1. Strategy

1.1 Definition and history

What are the main aims of a strategy course? The following objectives are good starting points:

1) to be able to conduct a sector analysis;
2) to be able to evaluate the financial performance of a firm;
3) to understand the type and sources of competitive advantage;
4) to understand the directions of firm growth;
5) to become familiar with the case study methodology.

Strategy derives from the ancient Greek term *strategos*, which defines a particular military job: that is, to lead a *stratia*, or group of soldiers. The modern concept of business strategy retains some of these military connotations, in that it comprises four "military" aspects: the selection of aims, the environment, the organization, and the implementation.

1) *The aims*: Knowing the targets. A firm might have several goals, in both the short and the long run, such as market shares, rate of growth, return on sales (ROS), return on investment (ROI), or return on equity (ROE). Determining the right aim is the first step of a good strategy (as in a military campaign).
2) *The environment*: Knowing a sector. For a firm, knowledge of the battlefield is fundamental. A firm should be aware of the main characteristics of its environment, to choose the right position and the right moves.
3) *The organization*: Knowing the firm. What are its strengths and weaknesses? What important resources does it need, and which of these resources

are missing? The potential strategies that might be applied depend on the type of resources at hand. This means that the firm must choose a strategy that can be implemented with its existing resources, otherwise it has to look elsewhere to acquire the required resources.

4) *The implementation*: Knowing the processes. How does a firm move all its resources (technological, financial, human resources) toward the objective? Implementation means designing and assigning tasks, setting the right incentives, motivating the structure, and avoiding mistakes.

From an academic point of view, the approach to strategy studies has not always been the same. Today, a mainstream business strategy course reflects the evolution of different approaches, which have emerged over several decades.

The first studies suggesting strategy thinking originated in accounting literature in the 1950s, which focused mainly on planning and forecasting. As the first mainframe computers became available for business applications (for example, at GE and IBM), scholars and practitioners also started looking seriously into the problems of setting aims and evaluating (accounting) changes according to different environmental scenarios. World War II provided an important spur to these studies because for the first time it posed the compelling problem of assigning rapidly scarce resources to (war) units.

In the 1960s, especially thanks to Carnegie Mellon School in Pittsburgh, attention shifted to the organization processes inside the firm and the problems of decision implementation. The main conclusion from this stream of research was that different methods for organizing firms would lead to different behaviors and thus to different results.

In the 1970s, the main contribution came from historians (Chandler, Rosenberg); they approached strategy with a historical perspective, studying histories of firms in different contexts and highlighting the importance of resources, path dependence, and the evolution of growth strategies.

From a practitioner-oriented perspective, between the 1960s and 1970s, consulting firms like BCG and McKinsey introduced the widespread use of matrixes to analyze problems and take decisions, especially in terms of firm portfolio planning. Even if these matrixes were criticized for the lack of a sound strategic theory, they should be mentioned because they brought to the forefront two important issues: sector characteristics and firm decisions.

Contextually, from an economic point of view, the 1970s marked the passage from a phase of rapid economic growth (the roaring 1950s-1960s) to a phase of stagnation and crisis due to energy crises (oil shocks). Firms, therefore, started being more concerned with understanding how to outperform competitors in static or declining environments rather than looking for growing markets and new opportunities.

The 1980s represented the birth of the modern concept of strategy, thanks to Michael Porter, who set the foundation for virtually every future interpretation and discussion of the issue. His approach highlighted the importance of analyzing the sector, with the idea that knowledge of the sector is fundamental to design optimal strategies.

In the 1990s, the Porterian vision was challenged by a heterogeneous group of scholars, who brought the firm to the forefront. Known as the "resource-based view," the theory promulgated by these authors stressed the importance of firm resources as determinants of competitive advantage. They also proposed that firm strategies could change the same characteristics of a sector, meaning that these characteristics are modifiable by firms' actions.

Today, if we want to sum up, the current strategy approach is a synthesis between the importance of sector characteristics and firm resources. The interest in sector dynamics and their influence on firm's learning and adaptation, the firm's position in the product space, and the identity that it is able to convey (largely due to contributions by sociologists), is also relevant.

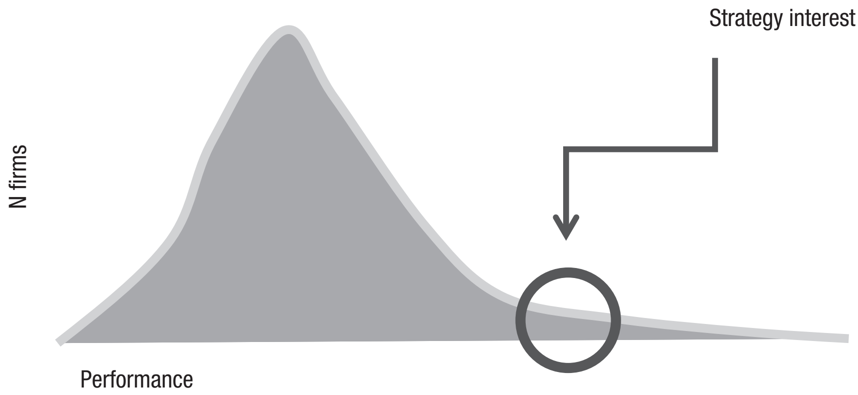
In summary, our definition of *strategy* recognizes that it is *a plan of action, designed on the basis of an understanding of the firm's environment, that seeks to achieve a specific competitive advantage through the use of firm resources*. In turn, we define *competitive advantage* as the outcome that arises when a firm is *able, for a significant period of time, to obtain a larger gap between average costs and willingness to pay than its competitors*.

1.2 Why is strategy important?

Why is strategy such a common term? Why are there thousands of consulting firms whose only job is to provide strategic advice? Why are there thousands of universities that offer strategy courses at different levels? There must be something valuable about strategy.

The first point that we need to acknowledge is that a good performance is not an easy aim to achieve. Let us imagine the distribution of performance

Figure 1.1 The usual distribution of performance among firms



for every firm in any sector or country; we will likely obtain a plot similar to Figure 1.1.

As Figure 1.1 suggests, being a top performer, in the right tail of the distribution, is a low-probability event; the low-performance section of the graph is a higher-probability event. This figure also reflects the particular form of science that is strategy: We are not interested in the average behavior of firms, but rather in understanding what the top performers in the right tail of the distribution do. This is why in strategy courses case study methods are so common. We pick a firm in the right tail and seek to understand how it got there. Usually, the answer is: a good strategy.

But how can we classify a good strategy? One common way is to decompose the answer in 4Ps. Strategy is a conscious *Plan* that, when applied correctly, offers significant value to the firm. In strategic terms, when we talk about value for a firm, we always refer to its ability to *create value* from the economic transaction and to *capture value*. Firms that are able to simultaneously create significant value and to capture a large part of it are those that accrue a sound competitive advantage.

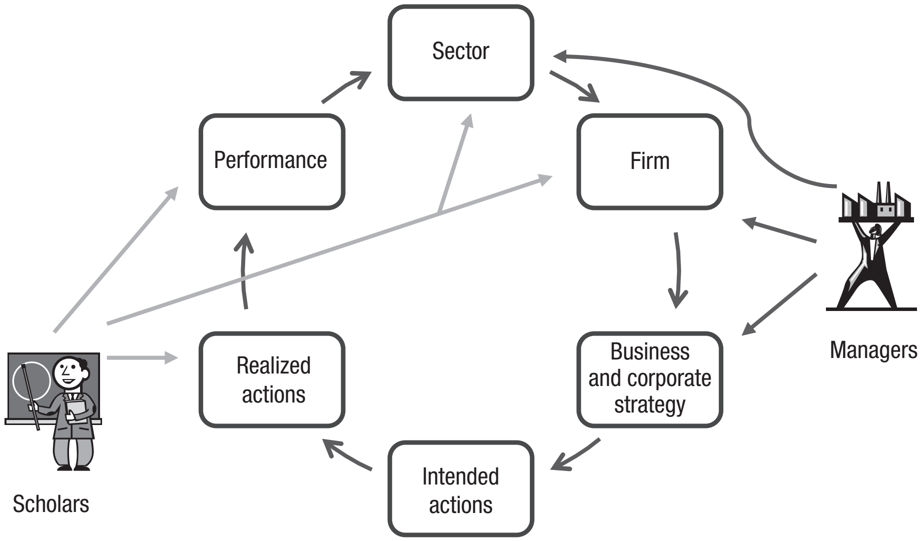
A necessary condition to create and capture value is to understand the environment, because it makes it possible to pinpoint the firm's *Position* and to highlight elements that might be changed, strengthened, or avoided. Moreover, the environment and the firms themselves are not frozen concepts but constructs that tend to change with time. Position also means understanding in how many markets the firm wants to compete and choosing the markets (product niche, geography) in which a firm wants to be present. The answer to this "where" question is the task of *corporate strategy*.

Strategy is also a tool that helps to strengthen power and create consensus on these decisions. How can a manager implement breakthrough decisions in an organization if not supported by well-crafted strategy thinking? How could a CEO kill a project proposal from a production manager without reasonable strategic motives? In this respect, strategy is also a *Pattern* of behavior, a series of rules that should be implemented in the organization with as much consensus as possible. Behavior also means deciding how to compete and achieve a competitive advantage in the selected markets: cost or differentiation? And using which resources? In conventional terms, this "how" question is the purview of *business strategy*. Business and corporate strategies are at the core of strategic thinking.

Finally, strategy is *Perception*, the ability to understand future directions with a correct framework. Without future strategy, firms are at risk of finding themselves in a condition of inertia or inability to understand the future and adapt to new situations. Dynamics, and therefore the interplay between current and future strategies, is essential to strengthen the competitive advantage of a firm and defend it from possible erosion due to competitors and changing conditions. Therefore, good strategies are always designed in motion. Reaching a competitive advantage usually requires a good fit between firm and sector, which in turn requires substantial coherence between sector characteristics and firm competences and resources. In more detail, *current strategy* deals with everyday implementation of what a firm aims to accomplish in the short run; *future strategy* helps firms anticipate changes and prepare for the future.

In a nutshell, Figure 1.2 shows the path of strategy formation: A strategy can be formulated from the interaction between sector and firm characteristics. This strategy will then lead to elaborate a series of potential actions, some of which will be realized. This implementation will generate firm performance that feeds back to the sector and firm characteristics. The task of the manager is to evaluate sector and firm conditions and then develop a strategy. The task of the scholar or of the consultant usually is to take a backward look at the process, by inferring the overall strategy of the firm from its performance and the realized actions.

Figure 1.2 The path of business strategy formation



To conclude:

a) Strategy is a conscious outcome of a rational assessment of resources, sectors and time (Plan).
b) Strategy helps to create a competitive advantage because it designs the best use of resources within a sector: It understands the interplay between firms and environment (Position).
c) Strategy is a tool to create consensus and leadership in the organization; decisions based on a good strategy are rarely criticized; it also defines how to compete in a market (Pattern).
d) Strategy fights inertia in firms because it moves the organization toward new forms of competitive advantage and facilitates adaptation (Perception).