynamic perspective on markets and resources for competitive survival

An established company will typically start its strategic analysis by looking at macroenvironmental trends and the industry, markets, customers, etc. they are currently operating in or serving. Due to increasing market dynamics and volatility, though, product-/market-combinations that have been successfully exploited by a company leveraging its competences might lose its strategic relevance in the future. To survive and grow, organizations have to execute in the present and adapt to the future (Beinhocker 2006 and 1999). This may well require an alteration or advancement of the firm's resources and capabilities. As explained and illustrated at the beginning of this book, past performance is no guarantee for future success. Existing competencies may become less relevant in the future if market requirements are changing and firms may need to develop new competencies to survive and grow in the long run. In other words, the integration or "fit" between the company's internal configuration and its environment has to be managed in a dynamic and evolutionary way to ensure competitive survival (Teece/Pisano/Shuen 1997). Driven by the quest for growth particularly public companies will seek new business areas when their traditional markets lose attractiveness. In company practice, this is not an easy undertaking as successful organizations will usually find it difficult to change and adapt to new conditions in their environment.

In addition to the market- and resource-based views of strategy there are a variety of other perspectives such as the (dynamic) capability-based view (Teece/Pisano/Shuen 1997) or knowledge-based view (Grant 1997), which are both related to the resource-based perspective. Furthermore, there is the value-based view, the society- or sustainability-based view (see chapter 1.1.3.4) and others which are not further elaborated on here.

1.1.2.3 Being Different and Making Choices

Doing things right—doing the right things

Probably one of the most quoted all-time principles for managers is to distinguish between *doing the things right*, that is efficiency, and *doing the right things*, that is effectiveness (Drucker 1966; see also Strategic Snapshot 1.4). This basic rationale can also be applied for sharpening the understanding of what strategy is. Excellent efficiency means performing similar activities better than rivals whereas strategy means performing different activities than rivals. This requires clear strategic positioning

Strategic Snapshot 1.4

Efficiency Versus Effectiveness According to Peter Drucker

"In the ongoing business markets, technologies, products, and services exist. Facilities and equipment are in place. Capital has been invested and has to be serviced. People are employed and are in specific jobs, and so on. The administrative job of the manager is *to optimize the yield from these resources*. This means *efficiency*, that is, doing better what is already being done. It means focus on costs. But the optimizing approach should focus on *effectiveness*. It focuses on opportunities to produce revenue, to create markets, and to change the economic characteristics of existing products and markets." It does not ask: "How do we do this or that better?" It asks: "Which of the products really produce extraordinary economic results or are capable of producing them? Which of the markets and/or uses are capable of producing extraordinary results?" It then asks: "To what results should, therefore, the resources and efforts of the business be allocated so as to produce extraordinary results rather than the 'ordinary' ones, which is all efficiency can possibly produce? Of course efficiency is important. Even the healthiest business, the business with the greatest effectiveness, can die of poor efficiency. But even the most efficient business cannot survive, let alone succeed, if it is efficient in doing the wrong things, that is, if it lacks effectiveness." (Source: Drucker 2008: 31 f.)

and choice. Strategy is about being different and making choices about what to do and what not to do. This will be explained more in detail next, drawing primarily on the ideas of Michael Porter (Porter 1996):

Operational excellence

Being asked on how to outperform their competitors many business practitioners, particularly in functional areas, will refer to improving efficiency in their operational activities. They continually optimize processes to reduce failure rates and customer complaints, increase productivity and cut down non-value add activities, reduce lead times and working capital, eliminate waste, etc. Many companies are adapting best-in-class practices in various areas of their supply chain to outperform rivals and gain competitive advantage particularly when it comes to cost and pricing. Corresponding performance improvement tools for eliminating inefficiencies can be derived from famous management concepts such as Six Sigma, Lean Management, Total Quality Management, Business Process Optimization, Benchmarking, etc. (Shingo 1986 and 1985; Womack/Jones 2003; Wunder/Bausch 2015). Firms leveraging those techniques are ultimately trying to improve efficiency which, generally speaking, relates to the ratio of output to input. They want to gain competitive advantage by performing the same or similar value chain activities *better* than their rivals. All those approaches can be summarized under the umbrella of "operational excellence" also referred to as "operational effectiveness" (Porter 1996: 61 f.).

Productivity frontier

Companies achieving operational excellence, that is best-in-class operational processes, are likely to benefit from their relative cost position as a source for competitive advantage and profitability at a certain time. However, there is a downside to this approach. Knowledge about best practices and techniques for eliminating inefficiencies are widely available and can be adopted by all competitors in an industry leading to competitive convergence in operational excellence. The more companies are embracing and implementing benchmarking, Six Sigma or lean principles, etc., the more indistinguishable they become from one another regarding their operational processes. Figure 1-6 illustrates this idea with a productivity frontier. Assuming a tradeoff between cost and quality, the productivity frontier represents the maximum value a company is capable to deliver at a given cost leveraging all available best practices in the operational processes. It can be applied to certain individual operational activities, a group of activities or the entire operational framework. The more companies in an industry applying best practices and striving for excellence, the more they move toward the productivity frontier. This maximum state of best practice shifts outwards with improvements in technology, overall skill levels or management practices that allow companies in an industry to improve the value and lower cost at the same time. Firms are getting better at the same time as their competitors. With an outward shift of the frontier, competitive pressure on operational excellence for individual companies increases, typically to the benefit of customers.

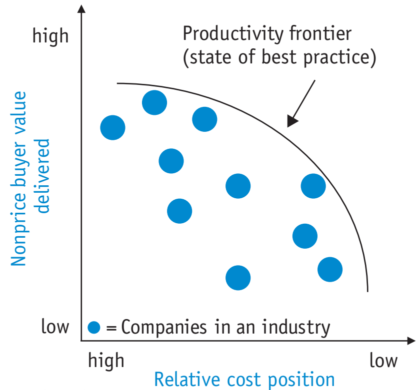
Strategic positioning

Instead of focusing on outperforming competitors based on operational excellence, the core of strategy is about establishing a unique position within a competitive arena through performing different activities than rivals do. In this understanding, strategy is about deliberately being *different* rather than only being *better* as a source for a more sustained competitive advantage. Hereby, the aspired strategic position comes from unique customer value the company is able to create and capture with its products, services or—most importantly—its business model (see chapter 3.4.4). Competitive advantage is based on creating and preserving what is distinctive about a company, that is its distinct strategic position in the competitive arena. This requires choice. "(…) strategy is an integrated set of choices that uniquely positions the firm in its industry so as to create sustainable advantage and superior value relative to the competition." (Lafley/Martin 2013: 5) Key principles underlying strategic positioning are (Porter 1996):

- **Creating a unique set of integrated activities that is different from rivals.** Hereby, the distinction may come from the activities themselves or from the way

Fig. 1-6

The productivity frontier



Source: Porter 1996: 62; adapted

they interact and reinforce one another ("fit"). The principle of strategic positioning based on a unique activity system is strongly related to the idea of a business model (see chapter 3.4.4). The company may position itself by serving a few needs and wants of many customers differently than rivals, by serving broad needs and wants of few customers, or by satisfying broad needs and wants of many customers but in a narrow market.

- **Choosing what to do strategically and what not to do.** "Strategy is making trade-offs in competing. The essence of strategy is choosing what *not* to do. Without trade-offs, there would be no need for choice and thus no need for strategy." (Porter 1996: 70) For some executives, making choice instead of working with very broad and generic strategic directions might be frightening as it comes with the risk of being blamed for a bad choice. Furthermore, strategic choice with tradeoffs may be perceived as a constraint to capture growth opportunities (see Strategic Snapshot 1.5). Lafley and Martin wrote: "It is natural to want to keep options open as long as possible, rather than closing off possibilities by making explicit choices. But it is only through making and acting on choices that you can win. Yes, clear, tough choices force your hand and confine you to a path. But they also free you to focus on what matters." (Lafley/Martin: 2013: 5) Companies with a lack of clear strategic choice end up allocating little but insufficient resources to everything, and thus, set the firm up for failure instead of focusing their resources on what really matters.

Superior performance requires both strategy and operational excellence.

Superior performance essentially requires a hybrid approach of both strategy and operational excellence, although the two elements work in different ways. First, competitive advantage may well come from best-in-class operational processes. Looking at annual savings that companies regularly report as percentage of their revenues once they finished efficiency improvement programs clearly reveals that operational excellence contributes to superior performance. Furthermore, those cost savings provide additional financial resources that can be invested in strategic themes such as innova-

Strategic Snapshot 1.5

Strategic Positioning and the "Growth Trap"

"Among all other influences, the desire to grow has perhaps the most perverse effect on strategy. Trade-offs and limits appear to constrain growth. Serving one group of customers and excluding others, for instance, place a real or imagined limit on revenue growth. Broadly targeted strategies emphasizing low price result in lost sales with customers sensitive to features or service. Differentiators lose sales to price-sensitive customers. Managers are constantly tempted to take incremental steps that surpass those limits but blur a company's strategic position. Eventually, pressures to grow or apparent saturation of the target market lead managers to broaden the position by extending product lines, adding new features, imitating competitors' popular services, matching processes, and even making acquisitions. (…) Compromises and inconsistencies in the pursuit of growth will erode the competitive advantage a company had with its original varieties or target customers. Attempts to compete in several ways at once create confusion and undermine organizational motivation and focus. Profits fall, but more revenue is seen as the answer. Managers are unable to make choices, so the company embarks on a new round of broadening and compromises. (…) Too often, efforts to grow blur uniqueness, create compromises, reduce fit, and ultimately undermine competitive advantage."
(Source: Porter 1996: 75–77)

tion, international growth or others. To keep pace with competition, operational excellence tends to be particularly relevant in industries where strategies of the market players do not differ significantly. As a matter of fact, unique strategies are desirable but rare. Being asked about the uniqueness of their strategies, the majority of companies actually state that they pursue similar strategies to their competitors (Horváth & Partner GmbH 2008: 9; Wunder/Bausch 2014b: 58). This means both a need for having efficient operations and an opportunity for strategic differentiation.

It also means that in addition to the skill of crafting an effective strategy, companies can gain competitive advantage by means of excellent execution. This is particularly the case where the strategies of rivals tend to be similar (Greiner/Wolf 2010: 5; Horváth & Partner GmbH 2014: 4). Note that this understanding does not necessarily relate to operational excellence but to the effectiveness of how well a defined strategy is executed (see chapter 4).

Operational excellence does not substitute strategy.

In markets where scale is important for achieving competitive advantage, operational excellence can be particularly effective. However, although it may well support the effort to establish a unique strategic positioning, it is not a substitute for strategy. Moreover, competing on operational excellence only may be a risky undertaking as it leads to a rather destructive path of efficiency-oriented competitive races of companies tempted to copying competitors rather than differentiating from them. A company can outperform its rivals in the long run only when it is able to establish a difference that it can preserve as long as industry conditions allow and establish new strategic positions in case there are major changes in the environment. Companies trying to be everything to everybody may end up being nothing to nobody. However, companies relying solely on their strategy might become vulnerable regarding operational excellence and may be outperformed in terms of flexibility, speed or cost. As described below and illustrated in figure 1-7, clearly distinguishing a management agenda of operational excellence from strategy but combining both elements seems to be the most promising recipe for sustained superior performance (see also Strategy Practice Example 1.2):

- **Management agenda 1: Operational excellence**
  Driving a continuous effort to achieve best practices, be better than rivals and possibly even shift the productivity frontier when it comes to operational processes.
- **Management agenda 2: Strategy**
  Establishing a unique strategic position with clear choices about what to do and what tradeoffs to apply, resulting in a unique integrated activity system or business model.

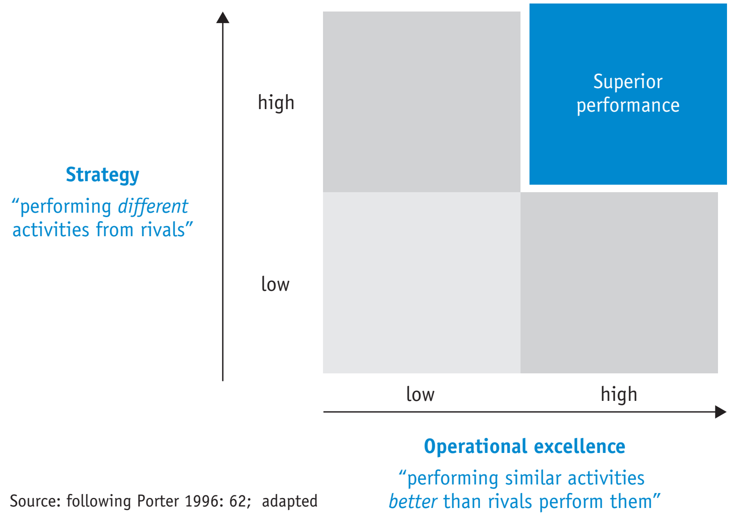
1.1.2.4 Path to a Destination

Strategy is a means to an end.

A company usually has an explicit or implicit aspirational idea about where it wants to be in the long run. This desired picture of the company's future is often articulated in terms of a vision (see chapter 3.1). The aspiration may be derived from various elements such as shareholder expectations regarding profit and growth, the company's long-term objectives regarding its stakeholders such as customers, employees or the society, a personal aspiration of the CEO to transform the organization or stretch it toward a certain performance level, an entrepreneur's "dream" about the future, or a desire to ensure long-term survival of the company and pass it on from one generation to another in the case of a family-owned firm. A strategy can be perceived as a

Fig. 1-7

Superior performance based on both strategy and operational excellence



Source: following Porter 1996: 62; adapted

Strategy Practice Example 1.2

Outperformers Leverage Both Strategy and Operational Excellence

In a 2012/13 management survey of more than 100 companies in the food industry, 70 % of the participants stated that they pursue strategies that are similar to those of their competitors. Only 12 companies emerged that were able to grow both revenues as well as profit stronger than their competitors for three years in a row. All of those 12 outperformers reported that they are well positioned in their corresponding competitive arena regarding both strategy as well as efficiency. The hybrid approach of combining strategy and operational excellence seems to pay off in terms of profitable growth. Among the rest of participating food producing companies more than 50 % stated that their strategic positioning is rather bad or very bad and roundabout 40 % gave this answer related to their relative positioning in efficiency. What did the outperformers do differently in their strategic planning process than their peers? The survey found four success factors:

- Better leverage of a systematic and formal strategy process
- Application of more solid tools for external strategic analysis
- Stronger engagement in business models
- More effective management of strategy execution

Source: Wunder/Bausch 2014b

path from today to a long-term destination (see fig. 1-8). It represents a means to an end, that is a course of action into the future.

Vision guides strategy formulation.

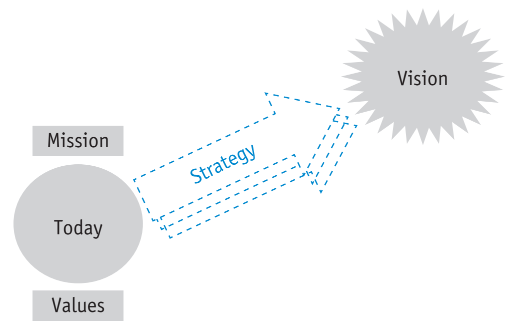
At the beginning of each entrepreneurial activity stands an idea of what the company wants to achieve in the future, that is a vision, even though it might not be explicitly articulated (Hinterhuber 2004: 75). Based on this understanding, a desired future state or vision has to be defined *first* before a strategy can be formulated (see fig. 1-8). “The vision creates the picture of the destination. The strategy defines the logic of how this vision will be achieved. Vision and strategy are essential complements.” (Kaplan/Norton 2001: 74) Together with the company’s mission and values the vision represents a normative strategic guidepost that is supposed to frame strategy formulation. Whereas the vision states what the company ultimately wants to accomplish in the long run, the mission articulates why the company exists (purpose) and what it actually does, and the values represent ethical norms and standards that govern behavior of individuals. More detailed elaboration on the strategic guideposts is provided in chapter 3.1.

Long-term aspiration versus strategic goals

Practically speaking, strategy is *not* the articulation of a long-term aspiration regarding market leadership, achieving certain growth or profitability thresholds or other foundational long-term objectives but the fundamental approach or combination of approaches how to make them come true. This must not be confused with the development of strategic goals that are supposed to refine and describe a strategy after it has been developed to focus management attention and resources on the most important strategic priorities (Schreyögg 1984: 87). Strategic goals along with performance metrics and targets as well as strategic action programs are elements of strategy execution. They are in place to describe and operationalize strategy to make it happen and not to formulate strategy (see chapter 4.3).

Fig. 1-8

Strategy as path from today to the vision



Source: Wunder 2004: 26; adapted

1.1.2.5 Consistency in Behavior

An understanding of what strategy is can be further sharpened by asking the question of what a strategy actually constitutes: intention or realization? On the one hand, strategy can be perceived as an intention or plan, which means it constitutes prior to the action (ex ante). On the other hand, strategy can also be viewed as something that constitutes once it happens (ex post). To better reflect and understand the reality of strategy, it is helpful to distinguish between different types of strategy making, which are illustrated in figure 1-9 (Mintzberg 2000: 23–25; Mintzberg 1987 and 1978):

Strategic intention versus what actually happens in reality

A strategic plan (see chapter 1.1.1) reflects an **intended strategy**. It is typically the outcome of a rational and structured development process based on external and internal analysis and top-level executive decisions about the course of action to be pursued by the organization. Business schools and strategic management literature have a general preference of teaching such a rational planning model (see also chapter 1.2). In case strategic intentions or plans are fully realized it can be called **deliberate strategy**. In reality, though, this does not happen too often. In business practice, only a small portion of effectively planned strategies are also effectively realized due to several reasons, such as unexpected events that have significant implications for the company and make strategic intentions obsolete or ineffective strategy execution (see chapter 4.1.1). Strategic intentions that do not come true can be called **unrealized strategy**.

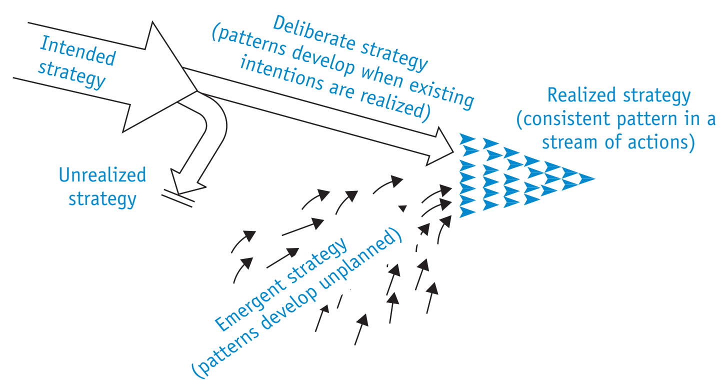
Intended strategy are either realized or unrealized.

By looking back to the strategic behavior of a company that shows some sort of consistency of pattern over the course of, for example, the last five years, a **realized strategy** can be identified. When asking business people to describe what strategy they have realized over the past five years, for example, and whether the strategy was intended, they generally follow three different lines of reasoning:

Realized strategies are a combination of intention and emergence.

Fig. 1-9

Realized strategy as result of deliberate and emergent strategies



Source: Mintzberg 1978: 945; adapted

- Some may claim that what they strategically planned five years earlier was realized perfectly.
- Others may claim that their realized strategies in the past five years had nothing to do with the strategic plan they developed five years ago.
- Most managers will probably give an answer that falls between these two extremes, that is some strategic intentions have been fully realized, portions of the strategic plan may have been deliberately adapted to reflect changes in the environment and some actions with strategic magnitude just evolved without previously expressed intention.

A realized strategy pattern or consistent strategic behavior that was not expressly intended is called **emergent strategy**. It evolves from autonomous unplanned strategic initiatives undertaken by employees of their own desire and choice that converge in time in some sort of consistent strategic behavior of the organization. For a sound understanding of strategy it is critical to accept that a realized strategy is typically based on elements from both intended strategies and emergent strategies. "The real world inevitably involves some thinking ahead of time as well as some adaption en route." (Mintzberg 2000: 24) Hereby, neither intended nor emergent strategies can be labeled good or bad only because of the type of their formation. For example, strategies emerging bottom-up in the organization may provide innovative strategic ideas for creating competitive advantage. However, a lack of strategy alignment (see chapter 4.3.3) can also result in emergent strategies that may be in conflict with planned strategies, and thus, breed friction and failure in an organization.

Strategy as planned emergence

What is the practical consequence of the described distinction of strategies? Managers should be aware that a planning approach—typically top-down—is only one way of trying to control a company's strategic behavior. They also have to be sensitive to emerging strategic initiatives—typically bottom-up—that must be identified, evaluated and, if promising, integrated into upcoming strategic planning cycles. Through their strategic leadership, executives can create an environment that is fruitful for emergent strategies, for example, by encouraging entrepreneurship and strategic ideation on multiple management levels and providing strategic context and basic direction with room for self-control mechanisms instead of detailed strategic plans that have to be executed rigorously. This approach of deliberately combining some sort of top-down strategic planning with room for bottom-up strategies to emerge can be called *planned emergence* (Rothaermel 2013: 46). Some companies pursue "what may be called *umbrella* strategies: the broad outlines are deliberate while the details are allowed to emerge within them. (...) effective strategies mix these characteristics in ways that reflect the conditions at hand, notably the ability to predict as well as the need to react to unexpected events." (Mintzberg 2000: 25)

1.1.2.6 Multiple Level and Theme Alignment

Strategies at different firm levels address different themes.

There is not *one* strategy in an organization. Whereas a corporation's top executive leadership team has to formulate corporate (or divisional) strategy, the CEO of a strategic business unit (SBU) works with competitive strategies and business models, leaders of functional areas develop their corresponding functional strategies to sup-

Strategic Snapshot 1.6

Planned Versus Emergent Strategy—Illustrated With Soccer

At the forefront of important sports team events such as the soccer world cup or the super bowl, finalist teams typically analyze their opponents very thoroughly leveraging a wealth of data. They conduct a number of planning cycles and develop a sophisticated game plan (**intended strategy**) including certain contingencies. The game plan is then communicated to the entire team and a disciplined execution is seen as a key success factor.

Imagine we are watching the final of the soccer world cup and some unforeseen circumstances are happening early in the game: A key player becomes injured and has to be replaced, another one is sent off and the opponent team is playing in a way which was not anticipated at all. In such a case, the previously defined game plan might not be valid anymore and might be abolished by the playing team (**unrealized strategy**). However, the team we watch will have no possibility for a new planning cycle to develop a new game plan that they can follow to deal with the new situation (**deliberate strategy**), at least not until the half-time break. There is also no “time-out” in soccer. A certain unplanned behavioral pattern is likely to evolve on the field based on a consistent stream of individual decisions and actions as well as the resulting team dynamics **(emergent strategy**). Independent of whether it was previously intended (planned) or not, as spectators we will be able to see and describe the team’s strategy once it has happened (**realized strategy**).

The question of whether the evolving strategic team behavior is successful or not is not driven anymore primarily by thorough analysis and planning combined with disciplined execution of the game plan. Winning or losing now strongly depends on other success factors such as trust between the players, individual excellence, strong will and motivation to perform, key players taking initiative and carrying the others along, well trained plays and automatic moves, etc. A successful **realized strategy** on the field is likely to be a combination of previously defined strategic intentions as well as emerging behavioral patterns.

port corporate and the businesses. A regional management team is driven by their regional strategy and general managers of international subsidiaries typically follow country strategies. Finally, product managers have to come up with product or service strategies that are typically based on some kind of marketing mix. Depending on the organizational area, each type of strategy has to deal with different questions and usually addresses different strategic themes. Here are some examples (Wheelen/Hunger 2010; see also chapter 3):

- **Corporate strategy** is primarily about choosing the general direction of a company as a whole. This includes the choice of industries and businesses in which the company wants to compete (division and business portfolio) and the related question of focus versus diversification. In multiple-business companies, corporate headquarters is classically managing various strategic business units in a way that they are collectively delivering more value under the corporation’s stewardship than if they were acting alone. Corporate strategy also includes decisions regarding the value creation activities the company should perform in those businesses (integration or de-integration). Furthermore, in multinational enterprises it is concerned with decisions about local integration and global responsiveness and the corresponding strategy postures such as a global, international, multinational or transnational strategies. For example, companies following a transnational strategy simultaneously respond to local needs, global demands as well as cross-border learning opportunities and consequently manage their international subsidiaries as an integrated network. In large corporations, divisions on the second management level are often huge and consist of multiple businesses, functions, etc. themselves. Therefore general strategic thoughts of corporate strategy do also apply to divisional strategy.

- **Business strategy** is concerned with how to position a company's (strategic) business units within their specific competitive arena (e. g., industry or market segment). Whereas corporate strategy asks what businesses the company should be in and with what intensity regarding the company's resources and management capacity, business strategy asks how a business should compete. It is about choosing generic competitive strategies such as cost leadership, differentiation or outpacing and may also include cooperative approaches such as strategic alliances with other firms in an industry to gain competitive advantage relative to rivals. At the core of business strategy is a business model which represents the anticipated mechanisms how the business is supposed to be successful in its competitive arena. It can be considered as refinement of a generic strategy on a business level by describing the fundamental principle of how a product and service offering for certain target customers (value proposition) is created and delivered (value creation and delivery) resulting in economic benefits for the firm's business (value capture). (Wunder 2013)
- **Functional strategy** is the strategic approach of a functional area in the organization to support achievement of corporate and business strategies with due consideration of resource efficiency or productivity. This includes strategies of core functional areas like R&D, Marketing, Supply Chain Management or Operations as well as support functions such as HR, Finance or IT, etc. In each of those areas there is a variety of strategy options to choose from in order to support the strategic thrust of one or several business units. In general, the resources and capabilities of functional areas are a crucial foundation for the company and its businesses to create and sustain competitive advantage. Hereby, the strategic orientation of a functional area strongly depends on the corporate parenting approach such as leveraging functional resources and capabilities across different businesses to create synergies or for entering new businesses based on the firm's core or distinct competencies. This may lead to the foundation of centers of excellence where functions in certain subsidiaries get a global strategic mandate based on local best practices. Furthermore, local content regulations in certain countries may lead to local production strategies in order to get access to regional markets targeted by corporate or business strategy.
- **Regional strategy and country strategy** deals with how competitive business strategies or functional strategies vary from one region or country to another. From a sales perspective, competitive arenas among regions and countries may differ significantly based on criteria such as level of market maturity (emerging versus mature regional markets), consumer preferences and buying power, local competitive environment, government regulations, local infrastructure, etc. As a result, companies may need to adjust their competitive strategies from one country to another. From a functional perspective, value chain activities may need to vary from region to region to gain competitive advantage. For example, some corporations put their R&D activities in certain countries to exploit local resources and

infrastructure, other concentrate global production facilities in certain countries to utilize factor cost differences and achieve economies of scale. Marketing has to think about establishing global (power) brands or local brands or both. Various international subsidiaries may fulfill different strategic roles for the implementation of the corporate or business strategies considering their local resource strength as well as the importance of the local market. (Bartlett/Goshal 2002: 121–128)

- **Product strategy or service strategy** is primarily concerned with the design and structure of the marketing mix. This includes questions about the product or service concept, breadth and depth of the product range, radical and incremental product innovation, branding strategies as well as strategic pricing, communication and sales decisions. In case of services, the classical marketing mix is supplemented with the three additional components *personnel decisions* (e. g., competence, motivation, loyalty, and customer orientation of employees), *physical environment decisions* (visible factors of the service infrastructure) as well as service *process decisions* to ensure high quality service levels. (Homburg/Kuester/Krohmer 2013: 82 and 375 f.)

Strategy alignment

Converting the illustrated strategic variety that comes from multiple organizational areas and multiple strategic themes into some sort of consistent strategic behavior (see 1.1.2.5) of the entire organization requires strategy alignment. Depending on the company's steering logic, the different strategy types build a hierarchy of strate-

Fig. 1-10

Strategy as a result of multi-level and multi-theme alignment

Level	Strategy type	Sample themes
Corporate (or division)	Corporate/divisional strategy	▸ Focus/diversification ▸ Integration/de-integration ▸ Global, multinational …
Business	SBU strategy/competitive strategy/ business models	▸ Differentiation/cost leadership/outpacing ▸ Business model patterns
Function	Functional strategy (core and support functions)	▸ R&D-, Marketing-, Supply Chain-, Operations Strategy ▸ HR-, Finance-, IT Strategy
Region	Regional/country strategy	▸ Market penetration/ market development ▸ Subsidiary strategic roles
Product/ service	Product/service strategy	▸ Product/service concept and product range ▸ Marketing mix (4 Ps/7 Ps)

ALIGNMENT

gic priorities that have to be aligned for being effective. Ultimately, all the different strategies have to complement and support one another as far as possible and desired by the overall strategic approach. (Wunder 2014b; see also chapter 4.3.3)

This concludes the elaboration on principles for sharpening an understanding of what strategy is. It should now be clear which strategy concept is considered foundational for the upcoming elaborations. An important question has not yet been addressed. How does a company know whether its strategy pays off? The next chapter deals with this question and provides some approaches of how to define and measure what a strategy is actually supposed to deliver in terms of results.

1.1.3 Measuring Competitive Advantage and Company Performance

Superior performance

How can a company measure whether its strategy works out and whether it has a competitive advantage? As explained earlier, competitive advantage is reflected in superior firm performance. Whereas it is relatively easy to define the "winner" or "outperformer" in a sporting event (see Strategic Snapshot 1.3), it becomes a bit trickier in business. For a company, it needs to be defined how its performance is measured, what is considered as "superior", and whether it is relative to its competitors or other stakeholders. A company's performance can be assessed by looking at different types of performance data, which leads to different ways for measuring competitive advantage (Barney/Hesterly 2010: 13–29; Rothaermel 2013: 115–128; Schaltegger/Wagner 2006):

- **Economic value:** A firm has a competitive advantage when it creates and captures more economic value—derived from the customer value it generates—than its rivals.
- **Accounting performance:** A firm has a competitive advantage when selected profitability ratios from accounting are greater than the industry average.
- **Shareholder value:** Companies that earn above their cost of capital are realizing above normal performance and are generally said to have a competitive advantage.
- **Corporate sustainability performance:** A firm has a competitive advantage when its integrated economic, ecological and social performance ("triple bottom line") is greater than the one of its rivals or the industry average.

1.1.3.1 Economic Value

Capturing more economic value than rivals

The question of how a company is performing based on its competitive advantage can be perceived from the perspective of an individual product or service. On the most basic level, profitability of a company depends on the value, price and cost as illustrated in figure 1-11 (Rothaermel 2013: 115–117 and Hill/Jones 2010: 77–81). The **value** (V) customers place on the company's product or service reflects the satisfaction or happiness the customer gets from it and is thus also called **utility**. It captures how much a customer is willing to pay for it at the maximum. This utility is the individually perceived benefit gained by the customer that purchases the firm's products or services. Given a generic product definition, this benefit can be created by different attributes such as (Homburg/Kuester/Krohmer 2013: 108 f.):

- Core product features (e. g., number of airbags in a car) and additional features generating a benefit (e. g., a car's sound system)
- The packaging regarding its function or design (e. g., 10 individually packed 10 g chocolate pieces instead of one 100 g bar) or the tangible environment—that is "packaging"—in case of a service (e. g., branch office of a bank or waiting and treatment room at a dentist)
- Basic services (e. g., a company website where manuals of current and past products can be downloaded) and value added services (e. g., 0 % financing option when purchasing a car)
- The brand (e. g., Polo Ralph Lauren reflecting exclusivity, PUMA telling a story about hipness and belonging, or Fiji water one of the bestselling brands of bottled water in the USA reflecting purity).

If this value or utility is greater than the **price** (P) charged, customers are likely to buy it. Typically, the **cost** (C) to produce the product or service does not matter to the customer but greatly to the company producing and selling it. The difference between the utility (or value) in the eyes of customers and the company's cost to produce it is the **economic value** created, which is split between these two parties. Some of this value is captured by the customer in the form of a **consumer surplus**. The other portion—what economists call the **producer surplus** and managers call the profit—is captured by the company, which usually tries to get as much of it as possible. If a company is able to create and capture more economic value than its rivals it has a competitive advantage.

Utility versus market price

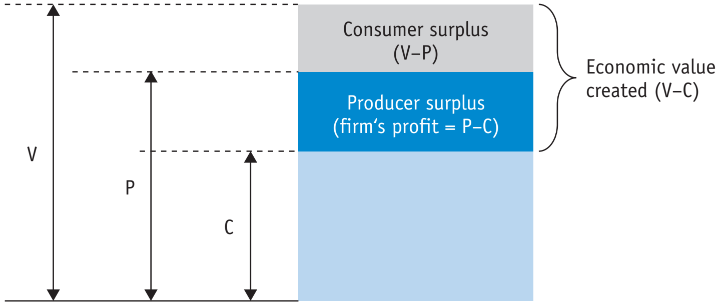
Why do companies not charge the price that represents the customer's maximum willingness to pay (value or utility)? Customers are able to capture a consumer surplus because companies are in competition with each other regarding their products and services, and thus, have to charge a lower price than in a pure monopolistic situation. Furthermore, it is practically impossible for companies to charge each customer a price that reflects the unique individual assessment of utility as the perceived value changes based on income, time and various other factors including cognitive or neuropsychological processes (Scheier/Held 2012). Even by looking at purchasing habits or analyzing customer preferences on an individual level with statistical techniques, like the conjoint analysis, will not fully solve this problem.

Improving producer surplus by increasing customer value or reducing cost

If the goal is to drive bottom-line growth—that is increasing the profit—a company can improve its cost situation through, for example, operational effectiveness techniques such as Lean Management or Six Sigma or changes in its cost structure and lower C relative to P, which is typically the initial response of engineers being asked that question. Another option—that might be the first answer of product managers or marketers—is to strengthen the utility provided by its products and services which gives the company a variety of pricing options. Typically, this will initially raise (production) cost because the company has to spend money on one or more value increasing mechanisms like quality improvements, value added services or emotionalizing the brand as listed above. Due to the increased utility, one pricing option is to

Fig. 1-11

Economic value creation per unit and competitive advantage



V = (perceived) customer **v**alue (consumer's maximum willingness-to-pay)*
P = market **p**rice
C = company's **c**ost

Source: following Rothaermel 2013: 116 and Hill/Jones 2010: 78

raise prices more than the cost increase, which will result in a higher profit per unit. Another option is based on a very different rationale. Despite the increased utility, the company is lowering the price so that customers clearly recognize that they are getting a great bargain. Based on the increased demand, unit sales volume expands allowing economies of scale. As a result, the average unit cost of production fall and the profit per unit increases.

Limited applicability on a firm-level

Knowing the principles of economic value creation and the fundamental dynamics among its components is a good starting point not only for measuring but for understanding competitive advantage. It provides managers a conceptual framework for strategic dialog and ultimately supports decision making. However, trying to operationalize competitive advantage this way on a firm level would require estimating and calculating the different components for all products and services of the company. For precise numbers on the performance of a company, people usually rely on accounting data.

1.1.3.2 Accounting Performance (Profitability)

Top- and bottom-line performance

Competitive advantage can also be assessed by looking at information from a company's published profit and loss (P&L) and balance sheet statements. As these statements are typically created based on widely accepted accounting standards such as US-GAAP (generally accepted accounting principles) and audited by certified public accountants they are widely used to calculate performance metrics. Data is usually available as financial statements of publicly traded companies are publicly available and many privately owned firms typically release some information about their financial results. Of particular relevance is the firm's top- and bottom-line performance. This relates to the achieved revenue and profit numbers in a certain time

Strategy Practice Example 1.3

Comparing Toyota and General Motors in Creating Value per Unit

"According to a 2008 study by Oliver Wyman, in 2007 Toyota made $922 in profit on every vehicle it manufactured in North America. GM, in contrast, lost $ 729 on every vehicle it made. What accounts for the difference? First, Toyota has the best reputation for quality in the industry. According to annual surveys issued by J. D. Power and Associates, Toyota consistently tops the list in terms of quality, while GM cars are at best in the middle of the pack. The higher quality translates into a higher utility and allows Toyota to charge 5 % to 10 % higher prices than GM for equivalent cars. Second, Toyota has a lower cost per vehicle than GM, in part because of its superior labor productivity. For example, in Toyota's North American plants, it took an average of 30.37 employee hours to build a car, compared to 32.29 at GM plants in North America. That 1.94-hour productivity advantage translates into lower labor costs for Toyota; hence, a lower overall cost structure. Therefore, as summarized in the illustration below, Toyota's advantage over GM derives from greater utility (U), which has allowed the company to charge a higher price (P) for its cars, and from a lower cost structure (C), which taken together implies significantly greater profitability per vehicle (P-C)."

(Source: Hill/Jones 2010: 80)

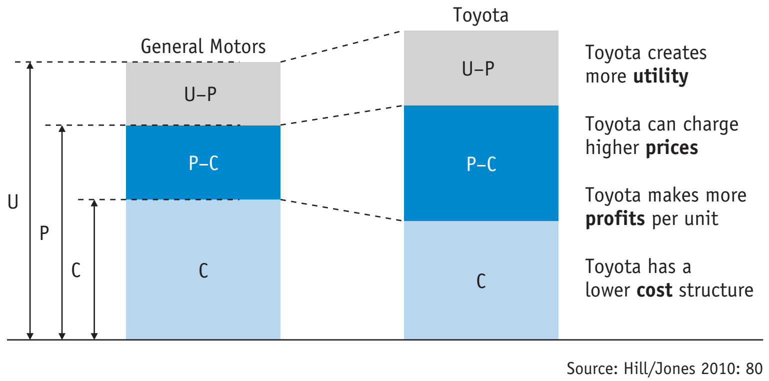


Fig. 1-12: Comparing Toyota and GM

frame, usually one fiscal year. Those numbers can be found when looking at the top line (revenue) and bottom line (profit) of a firm's profit and loss (P&L) statement. Correspondingly, managers speak about "top-line growth" when they refer to sales (revenue) increase and "bottom-line growth" when they refer to profit increase. A common understanding of competitive advantage is based on the idea of above normal returns, and thus, relates to profits that are excess of revenues over expenses. Common metrics for profit are EBIT (earnings before interest and taxes), EBITDA (earnings before interest, taxes, depreciation and amortization) or the Net Income. However, the problem of using siloed profit numbers for performance comparisons to understand competitive advantage is that they are only absolute values and do not say anything about the assigned capital or the revenue required to realize the profit, for example. Directly comparing financial statements of two companies for assessing their performance is almost impossible because of differences in size (see Strategy Practice Example 1.4).

Performance ratios

One way to overcome the problems involved when comparing companies of different sizes is to calculate and compare financial ratios. With a ratio analysis the relationship between different pieces of financial information is investigated. Ratios using data from accounting can be grouped into the following categories (Ross/Westerfield/Jordan 2010: 54–63):

- Ratios focusing on the firm's ability to meet its short-term financial obligations (liquidity or short-term solvency ratios)
- Ratios addressing the company's long-term ability to meet its obligations or its financial leverage (leverage or long-term solvency ratios)
- Ratios describing how intensely a firm uses its assets to generate sales (asset management, turnover or activity ratios)
- Ratios focusing on the bottom-line and measure how efficiently a firm manages its business, operations and assets to generate income (profitability ratios).

Achieving greater profitability than the industry average

Profitability metrics are probably the best known and most widely used financial ratios, particularly when it comes to measuring competitive advantage. These figures represent the profit (EBIT, EBITDA, etc.) proportionately to a measure like assets, equity, capital, or revenues. Some examples of profitability metrics that are most commonly used for direct performance comparisons of different firms are:

- **Profit margin**, **return on sales (ROS)** or **return on revenue (ROR)** measure the profit earned per unit (Euro, US-Dollar, etc.) of revenue (see Strategy Practice Example 1.4)
- **Return on assets (ROA)** measures the profit earned per unit (Euro, US-Dollar, etc.) of total asset
- **Return on equity (ROE)** measures earnings to owners or how the shareholders fared during the year
- **Return on investment (ROI)** or **return on invested capital (ROIC)** measure the profit in relation to the investment required to obtain that profit. It shows how effectively the company uses the (owned or borrowed) capital invested in its operations. Given the same risk, the investor wants the maximum return for any given amount of resources.

Without comparison, the listed ratios say very little about the performance of a company. They need to be compared with some standard such as the measures of main competitors (see Strategy Practice Example 1.4), benchmarks from within or outside the industry, or with the average of other firms within the industry. Using accounting information, a firm is said to have a competitive advantage when selected profitability ratios are greater than the industry average. When comparing those numbers, it is important to keep in mind that the listed profitability ratios are rarely computed in exactly the same way by different companies. Profitability does not mean the same thing to all people. One example is the question whether it is based on net income, EBIT or EBITDA. When numbers from different sources or people are compared it

Strategy Practice Example 1.4

Comparing Automakers by Using Difference Types of Performance Indicators

No other company sold more automobiles in 2012 than Toyota (9748 thousand cars). General Motors (9286) and Volkswagen (9075) ranked 2 and 3. The next biggest companies in terms of numbers sold are Ford with 5668 thousand cars and Nissan (4940). This huge difference in sales numbers shows the outstanding size of the top three as compared to the rest of global automakers. Only a slightly different picture is revealed when looking at total revenue in 2012. Toyota is ranked number 1 with € 206,894 million followed by Volkswagen (€ 192,676 million), General Motors (€ 115,479 million), Daimler (€ 114,297 million), and Ford (€ 101,823 million). Regarding the profit of those automakers, Toyota is again at the top of the ranking. With € 14,213 million in 2012, Toyota was the automaker with the highest profit (EBIT) followed by Volkswagen (€ 11,510 million), Daimler (€ 8,615 million), BMW (€ 8,300 million) and Hyundai (€ 5,791 million).
Those absolute performance indicators do not tell us much about competitive advantage. For understanding competitive advantage we need to look at performance ratios and eliminate the impact of size. For example, when using the Return on Sales as profitability ratio for measuring performance, the ranking changes significantly with BMW, Hyundai, Daimler, and Kia at the top, followed by Toyota at rank 5 (see fig. 1-13). It shows that BMW had a significant competitive advantage over its rivals in the automotive industry in 2012, not only based on a comparison with the industry average but also directly with main competitors. The average EBIT margin considering all automakers listed was 5.4 %. Hereby, German automakers achieved an average Return on Revenue of 7.4 %, Southern European companies 0.2 %, Japanese automakers 4.5 %, and US car manufacturers 3.8 %. The numbers cover the entire business results of the listed automakers including financial services from January to December 2012, independent of their fiscal year, based on different sources and an own calculation of Ernst &Young.

(Source: Ernst & Young GmbH 2013)

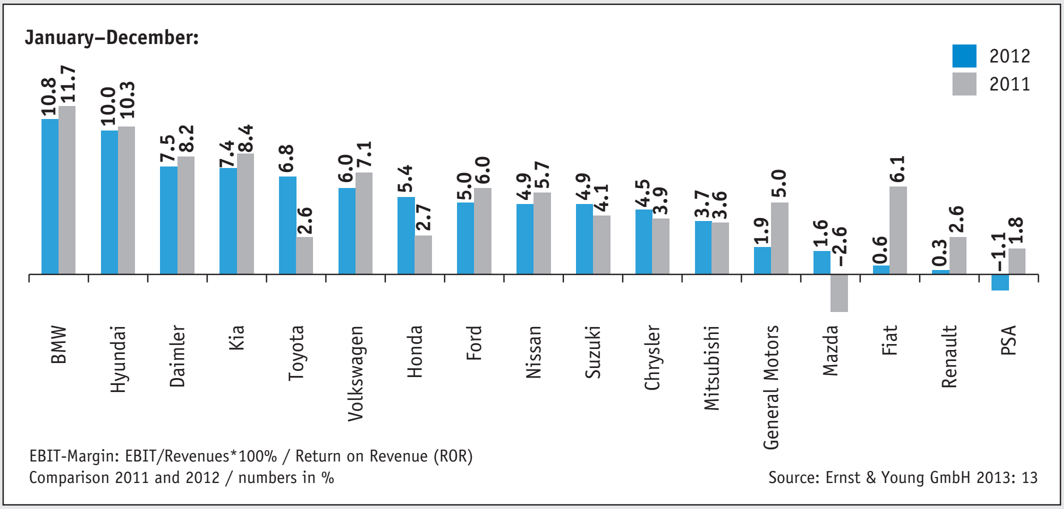


Fig. 1-13: EBIT-margin of automakers

needs to be ensured that they are computed the same way—according to the same standards and principles—or, if not, they need to be made comparable.

Limitation of profitability ratios

Using profitability ratios from accounting for measuring competitive advantage offers the great advantage that information is widely available and that they are relatively easy to compute. However, it also has some significant limitations. For example, it is important to note that profitability ratios such as ROA, ROE and ROI/ROIC are calculated based on the actual book value. This means that a sinking remaining book value of investments corresponds with increasing profitability although the performance of the company may not have changed at all. For example, a public company buying back stocks reduces both its assets (cash) as well as its equity because the number of outstanding shares is reduced. This improves ROA and ROE ratios even if profits are stable. Furthermore, accounting data is backward-looking. This means that the ratios reflect the results of past decisions and that they are no indicator for how competitive advantage might be affected in the future. Another major pitfall of using accounting data for measuring competitive advantage is the omission of the cost of capital that a firm employs to produce and sell its products in most accounting ratios.

1.1.3.3 Economic Performance and Shareholder Value

Providing a firm's shareholders higher "utility" than rivals

For some schools of thought, accounting measures understate the importance of a company's suppliers of capital. If the firm's equity and debt holders do not receive an expected return as a compensation for their risk, value will be lost and they will withdraw their capital in search for better investment options. Companies do not only want to avoid that their shareholders shift the investments to higher yielding companies but, moreover, attract even more capital to grow and expand their business. With this philosophy the focus shifts from traditional figures like revenue, profit and accounting performance ratios to shareholder value. The ultimate measure for a company's success is the capability to enrich its shareholders (shareholder value added).

Comparing profit with weighted average cost of capital

To quantify its shareholder value creating performance, a company needs to look at the cost of capital that a firm needs to operate. This is the rate of return suppliers of capital—for example, banks and bondholders (debt) or individual and commercial stockholders (equity)—expect for their investments given a certain risk level. Whereas the cost of dept equals the interest a company must pay for borrowing money from the debt holder, the cost of equity is the rate of return equity holders expect in order to invest in the company considering firm- and market-specific risk factors. Both elements are combined in the so-called weighted average cost of capital (WACC), which is the weighted average of the cost of equity and the after-tax cost of debt. Companies that measure competitive advantage this way need to compare their profit to its cost of capital instead of comparing profitability with main competitors or the average profitability of firms in the industry. If the profit is higher than the WACC, the company creates value, if it is equal it retains value, and if the profit is lower than the WACC, it decreases value. Increasing value means that the company is able to realize above normal economic performance. It has a competitive advantage based on which it can expect to get access to cheap capital for further expanding its business. Companies that earn their cost of capital just fulfill the expectations of their equity and debt holders. Based on their competitive parity they get access to the capital they need to survive but have only limited growth opportunities.

Stock market performance: total return to shareholders

Another way to measure competitive advantage from a shareholder perspective is by comparing a firm's total return to shareholders with the industry average or a broader market index. A firm has a competitive advantage if it is able to provide its shareholders or owners a higher "utility" than the competitors or market. Hereby, the total return to shareholders is the return shareholders receive for their risk capital over a specific period. It includes stock price appreciation plus dividends received. On the one hand, measuring performance through total return to shareholders is considered as an objective external performance indicator representing a stock market view that takes into account all available information about the company's past, present, and anticipated future performance with a special emphasis on growth. On the other hand, this type of measurement has severe limitations due to the psychological mood of investors reflecting irrational expectations, the impact of macroeconomical factors on stock prices rather than the company's strategy, and the increased volatility in the firm's environment that makes particularly short-term performance assessments based on total return to shareholders difficult. (Rothaermel 2013: 121 f.)

Shareholder value—relevance lost?

The visual impact of climate change, ecological and social calamities as well as human injustices have lead to an increased criticism of company practices that are solely driven by economic performance considerations. Although maximizing shareholder value might be a prime objective of strategy development in some companies, more and more firms embrace the idea of not only improving their profitability or economic performance but also their social and ecological performance (see Strategic Snapshot 1.7). This can be captured by looking at the corporate sustainability performance which will be explained next.

1.1.3.4 Corporate Sustainability Performance

Sustainability and the "triple bottom line"

Today's environmental and social challenges call for a more balanced definition of *superior performance* based on the principle of "sustainability". According to the World Commission on Environment and Development "Sustainable Development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs." (WCED 1987: 43) Applied to a business context, "corporate sustainability can accordingly be defined as meeting the needs of a firm's direct and indirect stakeholders (such as shareholders, employees, clients, pressure groups, communities, etc), without compromising its ability to meet the needs of future stakeholders as well." (Dyllick/Hockerts 2002: 131) In this sense, it relates to the stakeholder approach and the shared value idea (see Strategic Snapshot 1.7). Foundational for the principle of corporate sustainability performance is the so-called triple bottom line framework (Elkington 1997), which is applied by many companies today. In this approach, economic, ecological and social achievements are simultaneously considered and integrated to one holistic perspective on performance (see fig. 1-15). The term is based on the English and Anglo-American profit and loss statement (P&L) where the "bottom line" traditionally reflects the profit or net income. Following a triple bottom line perspective, companies should assess their overall performance not only by looking at their financial results—that is

Strategic Snapshot 1.7

Shareholder Value, Stakeholder Value, Shared Value

Companies exist to create value. The key question, however, is "value" for whom? Shareholder Value Management or Value Based Management is an approach that puts the creation of **shareholder value** at the focal point of all economic activities within a company. According to this philosophy, shareholders do not only provide the risk capital necessary to run the company's operations but are also the legal owners of public companies, and thus, deserve a special emphasis. Originated in the mid 1980s and 1990s and rooted in Anglo-American management philosophy (e. g., Rappaport 1986, Stewart 1991), the overall strategic intent of a company and the corresponding management methods and processes are directed on increasing or even maximizing shareholder value. Strategic management decisions regarding R&D, production, sales, marketing and other areas are very much assessed with respect to key drivers of shareholder value, the so-called "value drivers". Critics of that approach argue that a strong shareholder value orientation leads to short-termism in a way that, for example, quarterly financial results for shareholders are overrated and investments or innovations that may reduce short-term profits but drive success in the long term are neglected. Also, critics state that focusing solely on shareholder value exaggerates the importance of the company's equity and debt holders, often to the disadvantage or at the expense of other stakeholders such as employees or the society in general. The global financial crises 2008–2010 as well as global social and ecological problems lead to an increased demand for a stronger consideration of other stakeholders.

"Strategy strives to provide the business with a source of sustainable competitive advantage. For any competitive advantage to be sustainable, however, the strategy must be acceptable to the wider environment in which the firm competes." (Chandler/Werther 2014: 11) The Stakeholder Management approach—conceptually originating prior to Shareholder Value Management—(e. g., Freeman 1984) puts the management and integration of interests of different stakeholder groups in the center of strategic management. "A stakeholder is any group or individual who can affect, or is affected by, the achievement of a corporation's purpose. Stakeholders include employees, customers, suppliers, stockholders, banks, environmentalists, government and other groups who can help or hurt the corporation". (Freeman 2010: vi). The **stakeholder value**

Creating Shared Value
across Nestlé's Value Chain

Nestlé
Creating Shared Value
Nutrition | Water | Rural Development

	Agriculture and rural development	Manufacturing and environment	Products and consumers
Activity	Training farmers Water management Direct procurement	Local investments Water & energy efficiency Worldwide standards	Nutritional optimisation PPPs Education progr.
Value for society	Generating higher income for farmers Conservation of natural ressources	Value creation in local communities Natural ressources Knowledge transfer	Public health Local investments Economic growth
Value for Nestlé	Qualtity and availability of raw materials Efficient/sustainable supply chain	Cost savings Risk management People development	Trust in Nestlé brands Market shares Profitable growth

Source: Nestlé 2009. Reprinted with permission of Nestlé Deutschland GmbH.

Fig. 1-14: Creating shared value at Nestlé

Continued on next page

Continued from previous page

added can be seen as a consolidation of value added of the different stakeholder groups, such as shareholder value added, employee value added, creditor value added, customer value added, supplier value added, etc. (Figge/Schaltegger 2000: 29). The strategic task of management is to satisfy those critical groups who have a stake in the business in a way that ensures long-term success of the company. This perspective does not automatically mean that there is a conflict with the basic idea of the shareholder management approach. Actively managing all critical stakeholders such as customers, employees, suppliers, or the communities in which the firm operates can be seen as a key driver for increasing profits and shareholder value over the long term, as all of them have an impact on the success and failure of the company. Neglecting important stakeholders might destroy shareholder value and threaten the survival of the firm (Figge/Schaltegger 2000; Chandler/Werther 2014: 53–83).

In recent years, reconciliation between the shareholder value creation and the stakeholder orientation has been under way, partly driven by the increased role of corporate social responsibility. One example related to society as a key stakeholder is the recommendation that companies should not focus on short-term financial performance but on **shared value** that combines value creation for shareholders and for society: "The solution lies in the principle of shared value, which involves creating economic value in a way that also creates value for society by addressing its needs and challenges. Business must reconnect company success with social progress. Shared value is not social responsibility, philanthropy, or even sustainability, but a new way to achieve success." (Porter/Kramer 2011: 64) An example of how the shared value philosophy is applied across a high-level value chain at Nestlé is illustrated in figure 1-14:

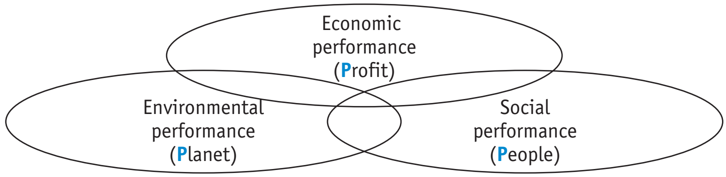
their P&L's bottom line or derived profitability measures—but also consider their ecological performance (e. g., carbon footprint, use of renewable materials and energies, waste, etc.) and their social performance (e. g., physical and mental well-being of employees, fair trade, equal opportunities, etc.).

Measuring corporate sustainability performance

There are various approaches that consider multiple bottom lines such as TIMM–Total Impact Measurement and Management (PWC 2015) or SROI–Social Return on Investment (Social Value UK 2015). However, such an undertaking is incredibly complex given all the possible metrics in the various dimensions that need to be captured in an objective way allowing comparisons across firms and industries. Currently there is no standardized way of measuring corporate sustainability performance by integrating all dimensions in one consolidated performance indicator. A common way of dealing with this issue is the application of standardized sustainability or corporate social responsibility (CSR) reporting guidelines such as the Global Reporting Initia-

Fig. 1-15

Integration of economic, environmental and social performance



Source: following Elkington 1997

tive (GRI G4 2015), the Commission on ESG Environmental, Social and Governance Issues (EFFAS CESG 2015), the International Organization for Standardization ISO 26000:2010 guidance on social responsibility (ISO 2015) and others with their corresponding key performance indicators measuring different sustainability dimensions (Kleinfeld/Martens 2014). As of today, a number of companies have integrated their financial and sustainability reporting into one report on performance (Eccles/Krzus 2010; Frank 2014; see also Strategy Practice Example 1.5). Additionally, there are examples of companies trying to capture their sustainability performance. An example is the sports and lifestyle company Puma SE and its parent company Kering, which were the first to globally publish an Environmental Profit and Loss Account (E P&L). PUMA accounted for € 145 million in externalized environmental damage in their fiscal year 2010, which was about 5 % of revenues and about 50 % of the accounting profit (EBIT) at this time (Hengstmann/Seidel 2014). A corresponding but more challenging approach for measuring the social dimension of performance is the Social Profit and Loss Account (S P&L). Imagining a requirement for all companies to pay for their externalized environmental and social damage and also getting rewarded for positive externalities—both based on a standardized and objective way to measure this—current profitability rankings and assessments of competitive advantage would change significantly (Elkington/Zeitz 2014: 71–85).

Triple bottom line and competitiveness

For an increased number of managers today, thinking about strategy in terms of the triple bottom line has become a critical element when analyzing competitive advantage and survival. They manage their performance not only in terms of financial profit or shareholder value but also with regard to their ecological and social conduct. For example, nowadays all 30 companies of the German Stock Index (DAX)—the so-called "Blue Chips"—commit and communicate a clear confession to their social responsibility (Blanke/Godemann/Herzig 2007; see also Strategy Practice Example 1.5). Moreover, the shareholder value philosophy of putting special emphasis on equity and debt holders because they provide the risk capital necessary to run the company's operations (see Strategic Snapshot 1.7) has been challenged recently. Studies have shown that companies performing high not only in economic but also in environmental and social categories have lower cost of capital regarding both debt and equity, meaning that they get better access to risk capital than firms with a low sustainability performance (Deutsche Bank Group 2012; Haßler/Häßler 2014; Löbbert 2014). As a result, integrating economic, ecological and social aspects of performance is not only a question of ethics and compliance providing boundaries for strategy but can be seen as levers of competitive advantage and key pillars for competitive survival.

Strategic relevance of sustainability

Considering non-economical factors in strategic management is not a new trend but has been an integral element of many strategic management models. For example, in one of the first integrated models of strategic management—the LCGA scheme of the Harvard Business School (see also Chapter 1.3.1)—the "acknowledgement of noneconomic responsibility to society" is considered one of four key components of strategy (Christensen et al. 1982: 99). Corporate social responsibility or sustainability has been moving beyond a primarily ethical-driven or compliance-oriented conduct. It has become a topic of high strategic relevance for the long-term survival of a company. Here are some of the reasons (Wunder 2014a: 66):

Strategy Practice Example 1.5

Performance and the Triple-Bottom-Line Approach at SAP

Toward a Sustainable Future

"Our commitment to a sustainable world is strong, as we seek to minimize our own environmental footprint and positively impact the communities in which we work. In 2012, for example, 60 % of the electricity consumed by SAP came from renewable sources. We reduced our greenhouse gas emissions slightly despite strong business growth. And, our employees delivered more than 130,000 hours of volunteering in the communities in which we work. Our commitment to achieving sustainable success is further demonstrated in this report, where we integrate our sustainability and financial reporting."

(Source: McDermott/Snabe 2013)

- In many industries, critical stakeholders such as customers, employees or public institutions are increasingly asking for sustainable business practices and present new requirements for companies.
- Companies are increasingly identifying sustainability as a source for gaining a competitive advantage over their rivals (e. g., brand positioning, company image, product differentiation, cost advantages, etc.).
- Being only reactive can lead to a competitive disadvantage if competitors are taking sustainability-related market opportunities faster.
- Implementing sustainability has an impact on all areas in the company and requires new ways of thinking and new competencies across the entire organization.
- The topic is not a short-lived management fashion but reflects the huge and serious global problems of our society that need to be solved urgently.

Business case for sustainability

Instead of a single-minded focus on short run economic results, the economic, ecological and social performance of a company is integrated in a "triple bottom line" perspective (see fig. 1-15). Corporate sustainability performance is achieved when environmental and social issues are managed in line with increased economic performance. Hereby, the substantial contribution of a company's activities to solve environmental and social problems of our society is considered a strategic success factor for ensuring long-term competitiveness and survival. In this understanding, competitive advantage is consequently not only related to a market-driven idea of creating greater customer value than competitors and capturing the corresponding economic value for the primary sake of shareholders but to creating and distributing stakeholder value in a broader sense (Loew/Clausen 2010; Dyllick/Hockerts 2002; Schaltegger/Wagner 2006). Hereby, a firm's environmental and social contributions are actively managed to create a business case, that is to "realize economic success through (not just with) an intelligent design of voluntary environmental and social activities" (Schaltegger/Lüdeke-Freund/Hansen 2011: 7 f.) Such a business case typically requires the incorporation of sustainability within the strategic management process (Chandler/Werther 2014: 65; Wunder 2014a). There are a variety of examples of companies that embrace and leverage sustainability as a principle for their business strategies. Many of those firms were able to gain competitive advantage coming from corporate sustainability (see chapter 3.4.4.5).

1.2 Strategic Decision Making

Strategy decision situation are not primarily analytical problems.

Strategy is about making choices. To accomplish this task, strategic management seminars, university classes as well as mainstream literature on strategic management are typically presenting methods and tools that essentially follow rational decision making models. Hereby, logical norms and a mathematical approach is seen as the basis for determining whether judgments are rational or not. While corresponding approaches are widely applied in business practice and seem to provide considerable benefits for tackling strategic management issues, they do not always consider how people actually make decisions. Strategic decision situations are often seen as primarily analytical problems that can be best solved with a sophisticated rational and mechanistic approach. The importance of intuition or "gut feeling" is often ignored although it is a powerful mechanism that can be highly effective, particularly when dealing with complex problems and uncertain or unpredictable environments (Gigerenzer 2007). Underlying "rules of thumb" (heuristics), however, can easily become biases to good decision making when improperly applied.

Managers are largely unaware of how their minds function.

Most managers remain largely unaware of how their minds help them to make strategic choices. Without basic knowledge about how the brain works, managers cannot anticipate when their cognitive processes that usually serve them well are likely to lead to severe and systematic errors in strategic decision making. The following provides a brief introduction to the foundations of decision making with the goal to create awareness for basic judgmental mechanisms and particularly for cognitive biases. It is intended to sensitize to the limitations of rather analytical methods and tools presented later on in this book and provide some guidelines of how to combine analytical approaches and intuition to ensure effective decision making in the context of strategic management.

1.2.1 Foundations of Decision Making

Decision making requires alternatives. If there are no alternatives to chose from, there are no decisions to make. Choosing among alternatives is not a simple act but a comprehensive process of decision making. There are various models to describe this process which will be briefly explained next.

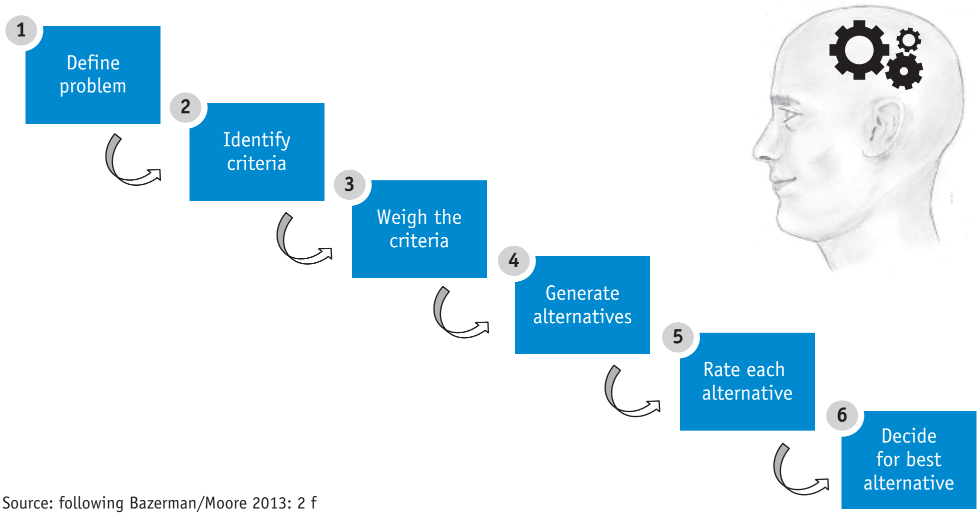
1.2.1.1 Rational Model

Objective and logical decisions for optimal results

The rational model of decision making assumes that people make fully objective and logical decisions that lead to an optimal result. When solving a defined problem, "optimal" means it can be proven that there is no better solution to this problem. A decision maker who was perfectly rational would optimally and consciously follow the six steps illustrated in figure 1-16 (Bazerman/Moore 2013: 2 f.): Based on a clear problem statement, criteria for evaluating various decision options are identified and weighed according to their relative importance. Each generated alternative is rated for each criterion. After multiplying rate and weigh the alternative with the highest score is chosen as it is the one with the highest value or utility. The model is prescriptive in a

Fig. 1-16

Steps in the rational model of decision making



Source: following Bazerman/Moore 2013: 2 f

way that it defines how decisions *should* be made rather than describing how they *are* actually made. In a business context, the rational model can be seen as consistently deciding for the alternative that maximizes a certain goal or expected *utility* like company performance (see chapter 1.1.3) within specified constraints such as available resources as well as the decision maker's values and risk preferences.

Assumptions of rational decision making

Deciding rationally has a number of assumptions. It assumes that managers know the utility of all available options and are able to compute what the optimal decision is. Furthermore, it relies on assumptions such as a clear and unambiguous problem statement, a precisely defined single goal to be achieved, complete information about all available alternative options that are identified in an unbiased manner as well as clarity about the decision maker's preferences that are constant and stable. (Robbins/DeCenzo 2008: 104; Robbins/Judge 2013: 209)

1.2.1.2 Bounded Rationality

Deciding rationally for satisficing ("good enough") results

It is unlikely that people actually decide completely rationally based on the rather optimistic assumptions of perfect rationality explained before. Nobel Prize winner Herbert A. Simon coined the term of "bounded rationality" to explain the fundamental incapability of a human being to make an optimal decision based on all the assumptions explained before (Simon 1957; March/Simon 1958). According to this model individuals are still consciously attempting to make rational decisions. However, a number of limitations prevent them from accurately computing the optimal decision such as:

- Time and cost constraints limit the quantity and quality of information to define the problem, identify criteria, generate all available alternatives and their utility, etc.
- Cognitive limitations of the decision makers such as the amount of available information in their usable memory, intellectual limitations, perceptual errors, etc.

Managers are satisficers not maximizers.

As a consequence of bounded rationality, individuals look for a solution that is "good enough" to solve the problem rather than an optimal one. This solution represents a so-called *satisficing* choice, that means it is satisfactory and sufficient. In the real business world, managers tend to behave within the confines of bounded rationality. They respond to a complex problem by reducing it to a level they can understand and construct simplified models derived from essential problem features. A few easy to find alternative solutions reflecting familiar criteria are identified. Ideally, those solutions have been tried and "proven" to work before. The first solution that meets an acceptable level of performance is selected and ends the search. (Robbins/Judge 2013: 210)

The concept of bounded rationality has been supplemented with a variety of other identified bounds to decision making such as bounded willpower, bounded self-interest, bounded awareness, and bounded ethicality (Bazerman/Moore 2013; Thaler 2000). Those concepts are not further elaborated on here. However, related common biases and errors in decision making and how to avoid them will be explained later on in this chapter. Before this attempt is meaningful, a third category of decision making needs to be introduced: intuition.

1.2.1.3 Intuition

Deciding unconsciously based on experience, associations, and affection

Intuition is often seen as the least rational way of making decisions. Truly intuitive decisions are made in an unconscious process which is based on the decision maker's experience, associations and affection (Robbins/Judge 2013: 211). In other words, intuition is not some sort of paranormal sixth sense but a result of past experience, knowledge, skills, individual perception, and feelings of the decision maker. This is why experts tend to make good intuitive decisions more frequently than others (Rausch 2013: 17). Intuitions come to mind quickly, are strong enough to trigger a decision, individuals are not completely aware where their intuitions come from, and they are based on two key principles (Gigerenzer 2007: 16–19 and 47 f.):

- **Heuristics**, that is simple rules of thumb or judgmental shortcuts that leverage the most important information and ignore the rest, and thus, enable fast decisions and actions. They are used by human beings to compensate their limited cognitive capabilities to handle with the complex environment.
- **Evolved capacities** of the brain, that is capacities such as cognitive abilities and social instincts, the ability to trust and to experience emotions such as love that evolved over millennia. They enable the heuristics.

Intelligence of the unconscious

Management decisions that are based on heuristics are neither necessarily false nor worse. In a positive sense, these decision-making strategies can be considered as efficient techniques to solve problems. Without them it would be impossible to find a solution facing complex and unstructured situations (Beck, 2009, 122). An example is the *availability heuristic,* which can be very useful for managerial decision making. It is a tendency for people to base their judgment on information that is readily "available" in their memory. Information regarding events of greater frequency is recalled more easily than rare events, which is often an indicator for their relevance in decision making. Another example is the *representativeness heuristic,* which fre-

Strategic Snapshot 1.8

System 1 and System 2 Thinking

Two systems or "modes of thinking" in the brain can been seen as the cognitive foundations for any kind of decision making (see fig. 1-17). Although these two modes have received many labels, the terms System 1 thinking and System 2 thinking are widely used. System 1 refers to intuition and operates automatically. Its functioning can be further described as unconscious with no sense of voluntary control, quick, implicit, emotional, and effortless. Examples of automatic activities related to System 1 are the interpretation of verbal language or visual information, orienting to a loud unexpected sound, brushing teeth, or driving a car on an empty road. By contrast, System 2 refers to reflection and operates controlled and conscious. It refers to reasoning that is slower, more explicit and logical, as well as more effortful. The rational decision making model illustrated in figure 1-16 can be seen as prototype of System 2 thinking. Mental activity of System 2 literally requires "paying attention" and deliberately disposing a portion of the limited attention capacity to corresponding mental operations. Examples are computing the product of 17 x 24, counting how often a letter appears on a page, learning to drive, or filling out a tax form. Most decisions in life are made using System 1 thinking.

Time-pressures and busy managers that have many issues on their minds are likely to rely more on System 1 thinking. Not only that more logical System 2 operation is not required for any managerial issue, it may even provide worse decisions than the intuitive System 1 thinking depending on the specific situation. Many managers have a great deal of trust in their intuitions. Sometimes, however, System 1 thinking can lead to severe and systematic errors in decision making caused by cognitive biases. The main reason is that people are usually unaware that they rely on heuristics. Left unchecked, these subconscious cognitive biases can undermine important strategic decision making. A key challenge for managers is to be aware of those pitfalls and identify situations in which they should move from the intuitive System 1 thinking to the more logical System 2 thinking.

(Source: Stanovich/West 2000; see also Bazerman/Moore 2013: 3 f.; Kahneman 2011: 20–24 and Kahneman/Lovallo/Sibony 2011)

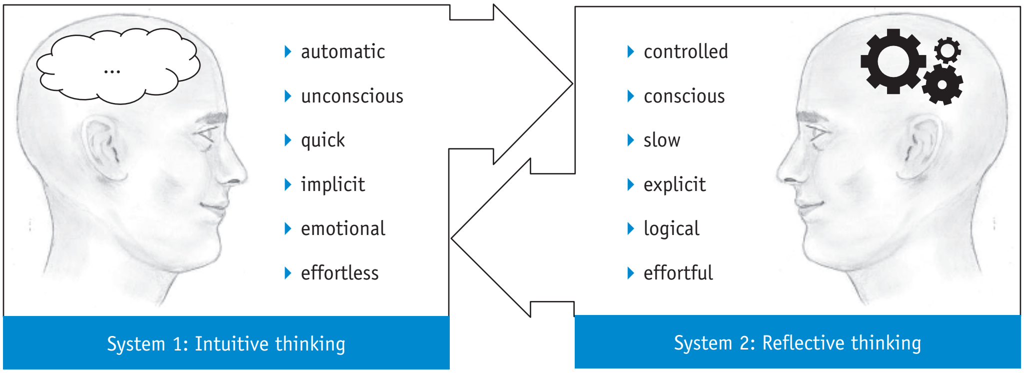


Fig. 1-17: Two modes of thinking

quently offers a good first-cut approximation. Managers who use it judge the likelihood of an occurrence (e. g., performance of an individual, event, etc.) based on how strongly its traits fit to something they are already familiar with (e. g., previously formed stereotypes they have in mind). Both heuristics provide time-pressured managers useful ways of dealing with a complex world. However, along with other heuristics they can also lead to serious errors in decision making which are outlined in table 1-1. (Bazerman/Moore 2013: 8 f.; Robbins/DeCenzo 2008: 108)

Intelligence of the unconscious

"A gut feeling is not good or bad, rational or irrational per se. Its value depends on the context in which the rule of thumb is used. (…) Gut feelings may appear simplistic, but their underlying intelligence lies in selecting the right rule of thumb for the right situation." (Gigerenzer 2007: 48 f.) Intuition is a highly complex form of decision making that does not substitute the conscious rational approach but rather complement it. The situational context determines how well a heuristics and our evolved capacities are working and how important intuition is for good decision making. Eventually, the quality of decision making does not only have to be a matter of elaborating on pros and cons or cost-utility analyses. What this means for typical strategic decision situations will be addressed next.

1.2.2 Strategic Decision Situations

Judgmental cognitive processes are important in strategic management.

Traditionally there has been an emphasis on rational analysis and decision making in strategic management. The more sophisticated analytical tools and techniques for preparing decision making are, according to the general assumption, the better will the strategic decisions be. Nowadays, trend analysis and future prediction industries are continuously developing more and more sophisticated tools that are essentially based on this type of approach. However, it is sometimes neglected that strategic management is not a purely technical process. Even the "best" strategic management processes and tools sometimes fail (Wunder/Stemmermann 2013). The role of intuition and judgmental cognitive processes in strategic management has gained tremendous attention in recent years (Lovallo/Sibony 2010; Powell/Lovallo/Fox 2011; Roxburgh 2003; Schrager/Madansky 2013). It is increasingly recognized that rational analysis has been overemphasized and that relying on intuition can actually improve decision making in certain instances (Gigerenzer 2007). But what is so "special" about strategic decision situations?

1.2.2.1 Characteristics of Strategic Decision Situations

Strategic management differs from operational management.

Typical strategic decision situations tend to differ fundamentally from operational decisions but both need to be aligned (see fig. 1-18). Strategic decisions are directional with long-term impact. Instead of dealing with a partial problem in a subarea of the organization, strategic decisions are often company-wide and more holistic. The decision base relates more to a political than a technical environment with problem solving that is often novel or rare instead of routine or a replication of precedent approaches. Whereas operational management has to deal with how to utilize resources in terms of productivity, strategic management requires decisions of how to

Fig. 1-18

Characteristics of strategic and operational decisions

	Strategic decisions (strategic management)	Operational decisions (operational management)
Focus:	direction ("What?")	efficiency ("How?")
Time horizon:	long-term	short-term
Impact:	company-wide; holistic	subarea; partial
Decision base:	political	technical
Problem solving:	novel/rare	routine/precedents to follow
Resources:	allocate/commit resources	utilize resources
Situation:	ambiguous	definite/clear

best allocate and commit limited resources in the organization. One of the biggest challenges of strategic management is the ambiguity of decision situations. In operational management, decisions tend to relate to rather definite and clear situations (e. g., the breakdown of a production line because a machine has stopped working, customer complaint, etc.). In strategic management the situation is often vague and uncertain (e. g., capturing a new market trend and adapting the business model). Whereas operational decision making may call for a rational process that is more related to System 2 thinking, this approach might not be sufficient for dealing with strategic decisions.

The essential characteristics of those ambiguous strategic decision situations can be described with complexity, dynamics, volatility, intransparency, and lack of "objective" knowledge about reality (Dörner 1992: 58–66 see also Strategic Snapshot 1.9):

Strategic Snapshot 1.9

Strategic Decision Making Illustrated With Chess

The characteristics of strategic decision making can be illustrated by using the analogy of a chess game where the players have to use a chess set with many chess pieces that are interconnected with rubber threads, so they cannot move one piece without moving the others (*complexity*). Additionally, the own pieces and the ones from the opponent are moving on their own based on rules the players do not know exactly or have false assumptions about (*dynamics and volatility*). On top of that, some of the own and the opponent's pieces are in the fog and not or only barely visible (*lack of transparency*). (Source: Dörner 1992: 66)

Complexity, dynamics and volatility

Strategic situations tend to be rather complex. This means that there are many interdependent elements inside and outside the organization that ideally need to be considered. Furthermore, if one element is altered it might impact the others. For example, if a competitor launches a new product it might have an impact on the behavior of our customers and the perception of our own portfolio. Launching a new product by our own might impose competitor response that we did not know before. Also, if the government releases new laws, it strongly affects the market. The recent turnaround in the German energy policy toward renewable energy, for example, changed the competitive landscape in the energy sector dramatically. Furthermore, strategic decision makers are facing a high level of dynamics as development occurs also when they do not act. This means that even the most comprehensive analysis of today's state is not sufficient as the competitive landscape is continuously changing. Moreover, companies have to deal with an increasing level of volatility. This means that the frequency and magnitude of change between growth and decline in the economy is increasing, which has widespread impact due to globally interconnected and fast moving markets.

Lack of transparency and "objective" knowledge about reality

Another characteristics is a lack of transparency, that is that neither the planner nor the decision maker has access to "all" information that would be necessary to consider. A decision needs to be made even though the current situation can never be fully understood, not to speak about the future. Furthermore, there is no "objective" knowledge about reality. People decide based on their individual explicit or implicit world view or assumptions based on which the individual brain is constructing its own reality. Most people strive for certainty which prevents them from dealing with the possibility that their assumptions might be wrong or their view might be incomplete.

1.2.2.2 Dealing with Strategic Decision Situations

Complexity and uncertainty call for good intuition

The challenge of strategic situations is that decisions need to be made in a highly complex environment today based on an anticipation of the hardly predictable future. Complex problems require complex solutions, we are frequently told. Finding an "optimal" solution for a strategic decision situation based on the characteristics explained, managers may want to use as much information as possible and feed it into the most sophisticated analytical decision-making process. Management leadership teams, for example, that are recruited from operational experts with technical backgrounds shaped by reasoning of natural sciences rationality, tend to approach strategic decision situations in a more "technical" manner and rely primarily on analytical tools to "compute" an optimal solution. Finding an "optimal" solution in such a situation, however, requires two preconditions:

- First, there actually is an "optimal" solution
- Second, there is a rational way to find it.

Given the complexity, dynamics, volatility, intransparency and flaws in perception of such strategic situations, it is very unlikely that the two preconditions apply. In such highly complex and uncertain situations, simplicity and good intuition becomes critical for success. Depending on the situation they may provide good or even better results than time consuming rational problem solving and decision-making processes. (Gigerenzer 2007: 81–92; Gigerenzer/Brighton 2009; Gigerenzer/Todd/ABC Group 1999)

Strategic decisions not only reflect the situation but also the person and environment.

In a strategic decision situation and its underlying conditions of complexity and uncertainty, executives "are not handed nicely distilled comprehensive summaries of the situations they face. Instead, the 'facts' that confront executives—if they can be called facts—are typically ambiguous, contradictory, and far-flung, and they emanate from various parties who have their own motives. As a result, the situations that executives face are not knowable; they are only interpretable. (…) the individual filters the facts through a web of personal qualities—including what he or she values, and how his or her mind works. As such, the person's actions are much more a reflection of the person than of the situation." (Finkelstein/Hambrick/Cannella 2009: 3 f.) Strategic decisions are not only driven by factors like customers, competitors, technology or the company's resources, capabilities and competencies but by the people making strategic decisions at different levels in the organization and their biases and dispositions. They are also affected by the decision making environment at a particular company, such as whether open discourse is encouraged with dissenting views or whether senior leaders reject input and seek affirmation of their own viewpoints (see also chapter 1.3.3.3).

1.2.2.3 Cognitive Biases and How to Counter Them

Relying too strongly on heuristics has pitfalls.

A "simple" and intuitive approach to strategic decision making has pitfalls. Relying too heavily on experience, gut feelings and convenient rules of thumb can also distort rationality. Heuristics sometimes lead to severe and systematic errors in decision making. The main reason is that people are usually unaware of the heuristics they base their decisions on. Besides emotional and motivational influences, this can lead to errors in intuitive judgment due to subconscious cognitive biases (Kahneman/Lovallo/Sibony 2011; Tversky/Kahneman 1974). Those cognitive biases breed failure and interfere with the idealistic assumption of rational decision making underlying most of the strategy tools. Left unchecked, this cannot only affect but undermine important strategic decision making resulting in a negative effect on the company. Helping organizations and management teams to become aware of the potential adverse impact of using heuristics that cause the corresponding cognitive biases are likely to improve their decision-making processes, and thus, lead to more beneficial outcomes. Organizations that worked on reducing such bias-based flaws in their strategic decision-making processes significantly improved their return on investment by up to seven percentage points (Lovallo/Sibony 2010: 6).

Cognitive biases unconsciously undermine decision making.

Cognitive biases are errors in intuitive judgment. They have to be distinguished from logical fallacies which are errors in logical argumentation. Cognitive biases are caused by System 1 thinking (see Strategic Snapshot 1.8). They unconsciously undermine the effectiveness of decisions that are based on heuristics. "Because System One is so good at making up contextual stories and we're not aware of its operations, it can lead us astray. The stories it creates are generally accurate, but there are exceptions. Cognitive biases are one major, well-documented example. An insidious feature of cognitive failures is that we have no way of knowing that they're happening: We almost never catch ourselves in the act of making intuitive errors. Experience doesn't

Tab. 1-1

Common biases in decision making

Availability bias	Reliance upon the knowledge that is readily available in the mind rather than examining additional sources of information.
Anchoring effect	Giving disproportionate weight and fixation to the initial information the mind receives without adequate adjustment for subsequent information.
Confirmation bias	Only seeking information that confirms pre-existing views or past choices and ignoring information that supports alternative judgments.
Egocentric bias	Decisions are influenced by the goal to maximize own gain. Also, own contributions are seen as overly responsible for outcomes of groups.
Escalation of commitment	Having increased commitment to and staying with a previous decision even when there is clear evidence that the decision is wrong.
Conjunction fallacy	Overestimating the likelihood of a scenario with more detail than with less. More specific conditions are seen more probable than general ones.
False consensus bias	Overestimating the extent to which own thoughts, opinions, beliefs, and experiences are common and shared by others.
Framing effect	Decisions are influenced by the way or expression of how logically equivalent information is presented (e. g., as a loss or as a gain).
Groupthink	A group consensus for a first remotely plausible option overrides the realistic appraisal of alternatives and engagement in critical thinking.
Halo effect	Drawing overall impressions about something (e. g., person, product, situation, etc.) based on only a single characteristic.
Hindsight bias	Believing that a known situation could have been accurately predicted and dismissing the possibility that it could have turned out differently.
Inappropriate attachment	Distorting judgments by emotional attachment of decision makers to people, projects, organizations, or other things.
Illusion of control	Overestimating the ability and power to control events. Illusionary believe to have influence on things that are beyond one's control.
Overconfidence bias	Placing exaggerated confidence in one's own knowledge or abilities to solve a certain situation other than it should be given by objective parameters.
Optimism bias	Believing oneself is less at risk of experiencing a negative event or more likely to be successful compared to others neglecting actual probability.
Positive outcome bias	Overestimating the probability of good things happening ("wishful thinking") and underestimating the probability of undesirable outcomes.
Reactance bias	Overrating something that is limited or taken away (e. g., decision option) as a reaction (resistance) to perceived constraints of freedom.
Self-serving bias	Attributing success as one's own personal contribution but failure to the result of external factors and rejecting the validity of negative feedback.
Status quo bias	Avoiding any changes from the current baseline (status quo), and thus, judging and deciding in a way that things remain the same.
Sunk cost fallacy	Judging investment decisions not only on their own merits but considering costs that have already been incurred and cannot be recovered.

Source: Bazerman/Moore 2013: 14–59; Kahneman 2011; Klatt/Möller 2011; Weber/Schäffer 2011, 263–268; Dobelli 2011; Montier 2007, 19; Riesenhuber 2006, 69–134; Pohl 2012; Robbins/Judge 2013: 211–216; Roxburgh 2003; Baron 2008 help us recognize them. (By contrast, if we tackle a difficult problem using System Two thinking and fail to solve it, we're uncomfortably aware of the fact.)" (Kahneman/Lovallo/Sibony 2011: 4) In strategic management, cognitive biases are likely to affect the most important strategic decisions made by even the smartest executives in top companies. Their decisions may be biased in ways that seriously compromise their quality. Managers can hardly eliminate their own biases on an individual level even if they know they have them. However, creating awareness of biases and incorporating those insights into the strategic decision making processes of management leadership teams helps to "debias" those collective strategic decisions in organizations (Kahneman/Lovallo/Sibony 2011). There is a very wide spectrum of the behavioral phenomena related to cognitive biases. Table 1-1 provides an overview and brief explanation of 20 common biases in decision making in alphabetical order.

Insights about the modes of strategic decision making and how to best deal with dangerous errors and biases have to be build into the construction logic of a strategic management process. It may be considered when selecting tools and methods for strategic analysis, strategy formulation and execution, defining standards of how strategic decision proposals should look like, forming strategic planning teams or an office of strategic management (see Strategic Snapshot 1.10 in chapter 1.3.3.1), building management leadership teams for making strategic decisions or defining norms for reaching consensus. The chapter on strategic decision making concludes with some suggestions for how to improve strategic decisions and avoid falling in errors caused by cognitive biases.

No logical reasoning for intuitive decisions

First, management teams making strategic decisions are well advised to take intuitive decisions of their members very seriously and complement conscious rational strategic decision making approaches they may follow with those intuitive judgments. Hereby, it makes little sense to ask a member who decided intuitively to explain the reasons for his judgment because those decisions are typically made in an unconscious process. Some management leadership teams give equal weight to purely intuitive decisions. Particularly when making important strategic decisions, they accept an answer like "I don't know why but my gut feeling tells me it is the wrong (or right) decision" as veto for their management team conclusion without asking for a more logical reasoning (Gigerenzer 2010).

"Debias" strategic decisions

Second, deliberately looking or asking for information that disconfirms one's beliefs or a strategic recommendation can help to counteract a variety of biases such as overconfidence, optimism or hindsight (Robbins 2004: 164–168). Asking questions like "What are major things that can go wrong? How likely are they?" may help to see how thoroughly a strategic recommendation has been investigated and may reveal potential biases of the recommending or deciding team. For example, those questions may help to reduce the liability risk of supervisory boards when providing their legally required approval for certain strategic decisions of management boards. Figure 1-19 provides a checklist of 12 questions for reducing cognitive biases and errors when making strategic decisions. Most questions can be related to both the team who prepared a strategic decision and makes recommendations based on deep analysis as well as to the management leadership team who has to make the decision with less time for its judgment.

Fig. 1-19

12 questions for reducing biases and errors in collective strategic decision making

1	Are there any self-interests in the team?	7	Where did the numbers come from?
2	Did the team fall in love with one proposal?	8	Could there be a HALO effect?
3	Were there dissenting opinions in the team?	9	Are we overly attached to past decisions?
4	Are there wrong or salient analogies used?	10	Is the base case overly optimistic?
5	Were credible alternatives considered?	11	Is the worst case bad enough?
6	How would we decide in a year's time?	12	Is the team overly cautious?

Source: following Kahneman/Lovallo/Sibony 2011, adapted

1.3 What is Strategic Management?

General management perspective on how to manage a firm strategically

Strategic management is an integrated management field that deals with decisions and actions that determine the long-run performance of a company. It explicitly applies a general management and cross-functional point of view that elaborates on decisions and strategies in the light of the entire company. Managing an organization strategically requires integrating knowledge and processes of different business disciplines such as finance and managerial control, marketing, operations, human resource management, organizational and human behavior, leadership, and others. Strategic management includes strategic analysis, strategy formulation at different levels in the organization including business modeling, as well as strategy execution along with control, testing and adaption of strategy. The wheel of strategy framework introduced in chapter 1.3.3 embodies this view with all relevant aspects. It is an illustrative holistic framework of strategic management that can be used as a reference point. Many concepts and techniques in strategic management have been developed and used by or for rather large multinational corporations. Foundational thought models and approaches, however, can be applied to business and non-profit organizations of any size.

1.3.1 Evolution of Strategic Management

From financial planning to strategic planning

Few if any companies today are operating only based on *basic financial planning* focusing solely on the following year's budgets. A firm is likely to engage in any kind of strategy process where it deals with the question of how to secure its future beyond next year based on some sort of analysis. Companies may conduct this more in the sense of *long-range planning* which could still be focused on financials but with a time-horizon of 3–5 years. Hereby, decisions are based on internal and available (ad hoc) external information and corresponding extrapolated trends. It typically relates to projects with durations longer than one year. Long-range planning activities can be found primarily at the middle to lower management levels. Traditional *strategic planning*, on the other hand, is based on a more systematic and formalized internal and external analysis. The goal is to increase the organizations responsiveness to changing competition with more comprehensive planning processes. Top management is the primary planning level and is supported by market and competitive intelligence units or strategic planning groups. Implementation is left to lower management levels.

Strategic management goes beyond long-range and strategic planning

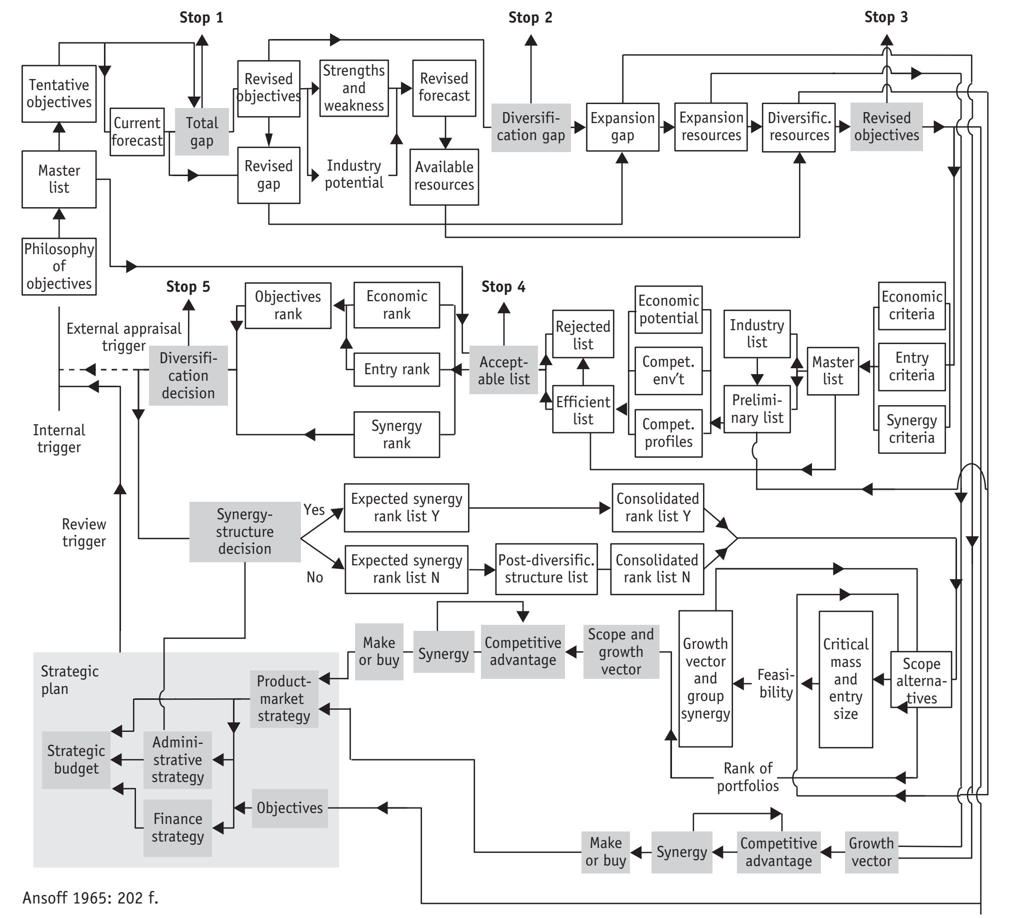
Like strategic planning, *strategic management* is also based on a systematic external and internal analysis or even a continuous monitoring of the business environment in the sense of strategic foresight. The time horizon is 3–5 years and beyond. Some companies elaborate on potential pictures or scenarios of the future with a 10, 20 or even longer time perspective, derive contingency strategies and make decisions about their desired position in an anticipated competitive arena of the future. Corporations such as Siemens with its technology oriented "Pictures of the Future" or Nestlé with its magazine "GOOD" regularly publish trends that will shape our lives over the next 10 to 20 years, draw on scenarios of the future and explain their corresponding strategic thrusts. Contrary to long-range or strategic planning, strategic management is not too focused on a certain planning level but tries to involve people at all levels in an interactive way in ongoing strategic thinking and ideation. Strategy execution as well as strategic agility and adaptability are considered as particular important elements given today's dynamic and volatile environment (see chapter 4.3.7.3). Also, behavioral aspects such as intuition or heuristics and the related biases are more and more elaborated on in strategic management to improve the strategic decision making process (see chapter 1.2). In company practice, the terms strategic planning and strategic management are sometimes used synonymously, that is companies officially engaging in "strategic planning" may actually practice strategic management and vice versa.

Strategy as own academic discipline

The origins of strategy as an own academic discipline can be found at the Business Schools at universities in the USA. One of the forerunners was the Harvard Business School where a course titled "Business Policy" in the Senior Management Training was based on solving company case studies dealing with selected general management issues including the strategic orientation of a company. The initial focus was not on scientific research or developing theories related to strategy but on solving real company problems. Dealing with strategy as an academic discipline advanced in the 1960s and 1970s. One example is Alfred Chandler (1918–2007) with his book "Strategy and Structure" in 1962, where he writes about the growth process of four companies (Sears, General Motors, DuPont and Standard Oil). Based on his insights, he formulated his famous strategic management principle "Structure follows Strategy" that is still frequently quoted by executives today. Another pioneer of today's strategy practice and one of the founders of strategic planning was H. Igor Ansoff (1918–2002) of Massachusetts Institute of Technology with his work "Corporate Strategy" in 1965. He described in depths the foundations of strategic planning and developed a detailed flow chart of analysis, gap identification and decision making. This was mapped out in the Ansoff Model for Strategic Planning which is shown in figure 1-20 (Ansoff 1965: 202 f.). It is an illustrative example for the level of planning detail and

Fig. 1-20

The Ansoff model for strategic planning



Ansoff 1965: 202 f.