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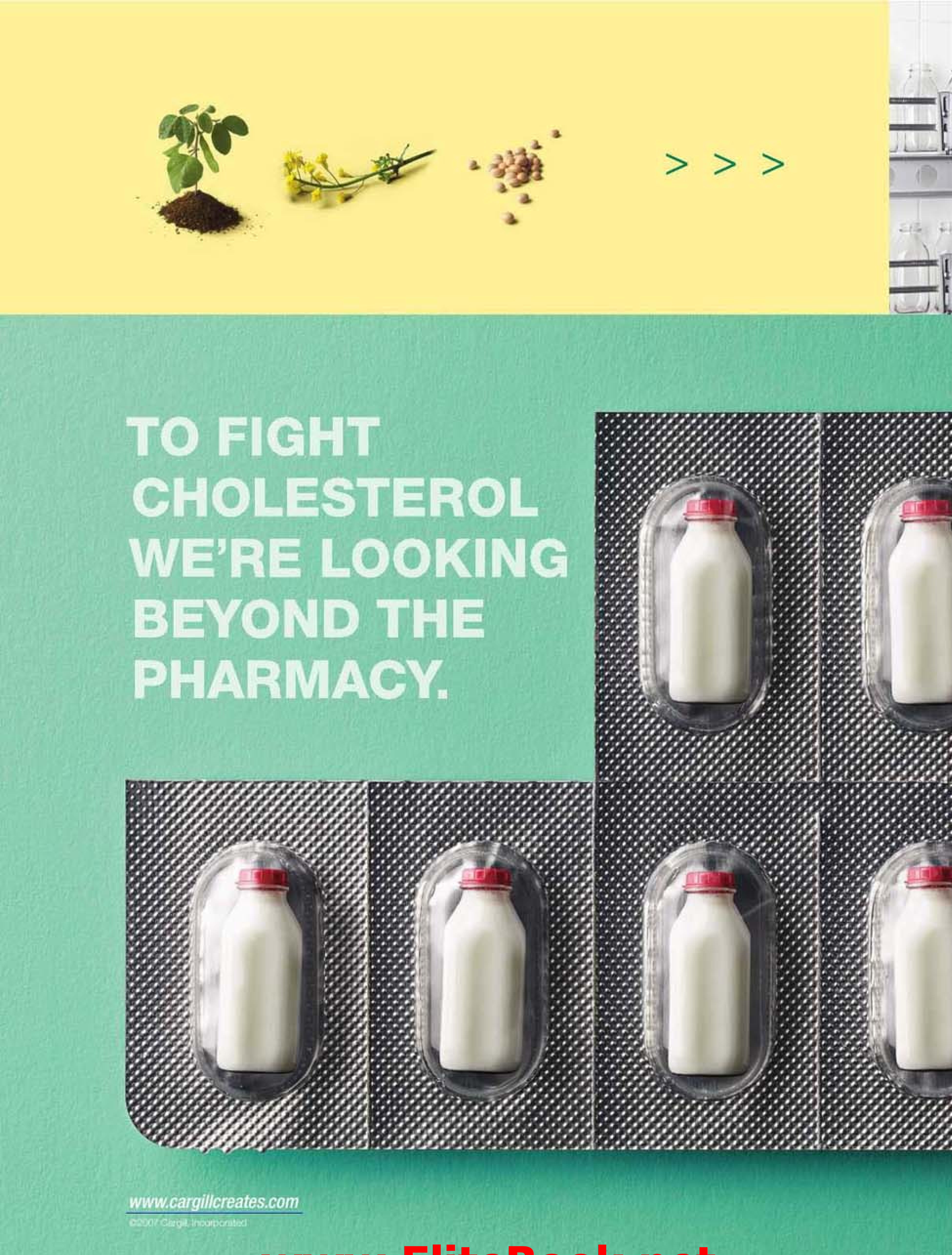
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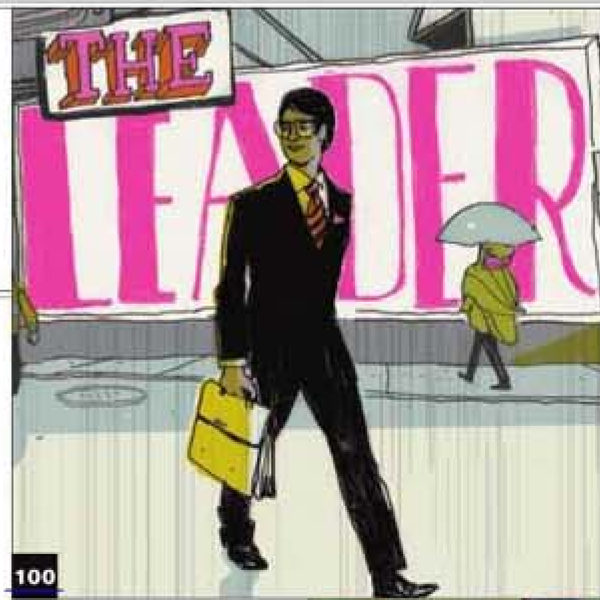

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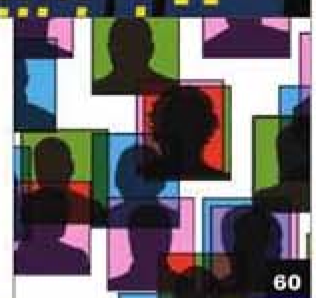

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Napoleon Bonaparte,
from 1798, a client of Breguet's.
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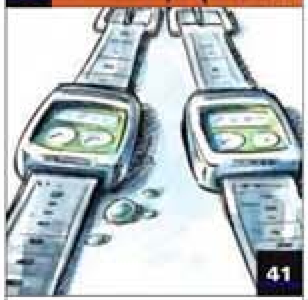

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> Creativity and the Role of the Leader

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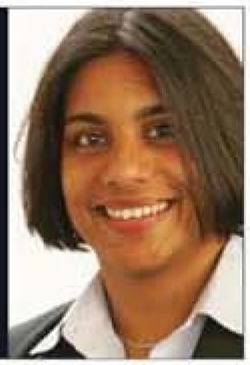

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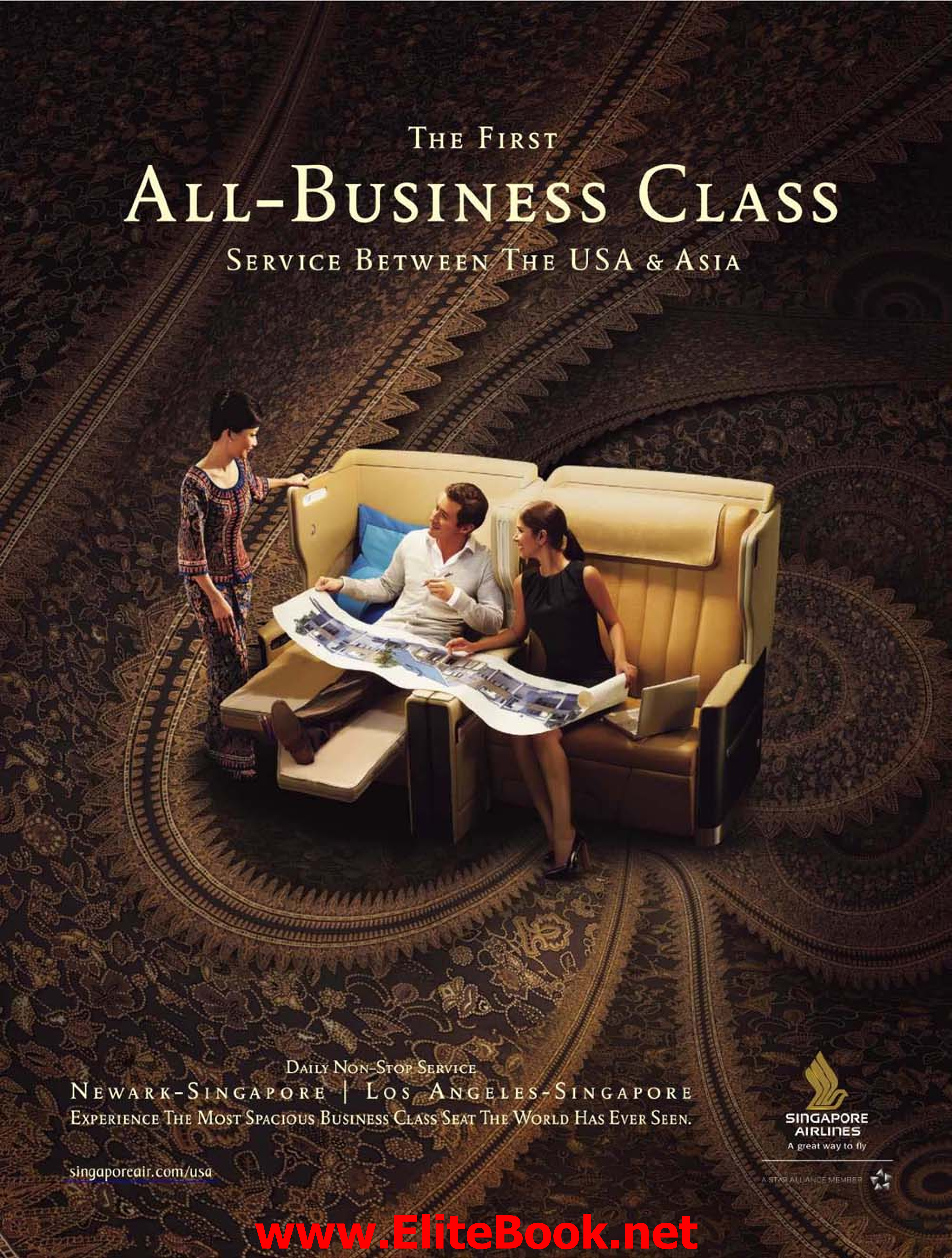
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"Hey! You forgot to nod your head in friendly acknowledgment before leaving the elevator."

P.C. Vey

Come Together

SOMETIMES THE most revolutionary acts are also the simplest. In our lead article, Intuit cofounder Scott Cook suggests that companies should collaborate actively with their customers. At first glance this advice may seem not quite groundbreaking, but the more deeply he explores the idea, the more profound it becomes. He points out that traditional companies can learn a huge amount from stars of the web like Google, Facebook, Wikipedia, and Amazon, all of whom profit greatly from freely offered user contributions. (It took Cook himself a while to come to that realization: When he served on Amazon's board, he failed at first to see the power of user reviews, even as Jeff Bezos grasped their potential.) What's great about this article is Cook's practical advice on how organizations can create competitive advantage in customer service, marketing, design – almost anywhere – if they start to think of users as contributors rather than just customers.

Of course, securing an edge is one thing, and keeping it is another. Ian MacMillan and Larry Selden claim that disruptive rivals won't be able to steal business from incumbents if the latter can learn to mine customer data intelligently. Their Tool Kit article, "The Incumbent's Advantage," goes into useful detail about how to segment customers according to the jobs they need to get done, in order to raise the profitability of those segments.

Four articles in this issue explore aspects of strategy and operations. Increasingly, companies must think not just about their own strategy but about the one that their whole ecosystem needs to adopt. John Hagel III, John Seely Brown, and Lang Davison offer a thoughtful approach in "Shaping Strategy in a World of Constant Disruption." First Person writer Stephen P. Kaufman, a former CEO of Arrow Electronics, outlines a rigorous process for evaluating the CEO (an important task that's often badly neglected). HBR senior editor Lew McCreary tackles the only partly ironic question "What Was Privacy?" in his HBR at Large article; even posed in the present tense, this turns out to be a difficult question to answer. In "How the Best Divest," Bain consultants Michael Mankins, David Harding, and Rolf-Magnus Weddigen argue that companies need to become as skilled at divesting businesses as they are at acquiring them – especially in tough economic times.

...

Harvard Business School celebrates its 100th birthday this year. In a departure from our usual practice, we've included a write-up from one colloquium organized to honor that centennial. The discussion in "Creativity and the Role of the Leader," by Teresa Amabile and Mukti Khaire, was so up-to-date – and at the same time so down-to-earth – that we couldn't resist.

The faculty and alumni at HBS have been putting a lot of thought into the future of management education. Rakesh Khurana and Nitin Nohria, both faculty members, think that it's time to make management a true profession in the sense that law and medicine are professions – that is, to insist that everyone who calls himself or herself a manager share certain training, knowledge, skills, and values. They use surprising arguments to support this position: For example, doctors picked up their pace of discovery considerably after the practice of medicine had been codified. Who knows what advances could follow the professionalization of management? You may not agree with this provocative article, but it will, without a doubt, make you think about the questions it raises.

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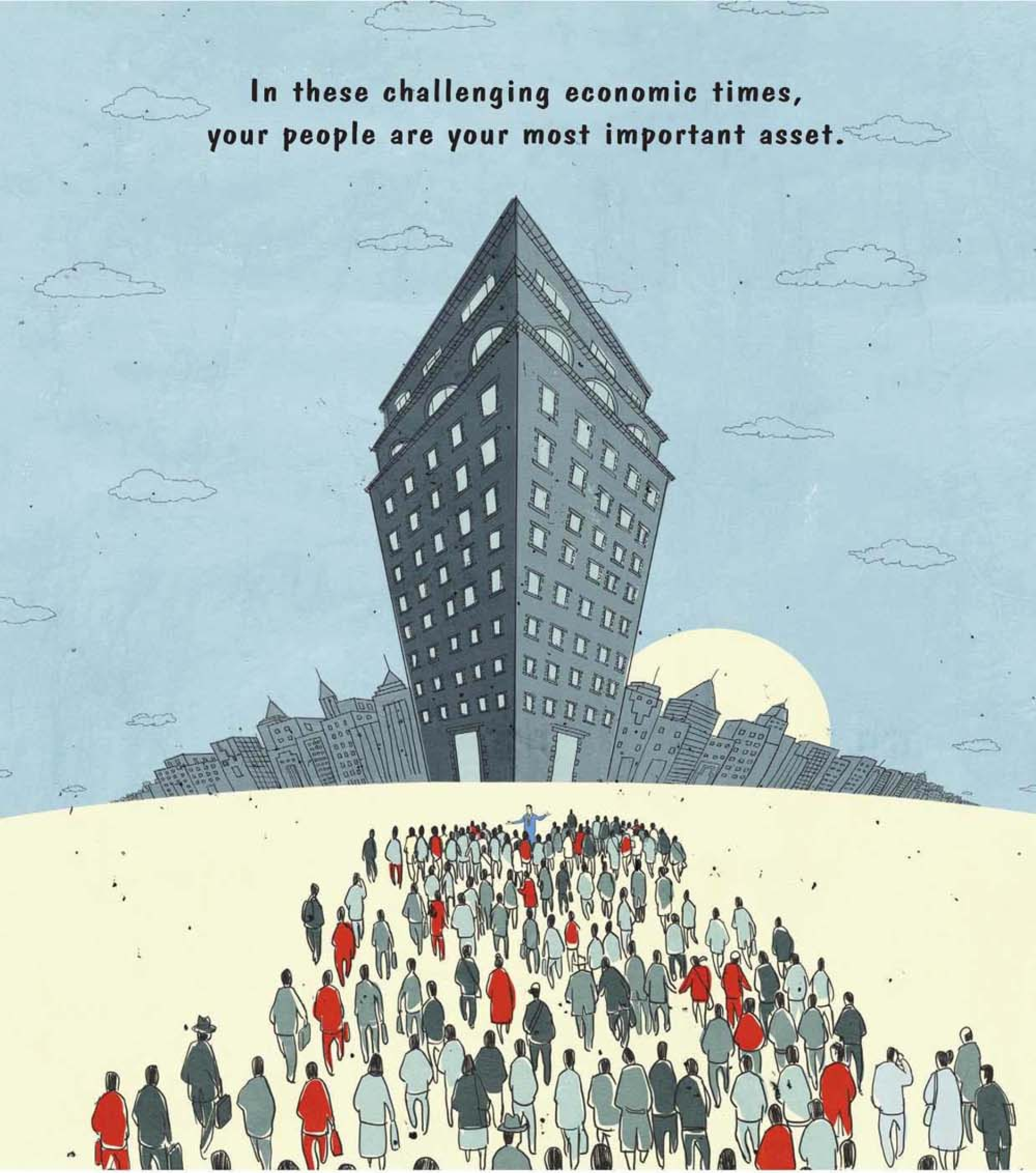
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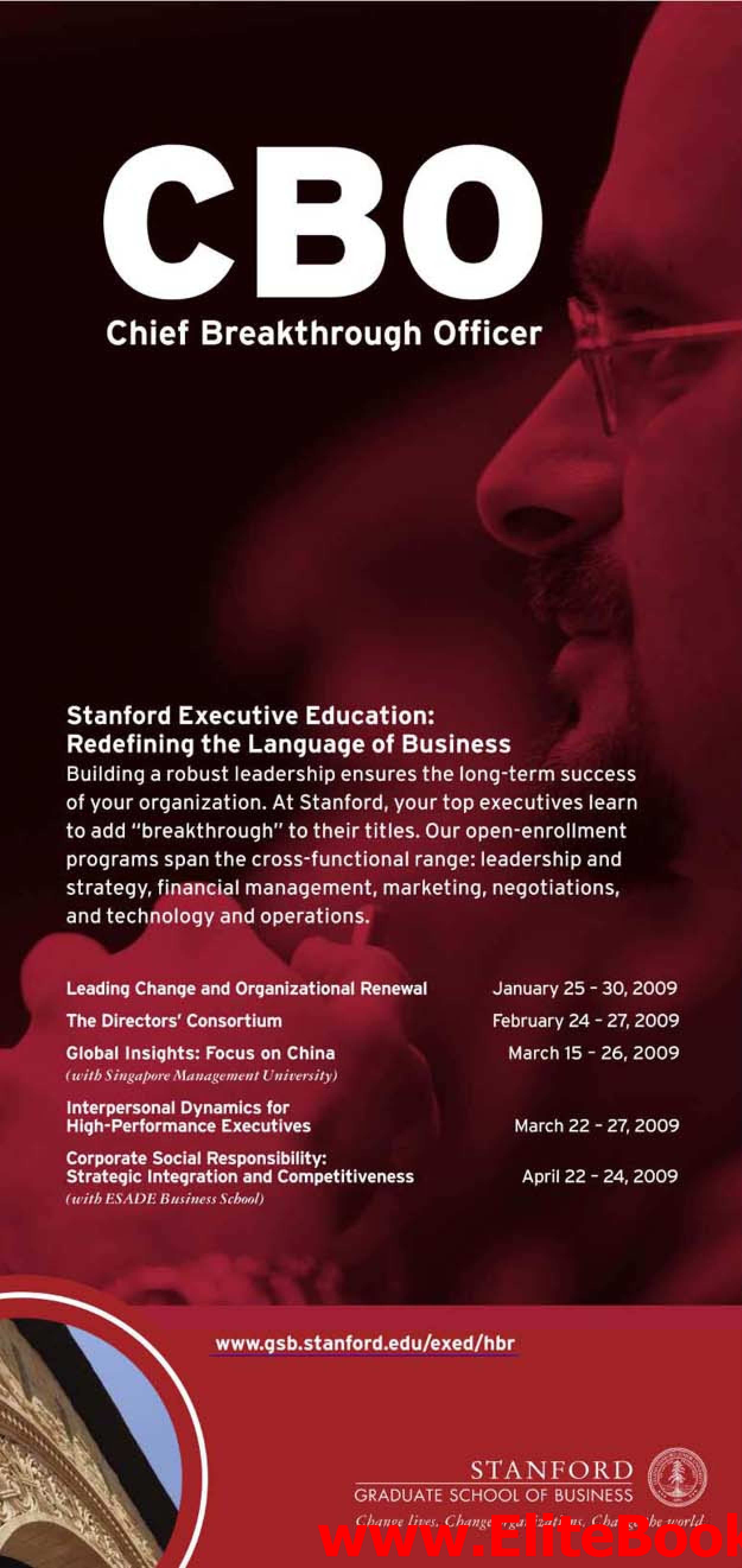

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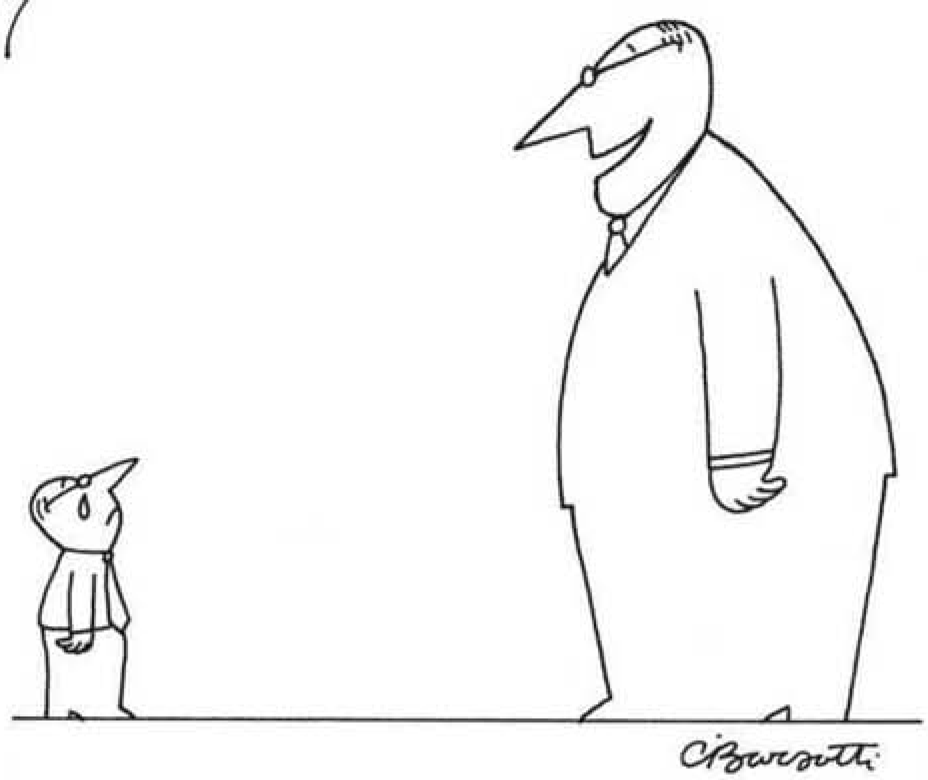
When Life Gives You Lemons

"To be resilient, an organization must dramatically reduce the time it takes to go from 'that can't be true' to 'we must face the world as it is.'"

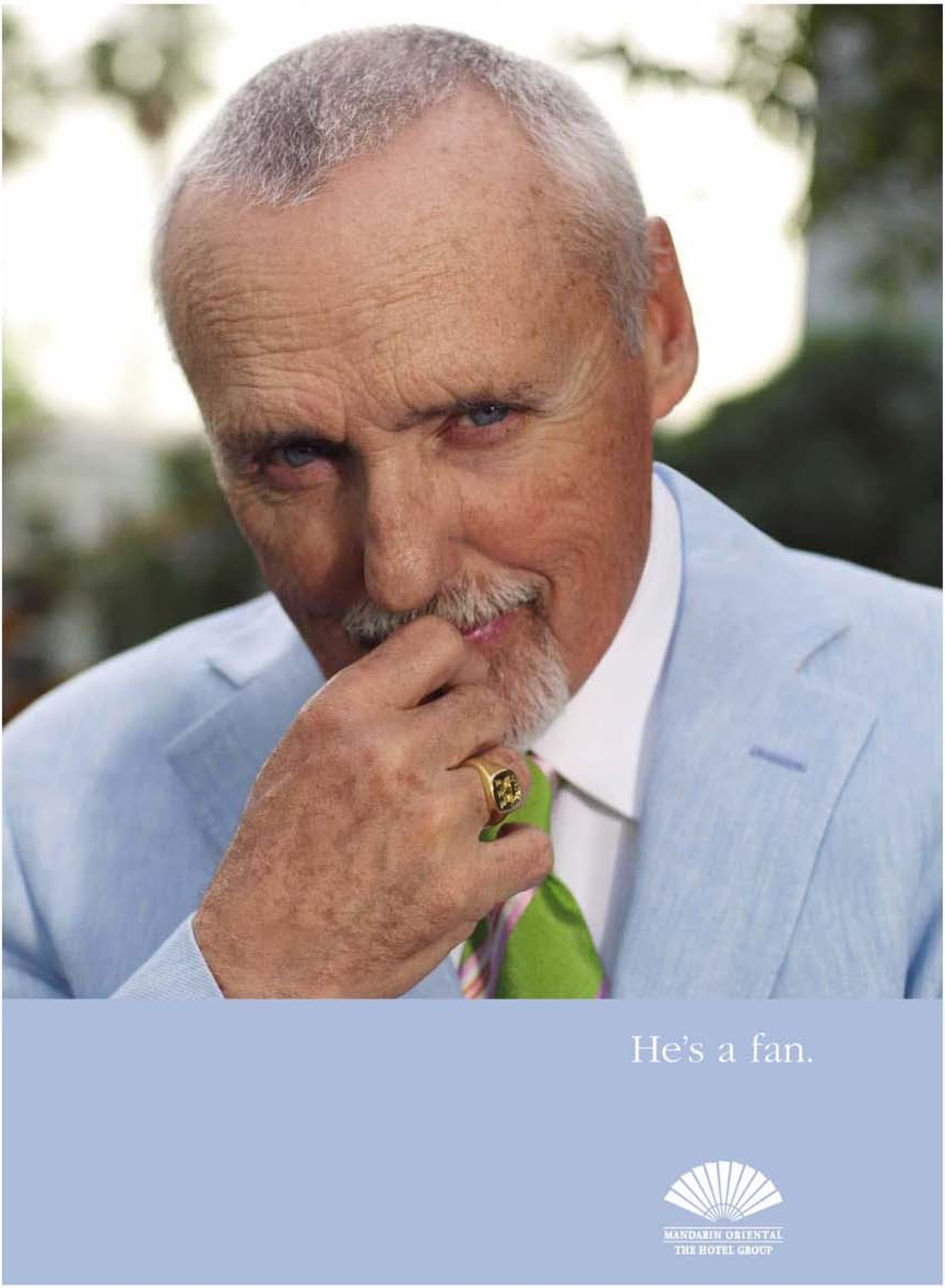
Gary Hamel and Liisa Välikangas
"The Quest for Resilience"
Harvard Business Review
September 2003

"By golly, Jones, I like your optimism. I didn't know we had a fifth quarter!"



"Hey, don't worry. It's a *layoff*. It's not as if you did anything wrong."

Charles Barsotti, Scott Arthur Masear, Chris Wildt


He's a fan.
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GRIST

The Year of Marketing Dangerously

by Christopher Meyer

At a recent meeting with top marketing executives from businesses ranging from consumer products to biotechnology and all the way to massively multiplayer online games, I was stunned to hear the games SVP say that 90% of her 2008 budget was earmarked for traditional TV advertising. This was a terminally hip, youth-oriented, net-dependent offering. Why had she set aside so little for web-based alternatives, event marketing, and word-of-mouth campaigns? Hadn't she heard that the mass-media era was over?

In fact, we've all heard about a wholesale shift to alternative channels – and yet it keeps not happening. But here's a prediction: A perfect storm is brewing for network advertising at the end of the year, and it will be gigantic for having been pent up so long.

Why now? First, the shift has already begun: Digital advertising is growing far faster than other categories – by 23% in 2008, according to Carat, compared with 6% for advertising overall. Alternative channels, which tend to cost less, have attained legitimacy. The internet has become a place to reach mainstream customers; marketers' experience with it has expanded; and organizations that help companies pioneer new approaches have grown, along with methods of gauging the effectiveness of targeted, permission-based marketing. These new measurement capabilities feed management's increasing insistence on proof of marketing's ROI.

By now it's clear – to many marketing executives, at least – that emerging options such as mobile advertising, community building, word-of-mouth campaigns, and new point-of-purchase techniques are more easily measurable, and more effective, than the mass media. But despite that clarity, change has been slow. The reason lies in one word: inertia. According to Michael Gale, whose firm Strategic Oxygen interviews 25,000 high-tech customers annually about their marketing approaches, that inertia is centered in advertising agencies. "Seventy to 80% of TV advertising is for share of voice [percentage of the messages heard by the targeted audience]," Gale explains, so advertising agencies have an incentive to continue focusing on this measure. "But," he adds, "marketers should look hard at it."

For the games SVP at my meeting, the source of inertia is closer by. She sees huge potential in alternative media, based on the results of programs such as product placement in other games and a high-profile tournament for players. But she and her colleagues concur that most senior executives resist giving programs like this a larger share of the budget. "They're just not ready," the consumer products executive said to the group. Across the wide range of companies at the meeting, the marketers all agreed.

So the capability is building, and the people responsible for results see increased ROI if they use it, but a high-level dam is holding back the flood. Again – why should it burst now?

Think about it. During economic crunch times marketing budgets are almost invariably slashed; they are among the few major discretionary items available to CEOs desperate to protect profits. Faced with painful cuts, marketing chiefs quickly look for bargains, hoping to avoid a commensurate loss of impact in the marketplace.

Suppose the games CFO demands a budget cut of 15%. If the marketing SVP announces that she can sustain the level of impact despite the cut, will her bosses be ready to listen? Here's how she might do it: She could cut TV in half, from 90% to 45% of her original budget, and return the requested 15% to the CFO. That would leave 30% – enough to *quadruple* the 10% she previously allocated to the media she believes in more strongly anyway.

What if many of her peers simultaneously make the same argument? If the U.S. economy hasn't pulled out of its tailspin by the final quarter of 2008, you can bet that the biggest marketers – the Procter & Gambles of the world – are looking at a zero-based media budget. If so, the effect on television advertising in particular is likely to be catastrophic. (Indeed, P&G may lead the way, given its recent investments in word-of-mouth marketing, point-of-purchase innovations, and even a new music label, Tag Records, to promote its products.)

Now let's consider one more ill wind in our cyclonic flow: The second half of 2008 contains two TV blockbusters: the Summer Olympics and the U.S. presidential election. Demand for TV time during these events is like the demand for software services prior to the Y2K scare – it masks an overall weakness that may lead to a crash. By the time we reach 2009, TV networks may be taking on water the way magazines – their revenues down by 8% in 2007 and forecast to decline by at least 10% in 2008 – are now.

The sudden evaporation of demand will force a steep cut in rates. And when the games SVP negotiates her TV contracts for 2009, she may find that 45% of her budget buys as much as 90% did in 2008. But stay tuned: In July, Tivo and Amazon announced a partnership to allow TV viewers to buy products placed in shows – Oprah's latest book pick, say – using their remote controls. Mass advertisers, it's going to be a bumpy ride.

Christopher Meyer (chris_meyer@monitor.com) is the chief executive of Monitor Networks, based in Cambridge, Massachusetts. His most recent book is *It's Alive: The Coming Convergence of Information, Biology, and Business* (Crown Business, 2003). Reprint F0810A

ONLINE COLLABORATION

Getting Real About Virtual Worlds

by Paul Hemp

You've probably heard someone in your organization argue that virtual worlds are the next big thing and that your company had better figure out how to use them before rivals do. At which point you may have thought, Yeah, I've read about Second Life. Lots of salacious stuff and bizarre people. Vandalism at the virtual stores of real-world brands. Customers whose identities are hidden behind their online representations, or avatars. Who'd do business in *that* terra incognita?

Let me offer another view that can help guide your company's thinking about online 3-D environments. As these worlds evolve, they're being shaped by two powerful and generally parallel forces: users' desire to *escape* reality and their drive to *replicate* reality. Rather than struggling to become part of fantasy worlds, businesses should be considering ways to create and exploit virtual places that exclusively mirror real life.

Companies are already using virtual venues to help employees and business partners collaborate and learn. IBM personnel from around the world regularly meet on a private island that IBM owns in Second Life. Silicon Image, a California semiconductor maker, does

part of its new-employee training in a 3-D environment where recruits can take a virtual tour of the company's facilities and learn from interactive exhibits in each area. Using precise terrain and infrastructure data, BP has created virtual environments that place a future oil pipeline in existing surroundings, allowing engineers thousands of miles away to roam freely and identify safety and constructability issues.

For efforts like these to succeed, companies need increasingly realistic and secure environments that they themselves manage. These might be in-house virtual worlds – the equivalent of today's intranets – or public shopping malls, built by virtual property developers for real-world tenants. Numerous companies, from small start-ups to tech giants like Sun Microsystems and HP, are creating more user-friendly and graphically sophisticated platforms. Other firms are working on environments similar to Google Earth, in which multiple users can together explore real-world cityscapes. Meanwhile, some companies will custom-design an avatar that replicates your physical self instead of veiling your identity.

Of course, a 2-D environment like the typical web page or a zero-D environment like the telephone is sufficient for many business tasks (a webinar, say, or a conference call), especially given the limitations of today's online worlds. But even now, the immersive nature of virtual environments makes them particularly engaging places. That's because, through a trick of the brain, people feel as if they're actually present with others. Unlike even the life-size, surround-sound videoconferencing systems being developed by Cisco and others, virtual worlds allow meeting participants to share a space, to pass a virtual object from one person to another. Chance encounters can occur as people leave a gathering, similar to those one might have in a real hallway. And when used for training and development, virtual worlds aren't just interactive, like a web-based learning module, they're "active": Users move from place to place, benefiting from the improved information retention that results when people learn in the location where they'll be using the new knowledge.

To be sure, fantasy worlds are also evolving. They may ultimately eclipse film, TV, and simple computer games as a form of entertainment. Marketers will need to figure out how users can interact with brands in these compelling environments. Virtual worlds' greatest potential for business, however, may be not as an entertainment medium but as the next-generation means of communicating and collaborating when people can't be physically in the same place.

Paul Hemp (phemp@harvardbusiness.org) is a senior editor at HBR and the author of "Avatar-Based Marketing" (HBR June 2006).

Reprint F0810B

SOCIAL INVESTMENT

How Wise Crowds Can Advance Philanthropy

by Steven H. Goldberg

Midsize nonprofits in the United States offer some of the most innovative solutions to our most pressing problems, but they are starved for growth funding because no efficient market mechanism exists to guide capital to them. In the absence of reliable information about the relative performance of nonprofits, billions of philanthropic dollars annually are distributed haphazardly among more than 1.5 million organizations, some deserving, some less so. One remedy may lie in the celebrated "wisdom of crowds": Prediction markets could consolidate information about which nonprofits provide the highest social returns on investment, thus guiding donors to the most attractive opportunities.

Well-designed information markets that aggregate the best guesses of large numbers of informed people have predicted the results of elections, movie releases, and sporting events as accurately as – and sometimes more accurately than – experts. An increasing number of forward-thinking corporations, including Best Buy, Eli Lilly, General Electric, and Google, are using internal prediction markets to forecast sales, allocate resources, and even plan strategy. Software developers such as Consensus

Point and Inkling and online market platforms including Foresight Exchange and InTrade now offer secure virtual trading that demonstrates the ease with which reliable information markets can be established. The tools required for creating a prediction market to gauge the relative performance of nonprofits are available.

This "guidance" market could list virtual "stocks" in the form of questions: Will KaBOOM's new model for supporting local playground construction create 4,500 new playgrounds by 2010? Will Jumpstart for Young Children recruit 5,000 volunteers a year to serve 20,000 preschoolers by 2011? Will KIPP charter schools number 100 by 2012? Traders could place bets rating each stock from zero ("It'll never happen") to 100 ("It's absolutely certain"). Trading would drive virtual prices up or down depending on whether traders considered the market assessments too low or too high based on dispersed information including strategic hires, grants and sponsorships, regulatory developments, and published data about performance. By revealing the consensus judgment of potentially millions of donors, employees, and volunteers in the nonprofit sector, the market could forecast the relative success of organizations competing for donations.

Such a market could be launched in stages: First, controlled private experiments with sophisticated investors and social entrepreneurs could demonstrate proof of concept. Second, planners could launch scaled-up controlled pilot projects in the field. Finally, the market could be rolled out to the public with nonfinancial incentives for participation.

If collective intelligence could index nonprofits' effectiveness, social enterprises would have an incentive to collect and report performance data to improve their rankings. Performance-driven philanthropy might then elicit real growth capital from donors looking for the most promising investment opportunities.

Steven H. Goldberg (stevegoldb@gmail.com) is the chief operating officer of Cradles to Crayons, a nonprofit with offices in Boston and Philadelphia, and a senior fellow at Root Cause, a nonprofit in Cambridge, Massachusetts. Reprint F0810C

continued on page 32

The Best Advice I Ever Got

Michelle Peluso
President and Chief Executive Officer, Travelocity

A few months before I was born, my father founded an environmental-engineering firm. I literally grew up watching him build it. Even as a little kid, I was struck by Dad's obsessive interest in and care for the people who worked for him.

Nights when our family's dinner-table conversation didn't include discussion of his employees were rare. "Sally's gotten accepted into an MBA program," he'd say excitedly, "and we're going to figure out how she can do that part-time." Or "John's wife just had a baby girl! We're going over this weekend to see her." Before company picnics we were thoroughly briefed: Bill had just won a new client; Mary was about to make an important presentation. His concern was authentic and unwavering, and it extended to all aspects of his employees' lives. When two of his top employees were killed in a plane crash coming back from a business trip, Dad spent time with their grieving families.

Now, my father's attitude and behavior were just part of his personality, not some maneuver to produce results – but they produced them all the same. He grew that start-up into a thriving 300-person business and then sold it to a larger company but continued to run it successfully. Two years ago, when he left to begin a new venture, more than half of his former employees sent him their résumés. So although my father never gave me management advice directly, his example provided a profound lesson: If you treat your employees as unique individuals, they'll be loyal to you and they'll perform – and your business will perform, too.

Treat employees as individuals and they'll be loyal.

The longer I'm in my own career, the more I attempt to put that lesson into practice. At a 5,000-person global organization, I simply can't know everyone personally. But I can apply my dad's techniques in a scaled-up way that lets me know as many people as possible, that encourages managers to do the same, and that makes our employees generally feel that this is a place where someone's looking out for them. I often visit our different offices; I hold brown-bag lunches every week; I regularly e-mail the whole staff about what's going well and what needs to improve; I hold quarterly talent management sessions with my direct reports; and I constantly walk the halls. When anyone at Travelocity e-mails me, I respond within 24 hours. I read every single word of our annual employee survey results and of my managers' 360-degree performance feedback – and I rate those managers in large part on how well they know and lead their own people.

Focusing on individuals instead of "the team" isn't easy. It takes a lot of time and genuine caring, and requires a long-term view – which can be tough when you've got a big business to run. Ultimately, however, it's worth the effort, for your employees and for the organization. A few years ago one of our senior managers was leading a huge project that had high visibility with our investor community when she began having pregnancy complications. I fully supported her in taking several months off, for her own health and for her kids. It was a daunting time, but the team worked through it, and that manager is still working here – as our COO.

I describe my leadership style in all humility. I don't have all the answers on how to lead people, and I learn from colleagues every day. But I share Dad's entrepreneurial belief: People aren't your "greatest asset" – they're your *only* asset.

– Interviewed by Daisy Wademan Dowling

Reprint F0810D

One way out of the energy fix: an energy mix.

It's going to take a menu of hydrocarbons and low carbons to build a more secure and greener sustainable energy future. Over the last five years, BP has invested more than $30 billion in U.S. energy supplies, which include oil and gas and lower carbon energies like solar and wind. We've also established the Energy Biosciences Institute to search for new breakthroughs that will lead to clean fuel sources for transport. Learn more about America's most diverse energy portfolio at bp.com/us.

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NETWORKING

The Difference Between Chinese and Russian Entrepreneurs

by Bat Batjargal

All entrepreneurs may be cut from the same basic cloth, but how they interact can be highly idiosyncratic. My study of Chinese and Russian entrepreneurs reveals distinct differences in the nature of their networks and suggests how best to approach them.

The character of institutional change and the national psyche in China and Russia explain many of the differences. Both countries are experiencing unprecedented transformations. China's is characterized by gradual institutionalization (the creation of procedures and organizations), whereas Russia's looks more like rapid deinstitutionalization (the dismantling of same). As for the national psyche, the Chinese tend to think concretely rather than abstractly and are drawn to harmonious and balanced ideas. In contrast, Russians tend to be keen abstract thinkers and are comfortable with contradictory thoughts and positions. These traits are reflected in the size and density of each country's networks and the levels of trust that characterize them.

Entrepreneurial-network characteristics

Chinese	Russian
SMALLER SIZE due to institutional stability and constrained migration.	**LARGER SIZE** due to weak institutions and high mobility.
HIGHER DENSITY due to preference for familiar contacts.	**LOWER DENSITY** due to comfort with looser social ties.
HIGHER TRUST due to institutional development and comfort with third parties.	**LOWER TRUST** due to deinstitutionalization and suspicion of third parties.

Network size. Chinese networks tend to be small and composed of family members, friends, and colleagues. China's institutional stability – and therefore job stability – has enabled Chinese entrepreneurs to preserve their work-related networks over time. Furthermore, China's rigid household registration system and state employment system constrain migration between localities and restrict opportunities for professional networking, while the rules of *guanxi* (informal connections) create barriers to network membership. In contrast, Russia's institutional chaos has pushed entrepreneurs to build new networks and strengthen others to compensate for weak institutions. Russian entrepreneurs are more mobile than their Chinese counterparts, which has helped to vitalize and expand their networks. Finally, the social walls between members of in and out groups – that is, "us" and "them" – are less robust in Russian than in Chinese networks, which facilitates growth in the former.

Density. Because Chinese institutionalization supports close relationships, and because the Chinese strive to reduce uncertainty in their social worlds, Chinese entrepreneurs' networks are denser than those of their Russian counterparts. That is, they have fewer "structural holes" – parts of the network where two people who are connected to a third are not themselves connected. Russian networks are more loosely knit.

Interpersonal trust. The institutional development and stability in China encourages relatively high levels of trust. A World Bank survey found that more than 50% of Chinese entrepreneurs – compared with only 16% of Russian entrepreneurs – fully agreed with the statement "Most people can be trusted." The Russians are less trustful of third parties, even when they've been recommended by reliable intermediaries, and prefer to establish direct personal relationships. They perceive three-person relationships as risky.

There are no hard-and-fast rules for approaching these networks, but Westerners can expect the Chinese ones to be harder to crack at first – perhaps more demanding in their entrance requirements than the bigger, more fluid Russian networks. However, once you're in, Chinese networks are often more likely to identify you as a member of the in group. In either case, understanding the relationships among network members is critical, as is strict adherence to social rituals, whether they involve gift giving among the Chinese or drinking vodka and socializing at bathhouses with the Russians.

Finally, don't try to be more Chinese than the Chinese or more Russian than the Russians. You will always be perceived as a foreigner and expected to be different. Trying too hard may actually undermine the trust you're striving to build.

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Reprint F0810E

continued on page 36

Conversation

Marketing CEO **Dave Balter** on achieving the corporate full Monty

Dave Balter, the founder and CEO of the word-of-mouth media company BzzAgent, wants you to see his company naked – even the ugly bits. His problem: Achieving that wind-on-bare-skin feeling gets tougher as the company becomes better established. With 90 employees in Boston, New York, Chicago, and London – and clients including Philips, Dunkin' Donuts, and Barilla – the firm marshals nearly 500,000 volunteer "buzz agents" to talk up products in exchange for perks and gifts. Balter is passionate about the power of word of mouth and equally so about what might be called radical corporate transparency.

What's an example of your firm's extreme transparency?

A guy outside the company called me something that would be unprintable in HBR, and I wrote about it in a blog that anyone can read. I said something like "Maybe he's right; maybe I *am* what he called me." That post really took off – it got lots of comments. Another time, someone in the company blogged about an awkward moment over whether he or I would pick up the tab for lunch. His perception was that I was being cheap. I love that kind of post. Clearly, some things are off-limits to transparency – certain types of personal and financial information, anything related to a nondisclosure agreement we've made. But my view on blogging is if the writer is getting the chills – hovering over the mouse and thinking, Should I *really* send this? – then it's probably going to be a good post.

Our attempts at transparency go beyond blogging. Most companies consider their internal presentations confidential; we publicly post our PowerPoint decks about sales presentations, for example. If a competitor wants to see our slides, so what?

What's the logic behind this mind-set?

For one thing, I'm fascinated by the petri dish that is corporate life, and I like to blog about it and experiment with it to better understand it. For another, there are practical reasons why a marketing company like ours should be provocative: Members of the press read the blogs, and the posts generate publicity.

But there's much more to it. We're trying to change how corporations operate. I once worked for a consulting firm where even though I was doing a great job, I was reprimanded for breaking unwritten rules about who was supposed to communicate with whom. I never forgot that. I realized that companies put rules into place to hide their ideas. They think the rules give them control over people and markets. But that's totally untrue today. There are so many communication routes that you can't possibly control the information flowing through them. Furthermore, attempts at secrecy prevent the company from making use of those information flows. You can't always foresee the benefits of letting ideas out into the world, but they often far outweigh any harm that may result. Comments on some of my posts have given us valuable answers to questions we've raised, such as what type of person we should hire at this point in our growth as a company.

Is extreme transparency a luxury that only a small firm can indulge in? Will you be able to keep it up as the firm grows?

It definitely gets more challenging for me to stick to my transparency vision as the firm expands. More and more, I have to balance the ideas in my head against the wants and needs of people around me. For example, when the company had to use the corporate blog to communicate with the volunteer agents about a technology change that would affect them, the blog became, in effect, a forum for agents. They steered it away from the subject of the company's internal workings and insisted on writing about such things as agent rewards. That was really frustrating. But I'm finding other ways to explore transparency. For example, when one of our executive office spaces opened up, we decided to offer it on a weekly basis to any employee, no matter his or her role, level, or tenure. I'm interested in understanding how offices motivate or demotivate people – some employees feel lonely in them – and how the status of having an office affects the occupant's interactions with others. Even if the doors are glass, there's something inherently nontransparent about offices. So are they good or bad for a company? We're trying to find out.

– Andrew O'Connell

Reprint F0810F

BRANDS

Protect Your Product's Look and Feel from Imitators

by Betsy D. Gelb and Partha Krishnamurthy

Too many U.S. companies believe that being first to market with a design feature, whether it's registered as a trademark or not, is the best way to ensure that your brand is associated with it. That's a false assumption – and a dangerous one. Instead companies must ensure that consumers connect a product's look and feel with the brand. That means conducting targeted research on design features and, in many cases, spending more money to hammer home the brand association in consumers' minds.

A design feature is what's known legally as *trade dress* – any nonfunctional characteristic of a product's or package's appearance and feel, ranging from the pink color of Corning's insulation to the cowhide pattern on Gateway's computer boxes. Many companies don't know how much trade dress is worth and therefore can't make informed decisions about how much to spend to protect it from being copied. And firms, especially small and midsize ones, often don't register design features as trademarks because meeting official requirements can be costly and difficult. Often they believe that the chances of being copied are slim or that they can successfully sue an imitator because they originated a feature.

But the legal climate for brands changed in 2000, when the Supreme Court ruled that because Samara Brothers, a New Jersey–based wholesaler, could provide no evidence that consumers associated its children's-clothing designs with only one brand source, Wal-Mart could sell items that looked a lot like Samara's. A product's design feature can now be protected from imitation only if it has "secondary meaning" – if buyers see it as a marker of the brand. That meaning must be acquired through marketing.

Fortunately, it's not difficult for a company to get the data it needs to help build a bulwark against imitation. It can conduct a simple experiment to determine what percentage of consumers associate a feature with the brand and whether the feature is valuable enough to be worth the effort of spreading that association to more consumers.

Say, for example, a maker of western boots with decorative stitching hires a research firm to conduct an experiment with current or potential buyers in five widely distributed malls, out of sight of the company's outlets. The researchers show half the shoppers the (unlabeled) decorated boots and the other half the same boots without the design feature. Then they ask the participants in both groups what they'd be willing to pay for a pair. The difference in the average price quoted by the two groups becomes the per-unit value of the stitching. Finally, they ask the participants to name the brand. Typically, few participants can do that – which may surprise the company.

Suppose the stitching added $40 to the perceived value of the boots, but the fraction of people who could identify the brand was only five to 10 percentage points higher in the with-stitching group than in the without-stitching group. The company would need to create a campaign to strengthen the association between the feature and the brand. That might mean increasing the marketing budget as much as threefold, at least for a while, but it might also discourage imitators and improve the likelihood of success in a legal contest. A difference of at least 20 percentage points that can be attributed solely to the design feature is usually considered a solid defense against imitation if the company sues a competitor.

Research data of this type are becoming common in infringement lawsuits. But companies should be collecting data even if no imitators are on the horizon, because trade dress is an increasingly important asset. The rising value of brands is illustrated by the $305 million in damages awarded to Adidas in May 2008 for imitation of its athletic shoes – believed to be the largest amount ever awarded for trademark infringement. Valuable assets like trade dress can be managed rationally only if their value is fully understood. In effect, what you don't know will hurt you.

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You're already a valued member
of a winning team when you
work with Beijing, challenge Houston,
negotiate with London, debate Cupertino,
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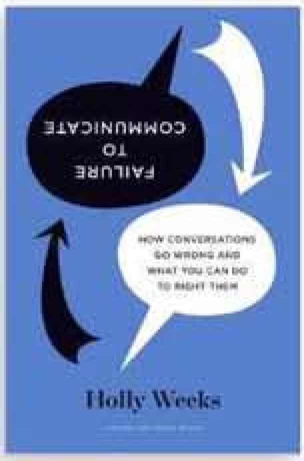
Reviews

Failure to Communicate
How Conversations Go Wrong and What You Can Do to Right Them

Holly Weeks
(Harvard Business Press, 2008)

Mike and Jack are in deep trouble. Back in college the two Grateful Dead fans were hockey teammates, but now Mike is floundering as a senior vice president in his old friend's concrete-products company. Jack asked him to handle the sensitive task of outsourcing the sales function, and Mike's blunt style left longtime employees feeling alienated and scared. Jack lashes out: "I had no idea a smart guy like you could know so little about people and make so many mistakes." Mike's job is on the line, and the friendship is pretty much shot. The real problem isn't with either of the antagonists or even their working styles. It's that they're enmeshed in what Holly Weeks, in her taxonomy of dysfunctional communications, labels a toxic conversation. It's but one type of difficult conversation that crops up frequently in business, and Weeks provides step-by-step tactics to help people successfully get through – not around – all of them.



Aware that it's highly unlikely that both the reader and his or her counterpart will be using this handbook simultaneously, Weeks wisely focuses on what a person can do unilaterally to maneuver emotionally laden, combative conversations. Drawing from her communications consulting practice and her experience in coaching executives, she shows how one person can defuse a conversation, not by attempting to control it but by easing out of combat mode and showing respect, thus encouraging the other person to do the same. All her tactics, in fact, are built on respect – for the self, the counterpart, and the problem at hand. Indeed, she stresses the importance of acknowledging that the problem, whatever it may be, is serious and difficult and must be dealt with.

Examples on practically every page show colleagues getting into trouble, sometimes making it worse, sometimes extricating themselves, and sometimes going back after an altercation to patch things up. The examples are followed by lucid analyses that for the most part leave jargon behind and introduce concepts such as conversational "blueprints" and "immunization" against counterparts' "thwarting ploys." The analyses occasionally even light up the intellect by quoting the likes of Joan Didion and David Mamet.

Perhaps most helpful is Weeks's emphasis on honing conversational skill. Although people may suspect that conversational skill involves manipulation, Weeks points out that it is crucial and should be practiced. She shows how to conduct a mock conversation, starting with a self-interview and concluding with an imagined dialogue with the counterpart. Returning to Mike and his old buddy Jack, she even shows how Mike himself could start repairing the damage that was done when Jack blindsided and undermined him. She offers no guarantee that Jack will respond positively, but the "recovery conversation" she outlines can only make things better. This is especially important in senior-level relationships, which are inevitably interpreted by, and set an example for, just about everyone else in the company.

– Andrew O'Connell

The World Is Curved: Hidden Dangers to the Global Economy

David M. Smick
(Portfolio, 2008)

Economists love to talk about the flexibility of markets, and Smick, a prominent adviser on international finance, is no exception. But he argues forcefully that the world economy is not as laissez-faire as we think. The very production-oriented government policies that have driven success in China and the rest of Asia have also brought corruption and a consequent investment bubble. If Western bankers are slow to overhaul the shortsighted financing strategies behind the present worldwide credit crunch, the bubble will burst – resulting in a protectionist reaction that will bring on a global depression. Smick concedes that any predictions are difficult given the complexity of capital flows, but he rightly points out that globalization is under attack everywhere because it tends to exacerbate income inequality.

Innovation Corrupted: The Origins and Legacy of Enron's Collapse

Malcolm S. Salter
(Harvard University Press, 2008)

After a series of solid journalistic accounts of the fall of Enron, here's an organizational analysis by a management professor. Salter portrays a hothouse environment emerging from some initial innovation and luck – one that transformed ordinarily clever and driven managers into the hubristic "smartest guys in the room." Enron had weaknesses common to public companies in the late 1990s: extravagant and politically charged compensation practices, passive directors, compliant accountants, and pressure to meet analysts' expectations. Every abuse began with ethically borderline steps that many companies would have taken, and most of them would probably have continued on Enron's path if they had faced the same stark crisis in profitability at a time of outward success. Salter blames Enron's executives for greed and utopianism, but even these faults are simply ambition and optimism taken to an extreme.

– John T. Landry

WHAT WE LEARNED FROM THE FIRE AT *BALL PACKAGING EUROPE* MEANS OTHER COMPANIES ARE NOW ABLE TO REMAIN

COOL.

A true story: It was April 2006. A major fire swept through *Ball Packaging Europe's* can-manufacturing plant in Germany. FM Global was immediately on the scene finding ways to minimize the company's loss of production. The experience has helped FM Global work with other corporations on better ways to protect against fire, too. So it's more than the true story of one factory fire. It's the story of many businesses that are better protected today because of it. **To read more true stories, visit fmglobal.com/insuranceevolved**

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HBR Case Study

BY PAUL F. NUNES AND
NARENDRA P. MULANI

COMMENTARY BY
GIORGIO BRANDAZZA,
J. MERRICK "RICK" TAGGART,
AND CANDACE S. CUMMINGS

Can Knockoffs Knock Out Your Business?

Counterfeiting of Ruffin products is on the rise. The company's CEO is obsessed with putting a stop to it. How far should he go?

Daniel Vasconcellos

SPLINTERS OF WOOD flew in all directions as the battering ram crashed through the bolted warehouse door. The police cordon surrounding the building waited nervously as Hong Kong's elite special unit swarmed inside, shouting what Ted Dwayne could only imagine was "Put your hands up, or we'll shoot!" and "Police!" in Cantonese.

As a client-service director for Brand Protection Services Limited, Ted used his nearly 20 years of law-enforcement and private-investigation experience to track down and bring to justice counterfeiters of his clients' wares. He had been working this particular case for almost a year now and was in Hong Kong to make sure the sting operation, intended to seize literally tons of fakes of his client company's products, went down without a hitch. Despite the dramatic expansion of the Hong Kong Police's Commercial Crime Bureau in recent years, the tracking of counterfeiters beyond street-level vendors still required months of work – and, on occasion, some assistance from individuals like Ted.

For this case, Ted had stalked a ring of criminals from a mall bust in northern Georgia, which netted a cache of purses, shoes, and watches worth more than $10 million on the street, to a labyrinth of tunnels under New York's Chinatown. From there he had followed the trail to this waterfront warehouse in Hong Kong, filled to the ceiling with knockoffs of high-quality brands. The police had been especially happy to get Ted's tip-off because the crates held not only clothing and jewelry but also cosmetics and pharmaceuticals – ersatz products that might threaten people's health and lives.

The current operation was yet another success, Ted thought as he watched the action from the relative safety of a storefront across the street, but it was just the tip of the dragon's tail. This wasn't some third-world machine shop stamping out fake watches so cheap they turned your wrist green; it was a highly organized global syndicate funding everything from street crime to international terrorism. And, Ted knew, once the tail was cut off it was destined to grow back. In recent years, the number of seizures like this one had increased dramatically around the globe, doubling in the United States, and still the problem seemed to be getting worse, not better.

As the lockdown continued, Ted made his way to a quieter spot a few blocks from the building. It was time to report to the client.

HBR's cases, which are fictional, present common managerial dilemmas and offer concrete solutions from experts.

In Too Deep

Bill Bronson reached for the cell phone on the nightstand in his hotel room. He glanced at the alarm clock: It was 4:20 AM in Dubai. As the CEO of Ruffin – "the world's leading provider of clothing, accessories, and recreational equipment for today's explorers" – Bill spent considerable time traveling the globe, so he was used to taking calls in the middle of the night.

"The raid went down," said the voice on the other end of the line. Bill easily recognized Ted Dwayne's thick Long Island accent. "The timing was perfect. They got over 100 tons of stuff. A few of the ringleaders, too – a half dozen of them were in cuffs when I left to call you."

Bill took in the details and hung up elated. It felt satisfying to catch the crooks who'd been ripping off his products – all the more so because his own life had been put in danger by one of the fakes, a knockoff of his company's diving watch, 19 months ago. Even now, Bill could recall the terrible sensation of his near-death experience. He had been 80 feet below the surface of Subic Bay, exploring the wreck of the *USS New York,* when he had found it nearly impossible to breathe. His watch indicated he had been down no more than 20 minutes, so how could an air supply that would normally last him more than an hour be gone? That's when he realized the bezel was no longer locked, and the instrument he had thought was his company's premier dive watch was, in fact, useless. He shot to the surface in desperation and then spent the next three days in and out of a recompression chamber, undergoing hyperbaric oxygen treatment to stave off the sometimes-fatal bends.

>> **hbr.org**

How should Ruffin tackle its problem? Weigh in with your opinion at **knockoffs.hbr.org.**

Just after his recovery, Bill abruptly fired the Ruffin marketing director who had given him the watch just to see if Bill could recognize it as a knockoff, intending to let Bill in on the joke long before he could ever actually use the thing. Then Bill hired detectives to find the source of the fake and track down illegal replicas across the company's entire product line. Finally, he used the publicity surrounding his experience as a bully pulpit for a series of attacks against the trade bureaus, and even governments, of countries that appeared to tolerate the creation and sale of fake products.

> "The raid went down," said the investigator. "They got over 100 tons of fakes."

Almost two years later, it *still* nagged at Bill that he had been so easily deceived. As an experienced outdoorsman who had reached the summits of peaks on all seven continents, Bill Bronson was not one to be careless about his equipment. In fact, finding so much of it inadequate had been the reason he had started Ruffin and driven it to become the world's number one maker of adventure gear and clothing. Had he just gotten careless with age, or was something going on that permitted today's fakes to fool even someone as demanding as he was?

A Plan to Foil Fakes

No project was too outrageous for Dubai: With more than 35 shopping centers, and a new one being opened seemingly every week, the place was a retailing gold mine – the perfect location for launching Ruffin's latest marketing and sales campaigns, Bill thought as he moved briskly through the streets of the emirate.

It was several hours after his wake-up call from Hong Kong, and Bill was on his way to the gold souk to meet with Kamil Zafir, the head of Ruffin's Middle Eastern operations, and Nels Volgren, the company's design chief. From there, the three would head to a nearby restaurant for a working lunch. Nels was in town to address the technical requirements of the Ruffin-branded adventure and retail environment the company was developing. It would include skiing, scuba diving, rapids rafting, surfing, mountain climbing, and motocross – all in the same indoor facility.

Bill easily found Kamil and Nels in the marketplace. As they finished greeting one another, a slight man approached and quietly said, "Watches? Top quality," and then offered a litany of high-end brand names.

"Get out of here!" Bill snarled. The CEO glared at the quickly disappearing figure. "When are we finally going to be able to do something about this?" he said to Nels and Kamil.

Bill had meant the question rhetorically, but Kamil's response was quite literal. "You might want to go easy – well, for a little while anyway – on the whole counterfeiting thing," he began a bit cautiously. "The word is, some important folks here are worried that you might stir things up, like you did in China after the accident. They've made a serious effort here to keep copycats out, and if you make trouble, well, I don't think we'd continue to get the kind of fantastic cooperation we've seen on the adventure project so far." As Kamil's voice trailed off, the Ruffin managers were again approached – this time by two different street vendors.

Nels saw the CEO's jaw tighten, and as Kamil made a big show of sending the vendors on their way, the design chief spoke up. "We've done a top-to-bottom review of the design of all our products, just like you asked, Bill. Faking them is going to become nearly impossible in the next 12 months," he assured his boss. "The Ruffin logo will be woven into fabrics, rather than embroidered, and will be laser-etched onto product surfaces

with fine textures that consumers can feel. We're also placing microtags in the plastics we're using to create our products. Special devices can then read the codes in these tags at any point in a product's life cycle." A unique 24-character alphanumeric identifier was also being sewn or etched into each Ruffin product, Nels said, and customers could then enter the code online to verify the product's authenticity. "The odds of guessing a valid number would be astronomical," the designer pointed out.

Bill was impressed – once again, he thought, Ruffin is on the forefront of technology. "It sounds like you took me at my word when I said spare no expense. Are the costs reasonable enough?"

"They're not cheap," the design chief admitted, "but on a per-unit basis we're managing to keep them to a tiny percentage of our retail prices. What is costly is trying to get buy-in from all our relevant business heads, making sure they're all doing the right things, all in the same way."

"We've been doing some simple things," Kamil added, "like performing spot checks on our contractors' raw materials orders. If we find they're ordering too much, we have a pretty good idea they're making extra for the gray or black markets."

Bill was glad to hear this. A study he had commissioned a year ago found that as many as a third of the company's customers had unintentionally purchased a fake version of a Ruffin product. The new technologies would help reduce that number, but Bill knew from his capital-budgeting meeting that sooner or later even these approaches would most likely be copied: Ruffin had bought the laser-etching equipment from a high-quality Chinese maker at a very low price, and potential counterfeiters could easily do the same.

Also troubling to Bill was the study's finding that two-thirds of the surveyed consumers were willing to buy a replica of a Ruffin product if the price were right – and would even brag about it to their friends. That's what really kept those guys selling on the street. Granted, two-thirds also said they would not buy fakes if they knew they could serve jail time for it, but would consumers ever face such a reality? It was hard enough prosecuting the folks making and selling the stuff. And after the company had spent years working with – and sometimes suing – online vendors and auction houses to get them to get rid of the fakes, counterfeit sales on the internet were still rampant.

Brand Builder or Spoiler?

Two weeks later, Bill was in Beijing for the Ruffin-sponsored XL Sports event. Walking through light winter snow in the Forbidden City, he couldn't help noticing all the people wearing Ruffin coats. He was a little confused by the variety he saw; he was sure his company had never introduced more than a half dozen styles.

"Sales must be better than I thought," he ventured to Lily Wang, Ruffin's director of East Asian sales and operations. Bill had met Lily ice climbing on Mount Siguniang a few years back. He'd been so impressed with her hard-charging manner that he'd hired her on the spot.

"Sales are tremendous as you know, Bill – doubling almost every year," Lily offered. "But that won't last if we can't quickly add retail outlets. That's a bottleneck for us right now."

The CEO heard Lily's words but remained distracted by the people walking past. "Are these some of our latest models?" Bill said, sweeping his hand across the parade ground.

Lily grinned a bit. "They're fakes, Bill. You know it, and I know it. But with all the world's top brands fighting for attention here, I think we're lucky to have a few thousand free billboards walking around. Just six months ago, we weren't all that well known in this part of the world, outside of a few big cities. Now, even in the rural areas, people know Ruffin. These aren't exactly lost sales, you know."

"Maybe they should be considered lost sales," Bill replied.

Disregarding the CEO's frown, Lily continued. "I know how important this issue is to you, but calling attention to the fakes doesn't help; it just leaves customers wondering how good our jackets and accessories actually are if they can be copied as easily and as often as we say they are. And if we lower our prices to discourage counterfeiters, we'll only end up hurting the brand and losing a lot of money. Besides, I'd just have all our European stores buying my product allocation here to resell there."

By this time, the two executives had wandered through the Gate of Divine Might and out onto the street. Lily led Bill to a cart selling baked sweet potatoes, a local treat. As she purchased two, she tried to lighten his mood. "Ruffin is going to do well here, you'll see – and very soon. When the new stores are up and running," she said. "This is just a temporary problem."

The Legal Bill Comes Due

"Bill, are you still with us?" The CEO was shocked back to his seat at the federal courthouse table. His mind had begun to wander to a time before all this had begun – a time when his company's legal expenses were not a material portion of its profits.

"The district attorney got five of the 25 arrested in the New York operation to cop a plea and turn state's evidence. That's good news for the prosecution. But that leaves us with 20 defendants in both the civil and criminal proceedings, and each one wants a separate trial," Ruffin's chief legal officer, Ben Kilgore, was saying. "We'll need to testify at the criminal proceedings and take the lead on the civil actions."

Bill was wondering how many employees would have to take time off to serve as witnesses, and how long he could afford to remain involved himself, when his legal counsel interrupted his thoughts again.

"I know we added three lawyers in-house only three months ago, but if we really are going to go through with all these prosecutions and class-action suits, continue to send out trade dress violation notices in all the cases where folks are copying our products, and continue our global M&A activities, patent filings, and normal business conduct, I'm going to need more help," Ben said. The company's retained law firm, Crabbe and Hyde, had done yeoman's work, no question, the CLO reported, "but they are just about tapped out."

Bill wondered now what he had gotten himself into. Was his indignation against counterfeiting after nearly losing his life just an overly emotional response to what should have been a more practical, economics-driven problem? Or was he right to pursue the threat head-on, not just because of the risks to customers but simply because it was in the best interests of the business? Was it time for Bill to press on or to move on?

How far should Bill take his campaign against counterfeiting?

Three commentators offer expert advice beginning on page 46.

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I'M A LITTLE SHOCKED at some of the Ruffin CEO's actions. He is looking at an economic problem through a very personal lens – not the reaction I would expect from the head of a multimillion-dollar global organization. His management teams in Dubai and China have a more balanced perspective: No matter how frustrating it is to coexist in a world teeming with counterfeit goods, the issue is still, at its core, purely a business one.

That's not to say it's an easy problem to manage. Increasingly, businesses in all sectors (pharmaceuticals, toys, music, food, and personal-hygiene products) are being forced to fend off look-alikes. Because of better manufacturing technologies, the quality of copycat goods has improved exponentially. As these products look more and more "real," consumers have fewer and fewer qualms about buying them – driving up demand further.

In the world of fashion, it's a particularly difficult problem. Counterfeits in this industry can quickly dilute brand value because of overexposure. That's what happened when I was at Calvin Klein from 1998 to 2003: Countries like Turkey and Russia were flooded with fakes of our jeans and tops, so it was impossible to develop real businesses there. Conversely, when we were in the very preliminary stages of developing a presence in China, all the CK replicas floating around were actually helpful in creating awareness of the brand.

Like Bill Bronson, we engaged a top law firm and a worldwide network of "enforcers" to help us get the counterfeits off the streets and out of the cyberalleys. We learned, as Bill has, that this fight has to be expansive (carried out at a worldwide level, involving multiple outside parties), which means it also is expensive (all those partners expect to be compensated). But ultimately, the outcome of Calvin Klein's crime-fighting plan paled next to the amount of time and money we devoted to it. That's why I think it will be near impossible for Ruffin to get to a place where it can declare 100% victory.

The business of counterfeiting is just too large and profitable at this point. Especially in recessions, the black market thrives. Knock-off products give bargain seekers a chance to show off and enjoy a high-end experience without having to pay top dollar. Even when you explain to consumers that these counterfeits may come from factories where human rights are not respected, they continue to buy.

To mitigate the effects of copycat products, Bill should work on building up the strength of the Ruffin brand instead of getting into testy exchanges with shady street characters. To paraphrase a recent quote from Patrizio Bertelli, CEO of Prada: Worry about who's copying you, yes, but worry more about building and maintaining a brand that others will want to copy. Bill can do this in several ways, not the least of which is increasing Ruffin's retail presence in China, Dubai, and elsewhere. Establishing more single-brand stores and high-level retail outlets would all but guarantee consumers that they are getting real-deal Ruffin goods. These stores could also showcase Ruffin's distinctive product lines in ways counterfeiters can't and could serve as a platform for encouraging one-to-one relationships with customers.

Worry about who's copying you, yes, but worry more about building a brand that others want to copy.

The CEO should continue in his efforts to stay on the leading edge of innovation and technology. That could be an important point of differentiation for his company, particularly if Ruffin tells customers as much as it can about what it's doing to protect the originality of its products.

Counterfeiting is a business problem that must be fought with business smarts, creativity, retail strategy, IT, and teamwork with worldwide partners – not vengeance.

Wendy Wray

Counterfeits make me incensed too – we just end up being the R&D facility for less-than-ethical entrepreneurs.

J. Merrick "Rick" Taggart
is the president of Victorinox Swiss Army (VSA) North America, based in Monroe, Connecticut. VSA makes pocket tools, cutlery, timepieces, fragrances, and other consumer goods.

BILL SHOULD definitely move ahead in his battle against copycat Ruffin products, but he needs to be less scattershot in his approach. He'd be better off targeting a few potentially big hits, making an example of the worst offenders, rather than attempting to put every counterfeiter across the globe out of business. When you try to flex your muscles everywhere, that's when your expenses go through the roof.

Bill's emotions about knockoffs come from a pretty horrific event, of course, and he's much more public with his feelings than I would be. But the notion that people are counterfeiting my company's products makes me incensed too. We just end up being the R&D facility for a set of less-than-ethical entrepreneurs.

At Victorinox Swiss Army, we invest heavily in brand protection. While we outsource the production of some goods (luggage and apparel) and components (the casings for our watches), we select our manufacturers with great care to make sure the designs we share with our partners won't be used to create a couple hundred (or a few thousand) unauthorized copies of our products.

We monitor websites that sell our goods, checking to see if they're operated by one of our 10,000-plus approved resellers worldwide. We've had people arrested, and we've helped organize raids. Once products are seized, specialized equipment – for instance, instruments that gauge the molecular structure of the stainless steel in a watch or pocket knife – helps us determine their pedigree.

The biggest allies for us – and a resource that Bill needs to take greater advantage of – have been U.S. and international customs and border patrol officers. Over the past few years, customs has confiscated thousands of faux VSA fragrances, tools, and timepieces so they could be destroyed before they even hit the streets. We communicate early and often: We inform customs officials about our typical ports of entry, consignee and consignor data, and so forth, which makes it that much easier for officials to sniff out illegal activity. The people creating and selling the fakes don't have to do R&D, marketing, or advertising, it's true, but they've still got to invest in raw materials and manufacturing. Having 14,000 products (or more) seized at a port and, ultimately, smashed under a bulldozer is probably a far more effective deterrent to them than chasing away one or two street sellers.

It's counterproductive for Bill to place any blame on consumers. Counterfeiters these days can easily go online, copy Ruffin's marketing images to post at their own sites, and dupe unsuspecting customers looking for discounts. (And the person shopping for fakes on Canal Street in New York probably isn't part of Ruffin's core, anyway.) At VSA, if a customer who unknowingly purchased a close counterfeit sends it to one of our repair centers, we'll sometimes send back an authentic replacement, and we'll tell the customer how to avoid making the same mistake in the future.

Finally, Bill might want to work on rallying his management team. The CEO and his lieutenants obviously aren't on the same page. The regional managers may be chafing against Bill's tendency to act impulsively, but even so, the strategic and financial goals he deems important should be a priority for them. He might be able to win them over by altering his public persona: working behind the scenes more, perhaps, and letting the press pick up on Ruffin's biggest successes in nabbing counterfeiters. No more sound bites of Bill acting like a big American bully.

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Candace S. Cummings *is the vice president–administration, general counsel, and secretary of VF Corporation, a $7.5 billion global apparel maker whose brands include Wrangler, The North Face, JanSport, Nautica, and Vans. The company is based in Greensboro, North Carolina.*

BILL DESPERATELY needs to professionalize his anticounterfeiting program. He should retain an outside investigator like Ted Dwayne or an outside legal team that has experience creating comprehensive brand-protection programs for manufacturing, distribution, and retail companies. Right now, there's an awful lot of sound and fury around Ruffin's counterfeiting problem but few well-thought-out solutions.

Executives have many variables to consider when devising a strategy against counterfeiters, and I'm not sure Bill has objectively taken stock. For instance, in which markets does he sell his products – premium, midtier, or low-end? In which countries does he manufacture and sell his goods? Is his intellectual property – including trademarks, patents, and copyrights – protected there? Has he trained national customs officers and law enforcement personnel to recognize fakes of his goods? And what does he really know about his key employees' backgrounds and ethics? Engaging in a systematic assessment of those variables, among others, can help Bill identify which aspects of his business might be the most vulnerable to counterfeiters. Armed with this information, Bill can then decide where to focus the dollars he's dedicated to combating copycats – revisiting his strategy as business, legal, political, and social factors change.

> If Bill doesn't handle knockoffs with a level head, Ruffin will pay a steep price.

Unfortunately, this battle won't get cheaper over time. Ruffin's legal bills will continue to stack up as the company investigates how counterfeiters of its products are organized, pursues civil litigation, and provides support to criminal prosecutions. We've experienced this firsthand: Recently, VF pursued (and won) sizable judgments against several enterprises in Asia that were manufacturing phony The North Face jackets and then importing and selling them to wholesalers and retailers throughout the United States. What's more, any litigation efforts undertaken outside the United States, Canada, and a handful of other countries are likely to increase poor Bill's frustration: Local cultural conditions matter quite a bit to the outcomes in these cases. If, say, the local politicians are friends of a counterfeiter you're investigating, you may decide to focus your time and resources on a target for which there's less chance of an "irregular" result.

Moreover, while Ruffin's technological investments are helpful, they're hardly a panacea. For instance, to be effective, the electronic-tag readers Ruffin is using need to be put into the hands of the people on the front lines – law enforcement or national customs personnel – not an easy or inexpensive undertaking. Customs officials have limited time to decide whether a shipment or carton warrants further inquiry. So if Bill makes it easy on them, as we do at VF – by describing the exterior of the shipping cartons and providing a list of authorized importers as well as a hotline number to call – they will be more likely to act.

The foundation for any good defense against counterfeiters is keeping tight controls over your own supply chain and distribution processes. That means being clear and consistent about the types of manufacturing partners you do business with, the countries you source from and sell in, and the rules and regulations you deem important to the future of the brand and the company. Your contracts with distribution partners should put strict limits on their activities – prohibiting, for instance, products from going anywhere but outlets you trust and where you can track them through point of sale.

Bill should continue his campaign against counterfeits; he can't ignore the problem. But if he doesn't handle this issue with a level head, Ruffin will pay a very steep price.

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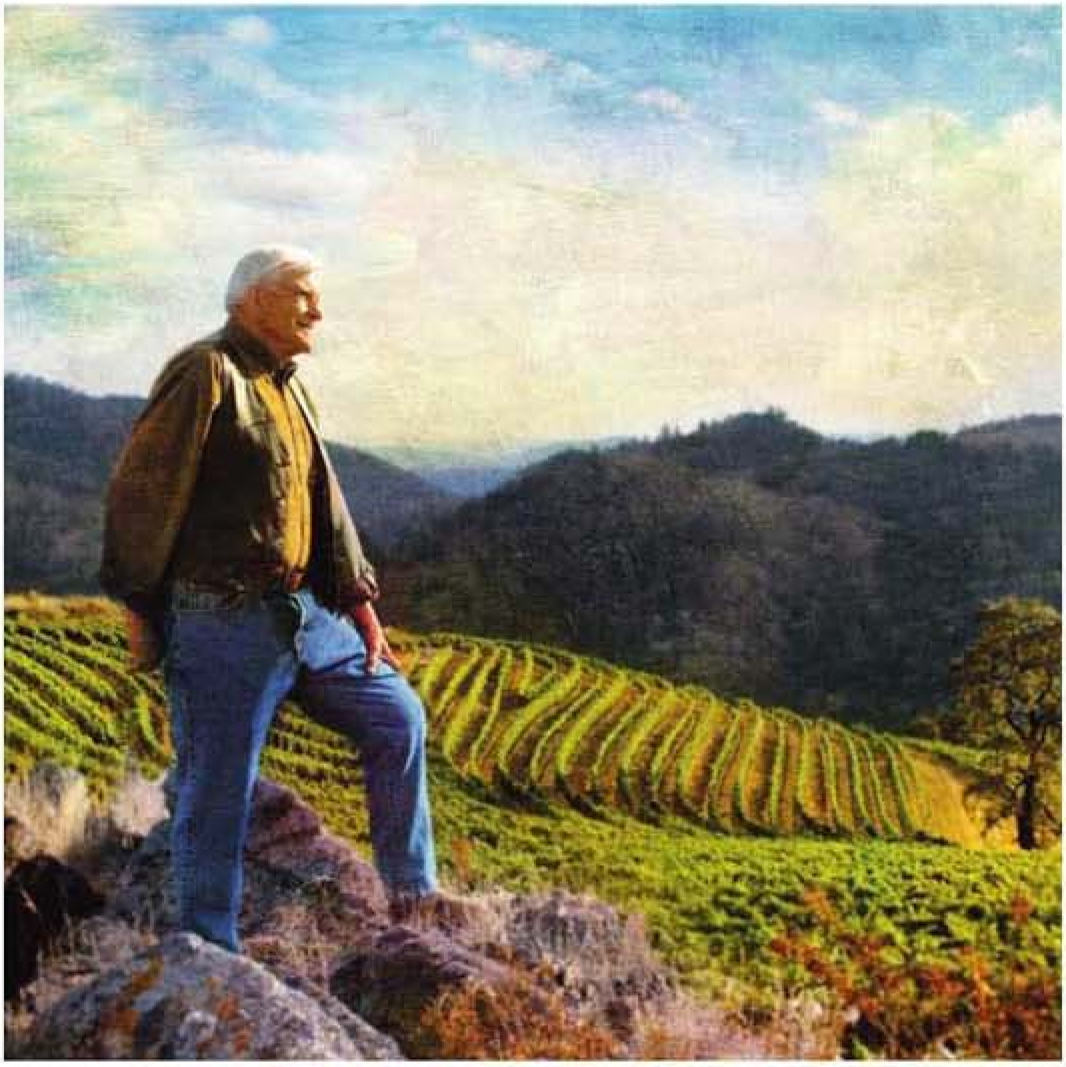

Jess Jackson, Upper Hawkeye Mountain Estate, Alexander Valley

Terroir can be defined as that mystical melding of light, water, soil, air and human touch. It is a definition I often use. The simple fact is, you must have a world-class grape in order to make a world-class wine. And when it comes to grapes, their source, the land is what matters.

Precious few places exist on this Earth that will produce grapes of this caliber. We have been fortunate to find several of those places in California's cool coastal mountains, hillsides, ridges and benchlands. It is some of the best land in California. And why you will see the Jackson Estates Grown designation proudly displayed on our labels.

My family and I have made it our life's work to seek out these special places, have the knowledge and respect to work in concert with Mother Nature, then commit to the hard work, expense and patience to steward the wine into the bottle. It is a commitment many in our industry are either unwilling or unable to make. But we are convinced you can and will taste the difference because, ultimately, the wine's distinct personality will reflect its source, the special terroir.

I understand that many of you enjoy the taste of our wines but you aren't sure why. My goal is to help with **A Taste of the Truth.**

Jess S Jackson

First Person

BY STEPHEN P. KAUFMAN

Evaluating the CEO

How I got the board to give me real feedback once I became CEO

AFTER I BECAME A CEO, I was struck by how perfunctory the board was in its feedback on my performance. The chair of the compensation committee would pop by my office for just 10 minutes after the year-end closed session of independent directors. He'd inform me that the board was happy that the company had made its numbers, thank me for my leadership, tell me what compensation it had approved, and express his regret that he couldn't stay to talk – but he had a plane to catch. He would then hand me an envelope containing the details of my comp package and leave. He wouldn't have even sat down.

Those reviews were very different from how I evaluated my team. I collected input from many sources and assessed performance on multiple dimensions. I worked with my direct reports to identify flaws in their management styles, and I tried to help them adjust before problems arose or their careers got stalled. I had received similar guidance on my way up to the C-suite, but that all disappeared suddenly when I became CEO. My total worth was based on just three or four financial measures, and the independent directors' assessment of me was driven almost entirely by their need to justify their compensation decisions.

Of course, a fine line exists between counseling CEOs and telling them what to do, and you need to give CEOs freedom to make choices. But to use CEO autonomy as an argument for limiting performance management to only financial measures makes little sense. All the incentives in the world won't transform CEOs into better decision makers. And when CEOs stumble or fall, they pull their companies down with them. Boards have an obligation to shareholders to ensure that companies are led well, and the sooner they can spot problems with leaders' performance, the better. As it is, by the time companies fire CEOs the damage has already been done.

In addition, just think about how we replace CEOs: It takes six to nine months from when a board recognizes that something's wrong for it to reach consensus and muster the courage to act. It then takes three to six months to find a new CEO and get her onsite, plus another year for that CEO to figure out what the business is, what she wants to do, and how to get started. At the minimum, that's almost two years of costly stasis.

To avoid such pitfalls, we at Arrow Electronics, where I was CEO for 14 years, came up with a process to improve how I was evaluated. The independent directors based their assessments of me on direct observation of the company and input given to them by executives at multiple levels of management. As a result, they could detect problems that I might not have noticed. My performance benefited materially, and I learned a lot about leadership. To put our method into context, let's first look at how CEOs themselves assess their direct reports.

What Makes a Performance Review Credible?

Any assessment of a top executive begins with his unit's financial and operating metrics and progress against strategy. But the former does not illuminate key management attributes, and the latter is often a manufactured set of data carefully aimed at presenting results in the best possible light. Neither helps to uncover what the executive is doing that might help or hurt the company in the long term. To accurately gauge a top executive's performance, CEOs have to go into the field and witness him and his colleagues at work firsthand.

By attending staff meetings and participating in various corporate activities, CEOs observe how a manager interacts with peers and subordinates. They cross-check those observations with what they hear from others in the organization. They may find out, for example, that the manager hoards resources or didn't buy into finance's latest supply chain initiative. For confirmation, they then speak to function heads and ask pointed questions about the executive's performance. When I was CEO, I'd follow up on what I'd heard by asking the head of HR outright what he thought about talent management in the manager's unit: Was he hiring and developing good people? Was he sharing them with other units? I'd go to the CFO and ask her whether the unit was hitting its numbers because of performance or aggressive bookkeeping. I even went one step further and asked my assistant what she'd heard through the grapevine. Did the other assistants think a manager was riding his people too hard? Was he becoming stressed and short-tempered? In taking steps like these, CEOs ensure that when the time comes for annual reviews and performance counseling, they will have a multifaceted view of a manager, well beyond the numbers.

It's clear that independent directors don't have the same opportunities to garner this kind of knowledge about CEOs. They generally meet them only in very structured settings – at board meetings and dinners – where CEOs tend to be on their best behavior. And often the sole chance directors have to speak with executives below a CEO is at a dinner the night before the meeting – in the CEO's presence. As a member of several boards, I often meet executives at such dinners, but when I ask them probing questions, such as whether they are getting the support they need for a key growth initiative, I see their eyes flick toward the CEO across the room. Is she listening in?

The solution is for independent directors to meet with executives outside these formal settings and on a more regular basis. I'm not the first to realize this: GE's Jack Welch encouraged his independent directors to visit major business units and meet with the operating executives on their own each year. It's also common practice for Home Depot's independent directors to visit a store once a quarter and draw their own conclusions about its operations. Did they find what they needed? Was the staff polite and knowledgeable? Their visits not only provide a chance to give the CEO feedback but also allow the directors to see how major initiatives are playing out on the floor of the store – a clue to the CEO's leadership effectiveness.

Given that Arrow has operations in most major cities, at first we thought it would be easy to get independent directors to drop in at local divisions. But an informal approach didn't work because unlike Home Depot, whose directors might go to a store for personal reasons, our directors had few incentives to visit our locations, other than their board responsibilities. If we were going to get

ARTICLE AT A GLANCE

- **The feedback that most CEOs receive from the board is based solely on the company's financial performance – a stark contrast from the comprehensive reviews given to senior executives on their way up the corporate ladder.**
- **To do a better job of giving feedback to a CEO, Arrow Electronics adopted a process that required independent directors to spend more time talking to executives and observing operations.**
- **As a result, the board was more aware of how the CEO performed throughout the year, and was able to detect and give advice on how to fix problems the CEO may have missed – before the issues escalated into disasters.**

these directors out to the front line, we discovered, it would have to be as part of a formal process.

Arrow's Revamped CEO Evaluation Process

Here's what we did. Every year between mid-December and mid-February, each independent director met with three executives separately to discuss topics selected by the comp committee chair. The structured conversations were focused on the state of the company's strategy, culture, competitive position, and operations: all indications of my performance as CEO. We had six independent directors, so some 18 executives were involved each year. If a director's schedule didn't permit a site visit, we would send the executive to meet that director. It was my assistant's responsibility to work with the comp chair to decide which directors saw which executives, but I had no part in preparing the schedule.

The night before the board meeting in late February – once they'd all had a chance to meet with their designated executives – the directors devoted a long, private dinner to sharing their insights. When two or more directors reported a similar issue, the comp chair flagged it for the comp committee to address the next morning.

At that meeting, the committee members talked through the flagged issues and tried to distill their main thoughts on my performance. They organized the discussion under five headings: leadership, strategy, people management, operating metrics, and relationships with external constituencies. (See the sidebar "Five Dimensions of CEO Performance to Consider.") As a reference, they also had a three-to-five page self-assessment that I had sent to them at the end of January, addressing the same topics.

The outcome of that meeting was reported at the year-end closed session of independent directors. At that stage, the group finalized my review – including an approved compensation – and afterward the comp and governance

Five Dimensions of CEO Performance to Consider

Arrow Electronics revised its CEO evaluation process to address each of these key areas:

Leadership. How well does the CEO motivate and energize the organization, and is the company's culture reinforcing its mission and values?

Strategy. Is it working, is the company aligned behind it, and is it being effectively implemented?

People management. Is the CEO putting the right people in the right jobs, and is there a stream of appropriate people for succession and to support growth goals?

Operating metrics. Are sales, profits, productivity, asset utilization, quality, and customer satisfaction heading in the right direction?

Relationships with external constituencies. How well does the CEO engage with the company's customers, suppliers, and other stakeholders?

committee chairs met with me for about two hours to give me their feedback. While they talked, I took notes and spoke up only for clarification. I didn't try to justify or defend myself.

For a week or so after the meeting, I reflected on our discussion. Taking this time was important because, like for most people, there was the risk of initially filtering the information, perhaps even becoming defensive about particular points. I then wrote up a two-page memo for the comp committee chair, recounting what I thought I'd heard to make sure we were in agreement about the major points. I remember coming out of one session convinced that the directors wanted me at all costs to hit the budgeted EPS target of $3.20. My memo reflecting that assumption prompted a call from the comp chair to tell me that the directors were not set on $3.20 if achieving that number meant compromising on strategic investments.

The success of Arrow's evaluation process was contingent on the ability of its independent directors to conduct nuanced interviews with executives that probed critical business issues. That's becoming rarer. Generally speaking, 10 years ago if you had a board of nine people, there'd be seven independents, most of whom were sitting, recently retired, or about-to-be CEOs. Today maybe three would have that kind of experience. Many seats are filled to acquire specialist knowledge or to engage specific constituencies. An organization might put a scientist on the board to make sense of an R&D pipeline, a former accounting firm partner to head the audit committee, or an environmentalist to help the company focus on its carbon footprint. But while issue-specific directors can probably all recognize the trailing financial indicators of poor CEO performance, they may miss its leading nonfinancial ones.

The Benefits of a Revised Process

I found that the Arrow process exposed my blind spots before I could get into too much trouble. One occasion in particular sticks in my mind. We had bid to acquire a competitor that I believed would welcome our offer. I had taken charge of the deal myself, on the basis that I knew the target's management well and wouldn't need to play the negotiating games investment bankers are fond of. We eventually lost the deal to another bidder, who put more money on the table.

But price wasn't the reason for the deal's failure, as the directors discovered from discussions with our executives. They learned that I had mistrusted and routinely ignored the advice of the investment bankers we'd engaged. In fact, as the comp chair pointed out at my review, we might have closed the acquisition quickly and at the price we wanted had I gone along with the bankers' recommendations regarding bidding strategy and mechanics. It was a valuable lesson about respecting the skills of our advisers.

As much as a process like Arrow's can help CEOs become better leaders, it's the company that can benefit the most. Take, for example, this cautionary tale from a friend. He served on the board of a company whose CEO said he would retire in 18 months. The board formed a succession committee, which began by getting to know three internal candidates. Each committee member met with each candidate several times for a few hours. Out of those conversations came a troubling picture of the outgoing CEO. He was an abusive micromanager who yelled at people in public and was creating a destructive, politicized working environment. One year he had forced all of management to support – in front of the board – an acquisition that nobody believed in (and which, fortunately, fell through).

None of this had been apparent to the directors from their regular interactions with the CEO. They knew he was tough and they were impressed with his command of detail, but they had had no idea of the pressures he placed on people in the organization. A number of well-regarded executives had left, but the CEO had always given a plausible explanation: This one was struggling with a family issue. That one had received an offer he couldn't refuse. When the internal candidates were asked why they had stayed, their reasons were a combination of loyalty to the company and their people, a belief that they could wait it out until the CEO retired, and the fact that they were being paid more than they could get elsewhere. In other words, the CEO was overcompensating his people to make up for abusing them. This practice would have eventually showed up in the numbers. Armed with that knowledge, the board announced and installed the new CEO nine months ahead of schedule and broke precedent by not inviting the outgoing CEO to remain on the board.

This board was lucky that the succession issue came up when it did. The independent directors had been completely unaware of just how toxic the CEO was. My guess is that if they had been having discussions with executives in the normal course of events, as Arrow's directors did, they would have uncovered and resolved the issue a lot sooner.

All the financial incentives in the world won't transform CEOs into better decision makers.

The Arrow process won't be useful in every case. If an organization wants a CEO to manage a company out of a crisis, it might need Attila the Hun. But if a company is healthy and stable, I suggest making a process like Arrow's a condition of the job for its next CEO. If the CEO accepts, that's a signal that he can put aside his ego and acknowledge that he's not perfect, and is open to receiving counsel. At the end of the day, my experience has taught me that it's when CEOs think they no longer need real, credible feedback that they get into trouble.

A former CEO of Arrow Electronics, **Stephen P. Kaufman** *(skaufman@hbs.edu) is a senior lecturer at Harvard Business School, in Boston, and has been a director of six public and four private companies.*

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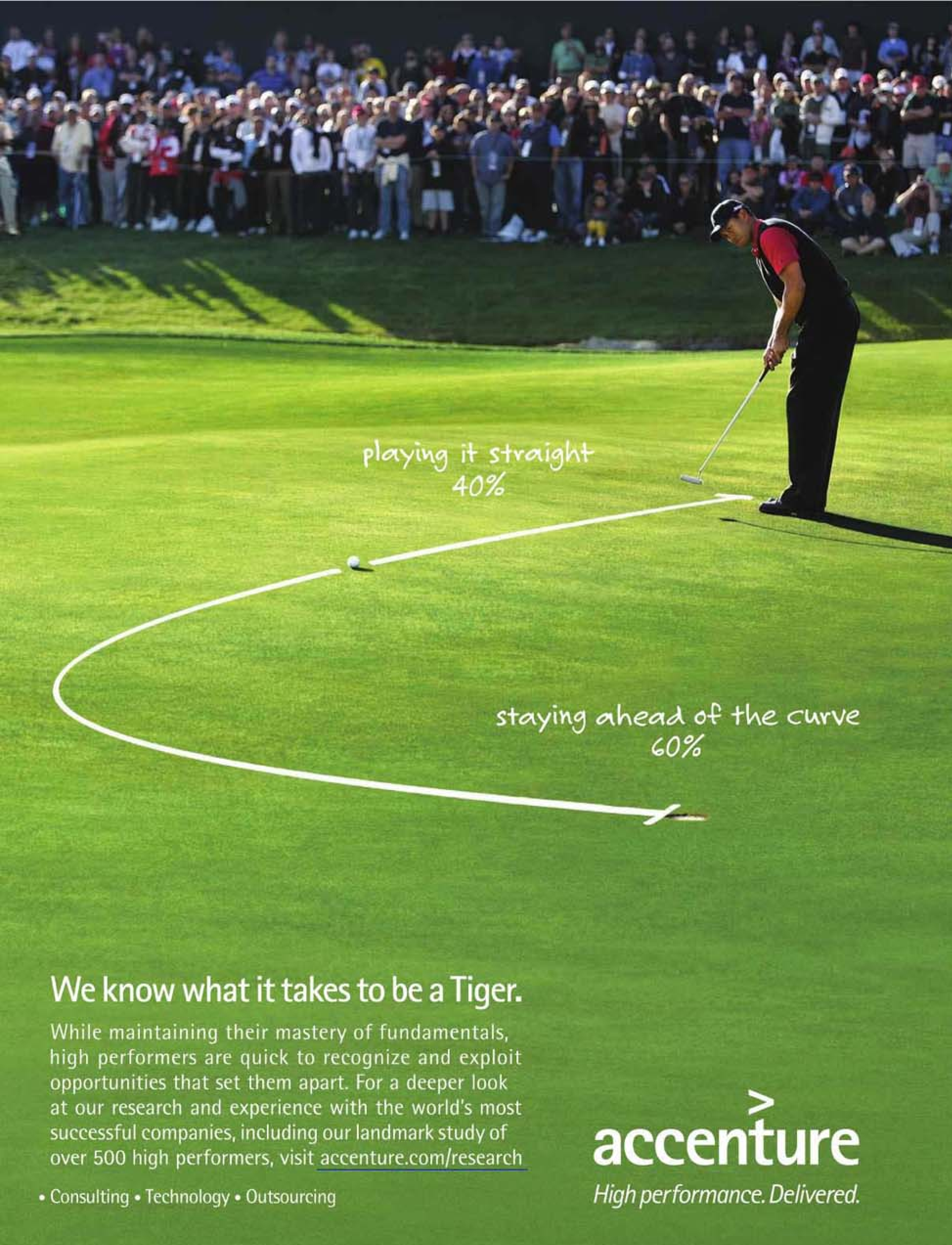
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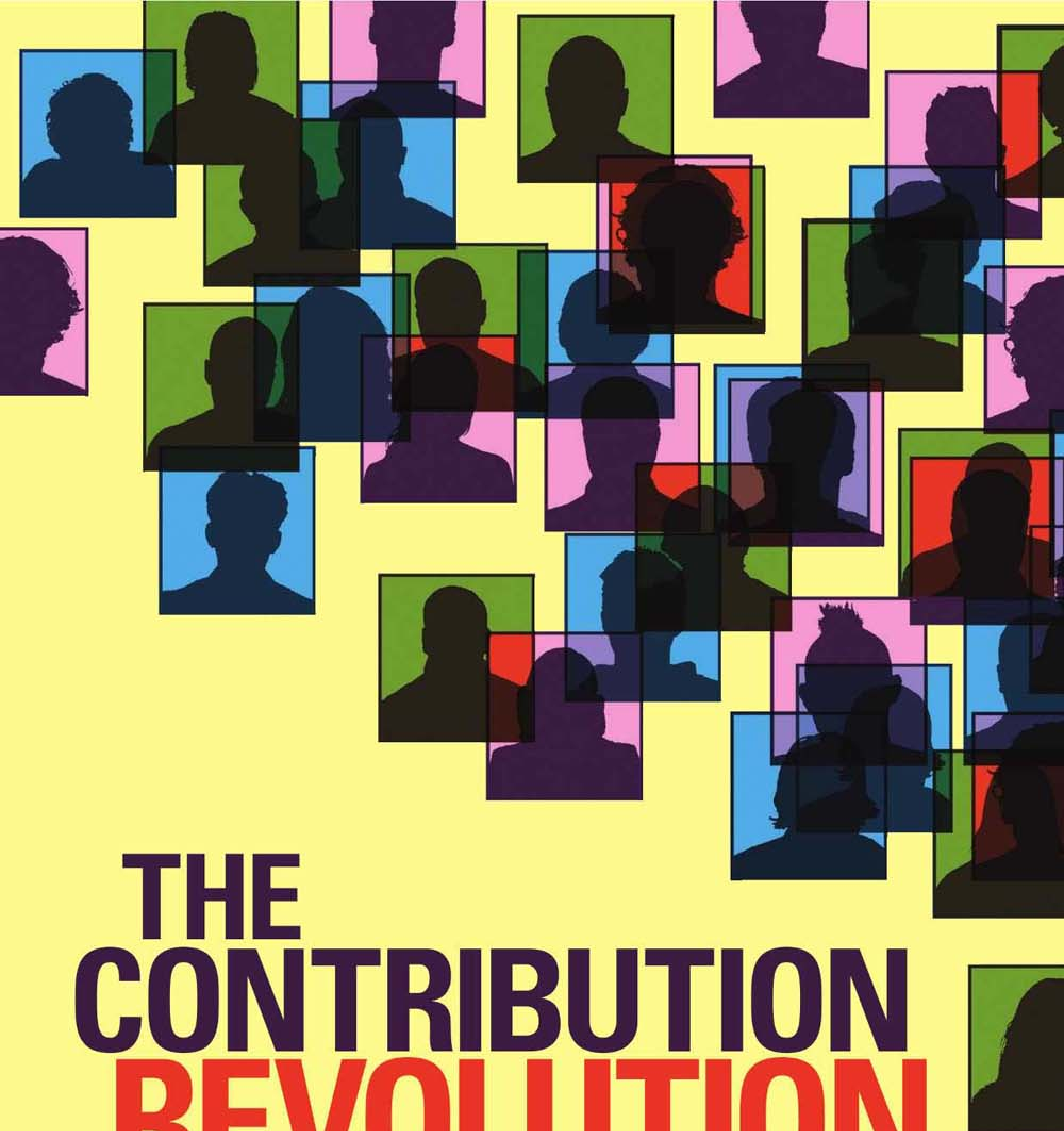


THE CONTRIBUTION REVOLUTION

Letting Volunteers Build Your Business

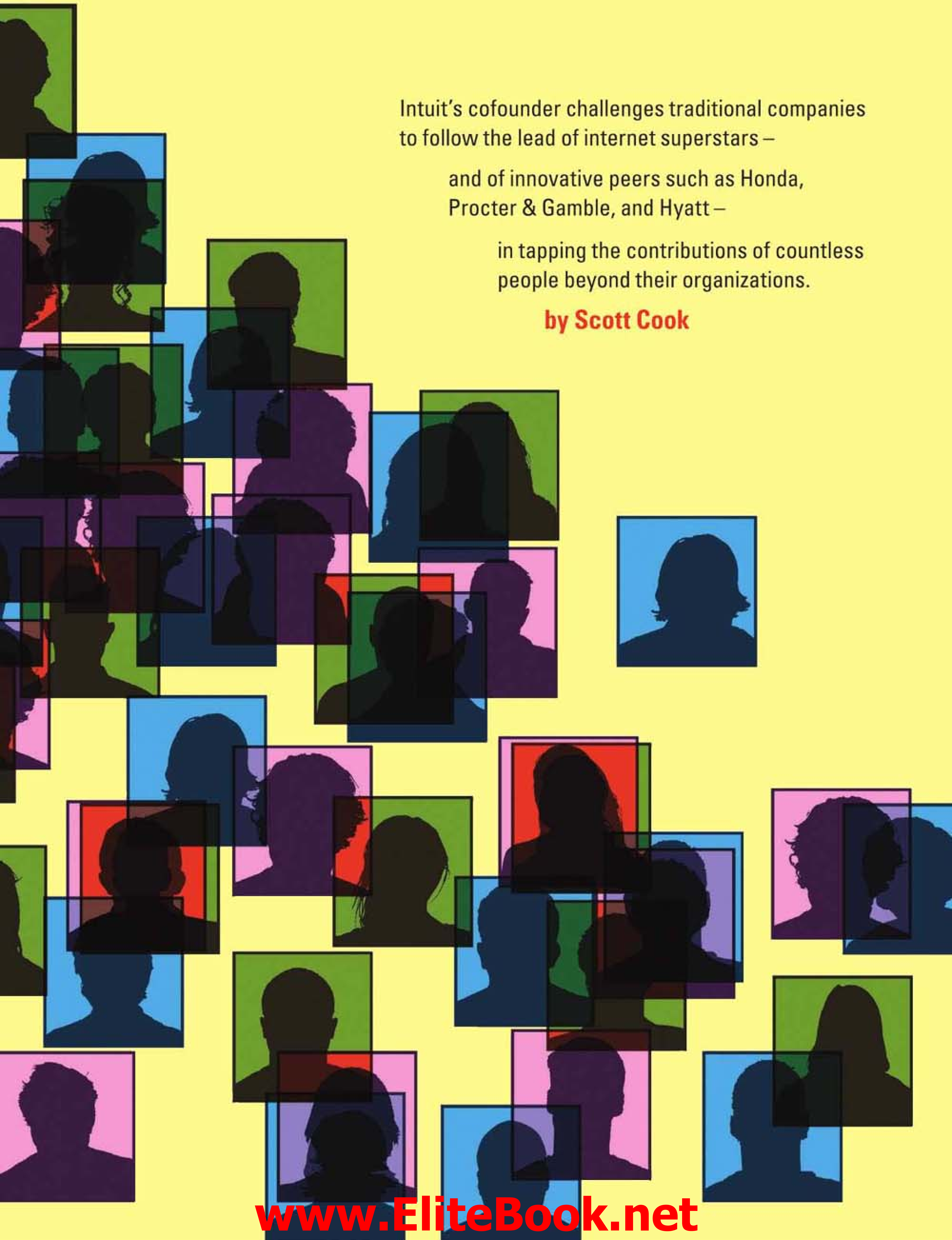
Joe Magee

Intuit's cofounder challenges traditional companies to follow the lead of internet superstars –

and of innovative peers such as Honda, Procter & Gamble, and Hyatt –

in tapping the contributions of countless people beyond their organizations.

by Scott Cook



Earlier this year, I spent an intense half-day closeted in a room with the top 70 executives at Intuit. Our aim was to come up with ways that people outside the company could volunteer their time, energy, and expertise to make life better for our customers. Sound odd? Well, if you're not conducting an exercise like that at your organization, you risk missing the boat on a sea change that's transforming business.

Every day, millions of people make all kinds of voluntary contributions to companies – from informed opinions to computing resources – that create tremendous value for those firms' customers and, consequently, for their shareholders. When I first encountered this idea, several years ago, it struck me as unfathomable: Volunteerism was for charities, not for red-blooded, profit-making firms.

That was just my first surprise. I also began to see that user contributions are fueling some of the world's fastest-growing and most competitively advantaged organizations – in some cases revolutionizing the economics of entire industries by radically shrinking their cost structures. Think of eBay, which opened as an online store with no inventory, leaving it up to customers to fill its "shelves" with goods to sell. Or Wikipedia, which gutted the value proposition of 230-year-old Encyclopaedia Britannica by offering a free encyclopedia written and updated frequently by unpaid amateurs.

In other cases, the contribution is not as obvious but just as central to the value proposition. Skype incurs almost no capital costs because its internet-based phone system is built on the unused processing capacity of its customers' personal computers. Google, too, is built on user contributions: Its search engine relies on the algorithmic aggregation of links created by others between websites, and its ad placement system relies on data from people's click behavior.

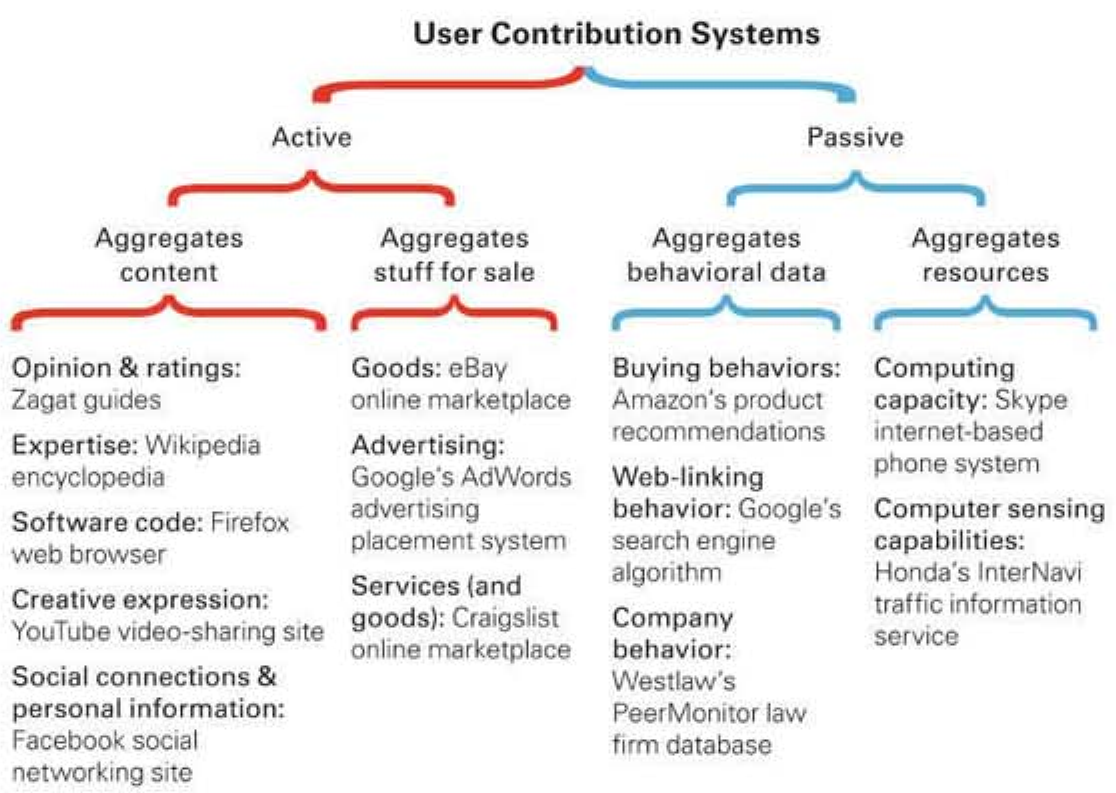
OK, I'm not saying you can or should transform your company into a Google or a Skype whose business model is primarily based on user contributions. But you should understand the power of the phenomenon and, as I have, learn from the growing number of companies in traditional industries – firms like Honda, Procter & Gamble, Best Buy, and Hyatt – that are tapping user contributions to improve products, better serve customers, generate new business, reduce costs, boost employee performance, and more. Contribution-driven results like those are achievable for pretty much any business.

The concept of user contribution isn't new. But the companies I've just mentioned – both the internet highfliers and the old-economy behemoths – have actively created something I call a *user contribution system.* That is, they've created methods for aggregating and leveraging people's contributions or behaviors in ways that are useful to other people.

The *users* can be customers, employees, sales prospects – or even people with no previous connection to the company. Their *contributions* can be active (work, expertise, or information) or passive and even unknowing (behavioral data that is gathered automatically during a transaction or an activity). The *system* is the method, usually internet-based, by which contributions are aggregated and automatically converted into something

A User Contribution Taxonomy

User contribution systems aggregate and leverage various types of user input in ways that are valuable to others.



useful to others. Although the company retains control of the system and may choose to modify its design, the system converts inputs into useful outputs in real time with little or no intervention by the company.

Such a system creates value for a business as a consequence of the value it delivers to users – personalized purchase recommendations, connections between buyers and sellers of hard-to-find items, new personal or business relationships, lower prices, membership in a community, entertainment, information of all kinds. (See the exhibit "A User Contribution Taxonomy" for a breakdown of various types of user contribution systems.)

The challenge for executives is twofold: First, you must learn how to spot opportunities for creating value from user contributions. Second – and here's the difficult part – in acting on these opportunities, you must overcome natural organizational resistance to the idea of relinquishing significant control to people outside the company. The advice I offer here is based on my personal experience at Intuit – the successes and failures, the moments of exhilaration and the times when I had to conquer my own fear of putting so much power in the hands of users.

Revolutionary Potential, Debilitating Myths

Though I didn't know it at the time, my interest in user contribution systems began in the early 1990s with a series of slim red books. The Zagat guides offered reviews with quantitative ratings based on sustained performance rather than on a single visit or two by one reviewer. And those recommendations originated not with paid experts but with regular diners like me. It was a decade, though, before I recognized the significance of the method to my own company. That "aha" came from watching the winners on the web.

The success of the leading internet firms has admittedly been touted ad nauseam by the media and business experts. Yet for better and for worse, the internet is a reflection of society and the preferences of hundreds of millions of people around the world. Like book best-seller lists, rankings of the most popular websites reflect what's winning the battle for people's attention.

The companies joining the list of most popular websites in recent years include Wikipedia, YouTube, Facebook, Craigslist, and MySpace. They have joined such older sites as Amazon, eBay, and Google. At first glance, these sites seem to have little in common, targeting unrelated areas of human endeavor: the cataloguing of information, video entertainment, social interaction, classified advertising, retail shopping, internet search. Some of the sites charge users; others are free. One's a nonprofit; another has one of the highest profit margins among public companies.

Despite their differences, all these winning sites rely on – or are themselves – user contribution systems. Much of their success flows from inherent characteristics of contribution systems that create advantages, detailed here, of a magnitude rarely known in traditional business.

Cost advantage. What does Wikipedia pay the authors and editors of its articles? What does Facebook or MySpace pay those who painstakingly fill in and update the personal profiles that make the site so valuable? Nothing. These sites enjoy free "raw materials," as users perform gratis work that companies typically have to pay for. People contribute for various reasons, some of them self-serving but all of them sufficient to make formal payment unnecessary. (See the sidebar "Why Do Contributors Contribute?")

Scalability advantage. Inexpensive does not mean incomplete. Quite the opposite: The contributions of countless people can be aggregated into vast compilations that surpass traditional offerings. Wikipedia has 10 times as many articles as *Encyclopaedia Britannica*. Craigslist's free classified advertising sites feature more than 30 million new offerings every month, and eBay's virtual shelves feature 120 million items, many times more than any other store on the planet can offer. Such scale doesn't require broad or deep contribution: Only a small percentage of users may contribute (about one user in 1,000 for Wikipedia) and active contributions may require little effort (as with Flickr, the photo-sharing site).

Competitive advantage. Some contribution systems give companies a structural advantage over rivals because of network effects. That is, the more people who contribute to the system, the more useful it becomes, creating an upward spiral in which increasingly more people choose to use and contribute to it. Network effects once drove the winner-take-all market-share gains of Microsoft's Windows; today, they propel the success of sites like Wikipedia and Facebook.

Contribution systems won't displace most traditional products or businesses: I'm not expecting Wiki-Milk to displace real milk or the dairy industry. Still, given the power of user contributions, too many business leaders are failing to look for opportunities to leverage these systems in their industries. I think that's partly because of the novelty of the phenomenon, but it's also because of beliefs rooted in the past. All too often, executives mistakenly view user contribution as:

An unmitigated threat to traditional for-profit businesses. But consider Schibsted, a 170-year-old Norwegian newspaper publisher that, instead of ignoring the online threat savaging much of the newspaper industry, started reinventing itself in the mid-1990s by embracing user contribution and becoming a leading European provider of online classified advertising.

Only for tech companies. But consider the Canadian grocery store chain Loblaws, which solicits online customer reviews and incorporates them in the marketing of new products.

Unreliable and error-ridden because the contributions come from amateurs. But consider the study in *Nature* that found volunteer-written Wikipedia to be, in general, about as accurate as expert-written articles in *Encyclopaedia Britannica*'s online edition.

Just another bubble, lacking a strong business case or profit-producing potential. But consider LinkedIn, whose social networking site for businesspeople now profits from numerous revenue streams: traditional ones, such as site advertising, upgrades to premium membership with more features, and paid job postings, along with more novel ones, such as tools that corporate HR departments can use to screen job candidates.

Where Can Contribution Systems Help My Company?

Even without knowing your business, I'd be willing to bet that contribution systems can address one or more of the business challenges you face better than the methods you currently use. To spur your thinking, let's look at some of the different ways that traditional companies are employing user contribution systems in a wide variety of business activities and functions. (See the exhibit "Putting User Contribution Systems to Work.")

Customer service. Company-hosted online support forums, in which product users answer questions from other users free of charge, are commonplace among software and personal computer companies. I admit my initial surprise when I experienced firsthand how a user community can answer tough questions that even the manufacturer cannot. Now non-computer firms, such as AT&T, are beginning to follow this practice.

Troubleshooting is just one way to harness user contributions for service. Hyatt Hotels and Resorts has launched an online concierge service called Yatt'it that aggregates and lets users rate travel tips posted by Hyatt's customers and concierges. The aim is both to reduce the burden on concierges and to give travelers tailored, extensive city information in advance of their trip – and, if they've already arrived, without their having to wait in line.

Companies also use contribution systems to serve customers in ways that create a brand-new business. Westlaw, the legal research service, created a B2B contribution system that helps its customer base of law firms address important strategic issues. West PeerMonitor automatically aggregates anonymized financial and operating information from participating law firms. The firms access the database to see how their performance compares with that of peers and how other markets compare with their own – data that may help a firm decide, for example, whether to expand geographically or whether a key practice area is operating efficiently. This customer service is valued so much that Westlaw charges handsomely for it.

Marketing. The power of contribution systems is now being tapped by traditional marketing powerhouses, including two of the giants: Procter & Gamble and Unilever.

Procter & Gamble has created a website, BeingGirl, aimed at teen and preteen girls – a difficult group to reach in the

Putting User Contribution Systems to Work

Contribution systems can improve a variety of company functions; the benefits to the business flow from the benefits that contributions provide to other users.

HYATT

Customer service

Yatt'it, an online concierge service: Users provide local travel tips, which are then rated by others

Benefit to Users

Better information when you want it – without waiting in line

Benefit to Company

Improved customer satisfaction and reduced costs for staffing concierge services

Unilever

Marketing

In the Motherhood, a user forum: Moms share experiences and also submit and vote on plot lines for an online comedy series

Benefit to Users

The exchange of information, a sense of community, and engaging entertainment

Benefit to Company

Increased brand awareness and loyalty to Suave products (through site sponsorship) and brand reach (20 million views of the online shows to date)

Even without knowing your business, I'd be willing to bet that contribution systems can address one or more of the business challenges you face better than the methods you currently use.

marketing of its feminine-hygiene products because young girls are often uncomfortable viewing TV ads on the topic in the company of friends or family. The site originally consisted solely of information from experts. But in 2005, P&G borrowed the contribution concept from tech websites, adding forums where girls could interact with one another. Now users can share their questions and personal experiences and get support and advice from other girls. This creation of a community around an important topic promotes engagement with the site – and with the Always and Tampax brands that it discreetly promotes. P&G says that as a marketing tool BeingGirl is now four times as effective as comparably priced television advertising.

The website In the Motherhood, cosponsored by Sprint and by Unilever's Suave line of personal-care products, also offers a community forum where users can share stories and offer tips – in this case on the subject of being a mom. In addition, mothers can submit stories (3,000 of them so far) that serve as potential plotlines for an online comedy series. The community votes on the submissions, and those selected by the users are produced by professional directors and actors and subsequently posted to the site. (Several dozen have been produced so far, and cumulative views have passed the 20 million mark.) Unilever research finds that the site increases users' intent to purchase a Suave product and engenders a feeling in customers that the makers of Suave really understand their lives.

Employee support. Most company intranet sites are one-way streets, with management broadcasting the "company line" to employees. Best Buy, the U.S. retail chain, uses the opposite approach in a contribution system dubbed BlueShirt Nation.

BlueShirt Nation allows employees to share and discuss their ideas and experiences: what works and what doesn't in carrying out a particular task or in interacting with customers,

Human resources

BlueShirt Nation, an employee-run intranet: The site offers advice for tackling job-related problems and promotes employee programs

Benefit to Users

Employee empowerment, better decision making, and increased awareness of company programs

Benefit to Company

Increased employee engagement and buy-in for company programs; identification of best practices

Capital investment

InterNavi automotive navigation and information system: Customers buy GPS devices, which provide traffic-related data that the system aggregates and makes available to system subscribers

Benefit to Users

Real-time information on traffic and driving conditions, as well as localized advice on food and lodging

Benefit to Company

Reduced cost of capital (which is borne by customers) and ongoing revenue from subscription service

Design and development

Community design process: T-shirt manufacturer lets users vote on designs submitted by amateur designers and produces shirts based on the winners

Benefit to Users

Designer exposure and recognition; customer sense of ownership in selected designs

Benefit to Company

Reduced R&D costs (because fewer staff designers are needed) and high inventory turnover (because user-selected designs typically sell out)

Production

Contribution-defined TV show: Millions of viewers cast votes to select a new recording star from a group of amateur singers

Benefit to Users

Compelling entertainment, resulting in part from user ownership of results

Benefit to Company

Access to inexpensive talent, reduced production costs, and significant advertising revenue for example. The site, launched two years ago by two junior employees with no corporate IT support or funding, today has more than 20,000 registered employee users.

Best Buy has discovered that unfiltered information from colleagues can be more effective than memos from HR. For example, Blue Shirt Nation ran a contest in which employees submitted videos they had conceived and produced, with no company oversight, to spur employee adoption of 401(k) plans. The result of the buzz generated by the contest? A 30% increase in plan enrollment.

Capital resources. Build a global telecommunications system with almost no capital equipment? Make free, high-quality video calls anywhere in the world? Both once were unfathomable. But that's what Skype has done, thanks to a contribution system.

Founded by Swedes and engineered in Estonia, Skype is the marquee example of how a company can reduce the cost of capital equipment to almost nothing by having users contribute the capital goods. Skype's free software utilizes idle computing power on users' PCs to manage the calls – as many as 12 million simultaneously – for its 300 million customers. Its costs are so low that the company, which was acquired by eBay in 2006, can deliver high-quality voice and video computer-to-computer calls between subscribers at no charge. And it's profitable: revenue comes from calls made by Skype users to mobile phones and landlines, as well as from services such as voice mail.

Traditional companies, too, get customers to contribute needed capital. In Japan, Honda captures real-time traffic data from GPS systems that Honda owners buy from the company. Speed and location reports from each vehicle contribute to a data stream that Honda aggregates with other traffic data to provide information on traffic jams and other conditions to Honda drivers who subscribe to the company's InterNavi service. Users benefit from enhanced traffic updates; the company can offer a superior subscription service without having to pay for the capital infrastructure.

And there's more: Honda drivers also contribute reviews of local businesses and points of interest that other drivers can read from their InterNavi-equipped Hondas – an automotive version of a Zagat guide. Honda's system thus combines three user contributions – capital equipment, data about user location and vehicle speed, and reviews.

Design and development. User contribution can tackle creative challenges from the technical to the artistic. The emblematic example of contribution in R&D is open source software, such as the Linux operating system and the Mozilla Foundation's Firefox web browser, which is created and regularly upgraded by communities of unpaid volunteer developers. (This low-cost model makes Mozilla one of the rare nonprofits that is highly "profitable.")

In the creative arts, Threadless, a company that manufactures T-shirts, relies on a community of volunteer designers and artists to submit designs and a community of customers to select those that will go into production. Both of the user groups, as well as the company, benefit. The designers get free exposure for their work and a chance at monetary compensation: They receive $2,500 plus a percentage of sales if their design is chosen by Threadless customers. The customers get distinctive T-shirt designs that they have collectively selected. Threadless gets inexpensive design services and an unusually engaged customer base that snaps up the T-shirts it produces, minimizing stale inventory, price promotions, and other margin-eroding practices.

Note that the Threadless user contribution system is subtly different from customer innovation approaches like "crowd-sourcing," which are used with success by Dell, Starbucks, and other companies. Crowd-sourcing is not a user contribution system, in the pure sense, because the company stands between the input and the output. For example, it sifts through people's ideas for new products and services, selects ones to pursue, and then invests the time and expense needed to develop them.

Production. In some cases, organizations can "delegate" some or all of the production process to users. Wikipedia delegates all of it. The producers of Fox Television's *American Idol* delegate part of the process.

The show relies on users (through their votes for performers) to make decisions traditionally reserved for television producers; it relies on amateur performers to offer entertainment usually provided by high-priced stars. The contributing singers benefit from a shot at stardom. Viewers, who contribute their opinions, benefit from compelling entertainment (if the show's high ratings are any indication) and a strong sense of engagement because their votes determine the show's content. Fox and its producers benefit from lower costs and from

The user contribution paradigm poses a challenge to long-unquestioned beliefs about the role of management.

How We're Doing It at Intuit

AS A MEMBER of the boards of eBay and Amazon in the late 1990s, I was exposed to user contribution through the work of Jeff Bezos, Pierre Omidyar, and Meg Whitman. But the concept seemed rare and specialized, so I missed seeing its broader application and value. (I once told Jeff Bezos I thought his plan to supplement professional book reviews on Amazon with reviews written by anyone who felt like it was crazy: Even if you got people to take the trouble to contribute, who'd give credence to the opinion of someone they'd never heard of? Wisely, Jeff ignored my advice.)

When our customer service team at Intuit began user contribution experiments – online support forums moderated by employee enthusiasts – I, along with others on our leadership team, really didn't get the significance of what they were up to. Over time, though, I began to see the contribution concept that underpinned these revolutionary successes. Reinforced by Tim O'Reilly – who taught me that user contribution is the most important concept in Web 2.0, the moniker he coined – I knew we had to act.

Early success. At our annual off-site in 2005, I put this question to the company's top 300 executives: How might we leverage user contribution at Intuit, both to enhance existing businesses and to create new ones? Two executives in our Plano, Texas, division began to think about how to solve a common problem faced by professional tax preparers – getting answers to obscure questions. The result was a quickly cobbled-together wiki/forum site where tax preparers could contribute both questions and answers for the benefit of other tax preparers. Just 33 days after the executive off-site, TaxAlmanac was launched. Today, it has 170,000 pages, drawing on the collective expertise of thousands of tax professionals, and is used by 400,000 unique visitors – about equal to the number of tax preparers in the country. Tax preparers benefit from expertise that's free. Intuit benefits when visitors then buy our tax prep software – customer acquisition at almost zero cost.

However, despite my evangelizing, the idea of contribution systems wasn't taking off elsewhere within the organization. TaxAlmanac was a small island in a sea of indifference.

A major setback. I then resurrected an idea that had been proposed several years before by an Intuit engineer: a website with user-generated reviews of local businesses to help folks find a good plumber, car dealer, or restaurant, linked to our Quicken financial software products. It seemed like a sure bet, so we put a big team on it, and in late 2005, we launched Zipingo. But the site failed to attract a critical mass of users, and we shuttered it in August 2007.

What went wrong? We made mistakes that stemmed from the difference between traditional products and contribution systems. User contribution is first of all about the users and their content. We failed to nurture and encourage early contributors, and we got distracted creating our own content – ancillary information like business addresses for the listings.

Zipingo's failure hurt. I stopped pushing big team efforts to develop new contribution systems at Intuit. But even as I pulled back, small contribution-system projects started sprouting up.

Gaining traction. One of our engineering leaders conceived the idea of embedding a Q&A community into a product itself – that is, creating a user forum on every page of TurboTax, with questions and answers relevant to the topic of the particular page. Many were wary of the idea, and some were even hostile. I encouraged the group's efforts, but in an echo of my own skepticism about Amazon's user reviews years earlier, I wondered silently whether people striving to finish their own taxes would stop to answer some stranger's questions.

Working with the support of his division manager, the engineer's team of three built the system and tested it in the least popular version of TurboTax Online in January 2007. Just five weeks into the initial test, one-third of the questions posed already had answers. Crucially, our internal tax experts were pleased by the quality of the answers, which seemed to be self-correcting as other users refined them. TurboTax Live Community, as it's called, was the kind of clear success I'd been seeking. Live Community systems have spread to our other divisions and are inspiring more contribution experiments.

Yet wariness persists. This year, when the TurboTax marketing team decided to solicit and post all user reviews, unedited, on a prominent link from the product's home page, I blanched and took a deep breath. Again a surprise: The vast bulk of reviews are so positive that it looks as if we've posted only the good ones (which, I hasten to add, is not the case). Once again, we're learning from that most reliable of sources – our customers.

advertising revenue driven by the show's tremendous popularity – which results, in part, from the drama generated by the show's user-contributed surprises.

How Do I Get My Company Started?

I became convinced of the broad business potential of user contribution systems in 2005. Only now, three years later, has the Intuit organization embraced the idea. (See the sidebar "How We're Doing It at Intuit" for the story of my company's successes and disappointments so far.)

I underestimated just how countercultural the whole user contribution paradigm would be. It poses a challenge to long-unquestioned beliefs about the role of management, the value of experts, the need for control over the customer experience, and the importance of quality assurance. User contribution seems messy and scary; giving customers a public podium to comment freely about your products and company seems to violate the management canon "Don't hold me accountable for what I don't control."

Naturally, adopting these methods is easier when competitors have beaten you to the punch and shown you where user contribution works in your industry. But what if you want to lead your rivals? Here's my advice for senior managers trying to create contribution systems in their companies:

Use personal experience to move mind-set. I've found that heads and hearts don't change until people participate in contribution systems themselves. To overcome wariness in inexperienced executives, ask enthusiasts to share stories of their personal experience with user contribution systems. To build awareness, have people count the user contribution systems found on an Amazon page and classify them by type. (If you look hard, you'll find 23 separate systems on a single Amazon product page.) Ask inexperienced executives to find and use contribution systems of personal interest to them – that helps develop a visceral feeling for how they work. Get sub-teams of leaders to brainstorm about contribution systems that might solve customer or employee problems and then ask them to sketch out prototypes they can present to a larger group.

>> online tools

Go to **usercontribution.intuit.com** for resources to help you create user contribution systems at your company.

Nurture small experiments. Encourage unofficial and "guerrilla" experiments. Challenge employees to create contribution systems that they are passionate about, without requiring them to get clearance from management. Experiment with small batches of employees or customers. (At Intuit, we tried one experiment on the TurboTax version that has the smallest sales volume, accounting for less than 1% of customers for that product.) Most of the experiments will fail; tell the organization in advance that this is OK. Communicate the value of the lessons learned from those failed experiments so that other teams benefit.

Why Do Contributors Contribute?

Most contribution systems offer no financial compensation to contributors. In fact, payment can destroy participation by undermining a sense of collaboration and trust. Rather, they rely on motivations intrinsic to humanity – or involve contributions that require no motivation at all, because the user contributes without realizing it.

I'm contributing?

Some systems collect participants' resources or data as a by-product of things people are doing for other purposes. As shoppers buy from Amazon, they automatically contribute to its recommendation engine, which suggests products based on the ratings and purchase decisions of other customers.

Practical solutions

In some systems, participants contribute in order to get reasonably immediate rewards. For example, the site Del.icio.us enables users to organize their bookmarks of websites. A by-product of this activity is that, when aggregated, the bookmarks produce an index to the web that is valuable to others.

Social reward

Many systems provide the benefits of interaction with others: being part of a community with a common interest, generating business prospects, getting a date – the drivers behind social networks like Facebook and LinkedIn.

Reputation

Contribution can be sparked by a desire for public recognition, like Amazon's badge for a "top 1,000 reviewer," or for the admiration of peers: Wikipedia articles carry no authorship credit, yet authors earn the respect of other contributors.

Self-expression

Many user contribution systems thrive on individuals' desire to air their thoughts, opinions, or creative expression, with the possibility of real-time feedback from users – witness the six million videos on YouTube.

Altruism

Why would a person write a glowing online review of a restaurant – when it may become harder to get a table if others act on the opinion? Some people want to help local diners or reward superb restaurant owners. Others simply want the truth to be heard.

Let enthusiasts and young employees provide ideas and leadership. Expect ideas for contribution systems to emerge from those who use them the most. Often, these will be your youngest employees. Seek them out. Make them your mentors. Ask them to take the lead in creating ways for your company and customers to benefit from user contributions. Have them develop prototypes and show them directly to you; then help them act on some of the ideas that emerge.

Set boundaries but guarantee freedom within them. I'm not advocating that you blow up your current business and completely reinvent it around a contribution system. Experiment at the edges of your business. Give experimenters a defined sandbox – spacious, perhaps, but defined – rather than an endless expanse of beach. Within those limits, though, make sure they aren't distracted by experts and that their experiments aren't smothered by larger initiatives with broader mandates.

Protect experiments from your company's natural control instincts. Ceding some control of business processes to outsiders, even in a sandbox, will be scary for your organization. Leaders in certain functional areas – marketers and lawyers, for example – will feel especially anxious. (I can identify, having had to swallow hard a few times over things we were about to try at Intuit.) To counter the instinct to preserve control and the status quo, name a godfather or godmother with big-time clout to protect experiments and break through barriers when initiatives meet organizational resistance. (Three people, two division general managers and I, played this role in our early experiments at Intuit.)

Use your customer base to jump-start projects. Some new contribution systems face a chicken-or-egg problem – that is, they're empty and useless until folks begin contributing to them, but few visitors will be attracted to something that is empty and useless. Your company probably has advantages that start-ups can only dream of: existing customers, traffic to your website, accumulated behavioral data, and, sometimes, media that will find your experiments newsworthy.

Let users "vote," early and often. Customers are better than executives at picking winners in this arena, so get experiments into the hands of real customers as quickly as possible. Minimize or eliminate time lost to market research, lengthy analysis, PowerPoint presentations, or frequent reviews by management. (We've borrowed an idea from Google by creating a public webpage – intuitlabs.com – that displays our current experiments and gives experimenters a fast, direct path to customers, bypassing normal product-launch procedures.)

Seek organizational buy-in only after you've had some success. The guerrilla experiments are designed to get around organizational resistance. Ultimately, you want innovation in user contribution to become embedded in the organization's normal processes, but you'll most likely struggle to shift mindset until you can point to a successful experiment or two.

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The meeting earlier this year of Intuit's top executives to spur action on user contribution systems would have been a wasted effort two years ago. Then, we had only begun to experiment. But with several successful initiatives now in operation, Intuit's newly promoted CEO, Brad Smith, and I felt the time was right to move the idea into the mainstream and talk about why user contribution is a focus of our evolving company strategy. I can't say everyone at that meeting bought into the concept. Some undoubtedly saw it as a distraction from their day jobs.

Still, there was real energy in the room that day. In the middle of the meeting, I stopped to ask whether folks had questions. Rather than answer them myself, I wrote the questions on the board and asked the entire group to tackle them. As I watched, people provided answers, better than the ones I would have given. (In fact, some of them became content for this article.) As we moved to take a break, I reminded our executives that we all had just experienced user contribution in action.

Since that meeting, the activity of teams working on user contribution has increased from a tide to a torrent around the company. And we've only just begun.

Your company probably has advantages that start-ups can only dream of: existing customers, traffic to your website, media that will find your experiments newsworthy.

Scott Cook *is the cofounder and chairman of the executive committee of Intuit, a financial software and web services firm based in Mountain View, California. He also is a member of the boards of directors of Procter & Gamble and eBay. He is a coauthor, with Clayton Christensen and Taddy Hall, of "Marketing Malpractice" (HBR December 2005).*

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It's Time to Make Management a True PROFESSION

by Rakesh Khurana and Nitin Nohria

A rigorous code of ethics will make you a better manager. Society will benefit, too.

MANAGERS HAVE LOST LEGITIMACY over the past decade in the face of a widespread institutional breakdown of trust and self-policing in business. To regain society's trust, we believe that business leaders must embrace a way of looking at their role that goes beyond their responsibility to the shareholder to include a civic and personal commitment to their duty as institutional custodians. In other words, it is time that management finally became a profession.

True professions have codes of conduct, and the meaning and consequences of those codes are taught as part of the formal education of their members. A governing body,

Brian Stauffer

composed of respected members of the profession, oversees members' compliance. Through these codes, professional institutions forge an implicit social contract with other members of society: Trust us to control and exercise jurisdiction over this important occupational category. In return, the profession promises, we will ensure that our members are worthy of your trust – that they will not only be competent to perform the tasks they have been entrusted with, but they will conduct themselves with high standards and integrity. On balance we believe that a profession, with well-functioning institutions of discipline, will curb misconduct because moral behavior is an integral part of the identity of professionals – a self-image most are motivated to maintain.

The idea of management as a profession is not new. It was launched in the United States with great hope a century ago with the founding of the nation's university-based business schools. A vanguard of institutional entrepreneurs, both academics and enlightened business leaders, saw the rise of the large corporation as a profound challenge to the existing social order. When large corporations began to sell shares of their stock to the public, thereby dispersing ownership and control, myriad stakeholders (shareholders, labor groups, government officials) all proclaimed the right to direct these powerful new entities.

The business school, in turn, was conceived as a way of legitimating another claimant's right to control the publicly owned corporation: a new group known as managers. The strategy for advancing management's claim was to ally the leaders of the business school movement with three institutions viewed as the pillars of the Progressive Era: science, the professions, and the new American research university. The leaders of the business school movement proposed to ensure that the large corporation would be run in the interests of society by turning the occupation of management into a bona fide profession, with the educational underpinning, certifications, and code of conduct that go along with it.

That ambition has so far gone unrealized. The claim that managers are professionals does not withstand scrutiny when you compare management with true professions such as medicine and law. Unlike doctors and lawyers, managers don't need a formal education, let alone a license, to practice. Nor do they adhere to a universal and enforceable code of conduct. Individual companies may write and enforce corporate codes or value statements, but there's no universally accepted set of professional values backed up by a governing body with the power to censure managers who deviate from the code.

In principle, there's no reason why management couldn't strive to become a profession. The institutional arrangements are known and easy enough to put in place. What's more difficult is determining whether to push in that direction. Would formalizing management education make individual managers more effective? More generally, how would creating a professional pool of consistently trained managers affect the entrepreneurial activity that drives economic growth? Could we reach a consensus on a set of common standards that would be plausibly enforceable? Would having such a code have any impact on behavior? In the following pages we explore the differences between management and the true professions, describe how a professional management system might work, and examine whether such a system would be desirable.

A Hippocratic Oath for Managers

AS A MANAGER I serve as society's fiduciary for one of its most important institutions: enterprises that bring people and resources together to create valued products and services that no single individual could produce alone. My purpose is to serve the public's interest by enhancing the value my enterprise creates for society. Sustainable value is created when the enterprise produces an economic, social, and environmental output that is measurably greater than the opportunity cost of all the inputs it consumes. In fulfilling my role:

Does Management Education Add Value?

Thanks to television shows, films, and books, the education of doctors and lawyers has become the stuff of legend. Typically, true professionals undergo an intense three- to four-year postgraduate program. On graduating, they then have to obtain a formal license to practice by passing a comprehensive state or federal exam designed to test their mastery of the body of knowledge their educational degree ostensibly conferred. Once they pass this test, they have to invest in a certain amount of clinical training and continuing education to stay abreast of evolving knowledge. In some fields, licensed professionals must periodically pass further exams in order to recertify their licenses.

Managers don't face such challenges. Although the MBA has been the fastest-growing graduate degree over the past 20 years, it is not a requirement for becoming a manager. Managers do not have to sit a formal exam to demonstrate their knowledge even at the end of an MBA, let alone stay current in their field. There is no obligation for them to know anything

I RECOGNIZE that any enterprise is at the nexus of many different constituencies, whose interests can sometimes diverge. While balancing and reconciling these interests, I will seek a course that enhances the value my enterprise can create for society over the long term. This may not always mean growing or preserving the enterprise and may include such painful actions as its restructuring, discontinuation, or sale, if these actions preserve or increase value.

I PLEDGE that considerations of personal benefit will never supersede the interests of the enterprise I am entrusted to manage. The pursuit of self-interest is the vital engine of a capitalist economy, but unbridled greed can be just as harmful. Therefore, I will guard against decisions and behavior that advance my own narrow ambitions but harm the enterprise I manage and the societies it serves.

I PROMISE to understand and uphold, both in letter and in spirit, the laws and contracts governing my own conduct, that of my enterprise, and that of the societies in which it operates. My personal behavior will be an example of integrity, consistent with the values I publicly espouse. I will be equally vigilant in ensuring the integrity of others around me and bring to attention the actions of others that represent violations of this shared professional code.

I VOW to represent my enterprise's performance accurately and transparently to all relevant parties, ensuring that investors, consumers, and the public at large can make well-informed decisions. I will aim to help people understand how decisions that affect them are made, so that choices do not appear arbitrary or biased.

I WILL NOT PERMIT considerations of race, gender, sexual orientation, religion, nationality, party politics, or social status to influence my choices. I will endeavor to protect the interests of those who may not have power, but whose well-being is contingent on my decisions.

I WILL MANAGE my enterprise by diligently, mindfully, and conscientiously applying judgment based on the best knowledge available. I will consult colleagues and others who can help inform my judgment and will continually invest in staying abreast of the evolving knowledge in the field, always remaining open to innovation. I will do my utmost to develop myself and the next generation of managers so that the profession continues to grow and contribute to the well-being of society.

I RECOGNIZE that my stature and privileges as a professional stem from the honor and trust that the profession as a whole enjoys, and I accept my responsibility for embodying, protecting, and developing the standards of the management profession, so as to enhance that respect and honor.

about investing in innovative new financial derivates or special purpose vehicles, for example, even if they serve on boards required to approve such potentially risky transactions. To the contrary, data on enrollment in executive education programs offered by business schools suggest that people who already possess an MBA are less likely than those who don't to invest in lifelong learning in the form of continuing education.

Management today could easily adopt the more stringent knowledge and competency standards required by the true professions. The Association to Advance Collegiate Schools of Business (AACSB) already sets modest accreditation requirements for business school programs, and the Graduate Management Admission Council administers the GMAT exam in an effort to gauge a potential MBA student's intellectual ability. The council also examines and accredits the MBA curricula of most schools granting this degree. The AACSB or another similar body could devise and administer an exam that all graduating MBAs would have to pass before they were licensed to practice. Imagine a Certified Business Professional (CBP) status granted for fulfilling this additional requirement beyond the MBA. The same governing body could also devise the standards for continuing education courses that managers would need to take to maintain the CBP license over time. Professionalizing management in this way would have the additional benefit of making it easier for firms and employees to invest in continuing education and development. The costs would no longer be borne by just a few employers who provide such training, only to have their employees move on to other companies.

The bigger challenge is gaining acceptance of the idea that educational standards will improve the practice of management. Many management scholars and practitioners believe that management is as much art or craft as science, better mastered through experience than through formal education. The softer skills of management (interpersonal effectiveness, communication, leadership) are hard to learn through formal education and harder yet to test for in a standardized exam. Some people, notably Jeffrey Pfeffer of Stanford's Graduate School of Business, go so far as to argue that experience is the *only* valid teacher. In other words, those who possess a management education are no more effective than those who don't. Even if few people go quite that far, many agree with Nobel Prize–winning economist A. Michael Spence, who says that higher education is simply a signaling device: Going to a business school allows individuals to credibly signal their greater commitment to a career in management (admittedly useful information for employers). And many MBA students have yet a different perspective: They believe that business school is simply an opportunity to develop a robust network of peers and alumni.

In the absence of empirical evidence, the idea that people can improve the practice of management by mastering some body of knowledge rests on faith. If you believe that the only value in management education is derived from signaling dedication to the field or building networks, it makes no sense to advocate the professionalization of management. It also calls into question the legitimacy of all current university-based management education, which does entail studying a broadly similar curriculum across all schools offering management degrees.

But if you believe, as we do, that the practice of management can benefit from judgment that draws upon a coherent body of formal knowledge, then pushing management in the direction of the true professions makes a lot of sense. That's not to ignore or underestimate the importance of experience or skills that can't be easily taught such as exercising good judgment and becoming a more effective manager. Indeed, experience and soft skills are highly valued in professions such as medicine and law. A belief in the value of professionalizing management does not require us to endorse the current management curricula and methods of teaching. A healthy profession will always challenge its existing paradigm and be open to changing it. For instance, the accepted bodies of knowledge and teaching methods in medicine have continuously evolved and at times have changed dramatically.

Will Professionalism Choke Creativity?

Even if we accept that the average professional manager would be better than the non-professional, the real engine of a capitalist economy is not in the middle of the competence distribution, but in the tails. As acolytes of the political economist Joseph Schumpeter might argue, the true hero of the capitalist system is the rogue entrepreneur, who defies conventions and through a process of creative destruction reinvents them. If professional managers were solely entrusted with the management of economic enterprises, we might choke off the creative genius of people like Bill Gates and Sam Walton, who were unschooled in management but have had more impact on economic progress than the vast majority of professional managers.

But would Bill Gates and Sam Walton really have been worse off if they had complemented their entrepreneurial talents with professional management training? Or to take another example, would medicine have made more creative progress had it not been professionalized? What we know to be true is that the pace of discovery and creative progress rapidly accelerated in medicine once it became a profession. The requirement to master a body of knowledge did not stymie bold new pioneers. Indeed the existence of a common body of knowledge may actually have accelerated and spurred innovation. Professionalizing medicine has also greatly diminished the harm that could be done by untrained doctors. The harm to society that untrained managers could cause – particularly in a more complex, globalizing world – cannot be underestimated.

The persistent skeptic may yet argue, what about the stunting effect that professionalizing medicine has had on alternate forms of therapy and healing? Would the next business revolutionaries be similarly stifled under such a system? In response, we point to the growing success of alternative medicine as proof of the opportunity for entrepreneurs to challenge the existing order in an open, democratic society. Even if all management jobs were professionalized, creative destruction would always be open to any entrepreneur, whether certified or not, who could mobilize the resources to launch a venture.

It is also a matter of choice how restricted management jobs need to be. In medicine and law, entry into the profession is totally closed. In the case of medicine, hospitals will hire only licensed doctors, and the state and insurance companies will reimburse only for care provided by licensed professional doctors. The system, however, is not closed from the standpoint of consumer choice. Consumers are free to go to any medical practitioner, licensed or not, if they are willing to pay for the services themselves and bear the risk of the outcomes. (Note: The state does protect minors, who must be treated by licensed doctors because they can't make independent choices in their own interest.)

In management, one could imagine a closed system for certain sectors – for instance, the state might restrict investment of public and state pension funds or tax-protected retirement savings to "professionally" managed public enterprises. Even in this closed system, much as in medicine, individuals could choose to invest their personal money in any enterprise (professionally managed or not). One could also imagine a much more open system, in which management positions would be attainable by individuals with varying credentials, depending on the job responsibility: none; experience only; experience plus education; MBA only; MBA plus CBP; CBP only (which might be granted to an experienced manager who passed the certification exam without having completed the MBA, as people without a law degree are allowed to pass the bar and practice in some states). In this system, the market would determine the value of a professionally certified manager relative to those with other qualifications, as it does today for MBAs. We believe that the added confidence in the intellectual capabilities of certified professionals (that they have mastered a body of knowledge and are current in their knowledge of new ideas in business) would enable them to command a premium.

Could Management Embrace a Code?

Most successful codes – such as the ancient Hippocratic oath, for doctors – establish the ideals and social purposes that members of the profession embrace. As the sociologist Robert K. Merton has argued, such codes have enormous influence because they provide guidelines for how an occupant of a role ought to behave. They can trigger strong positive emotions such as pride (when one acts in a manner that exemplifies the code) and equally strong negative emotions such as guilt or shame (when one acts in ways that transgress the code). The influence of such emotions in shaping behavior can be as significant as the expected material or reputational consequences of a professional's behavior.

Codes create and sustain a feeling of community and mutual obligation that members have toward each other and toward the profession.

Codes and their supporting institutions also help define an implicit social contract among the members of the profession. By establishing a standard for inclusion, they create and sustain a feeling of community and mutual obligation that members have toward each other and toward the profession. These bonds shape the social capital of a profession – capital that builds trust and greatly reduces transaction costs among the members of the profession and between the profession and society.

There's no mystery to the process of establishing a professional code for management: Articulate the code (as so many other professions have done); familiarize students with it during their formal management education; require students to embrace the code as part of their professional license or certificate to practice; and create peer review bodies to monitor adherence, establish protocols for due process to review infractions, and administer sanctions as necessary.

The challenge in writing a code lies in forging a broad enough consensus on the proper aims and social purpose of management and the norms for pursuing these aims. There appear to be two deeply divided schools of thought on this topic. One school, anchored by economists like Milton Friedman, argues that management's aim should simply and exclusively be to maximize shareholder wealth using means consistent with prevailing laws and customs. Let markets and the state take care of the rest. The other school argues that the corporation should properly be thought of, as organizational theorist Chester Barnard wrote long ago, as a social institution that enables individuals to come together to create value they could not create individually. In this view, the proper purpose of management is to judiciously balance the legitimate, potentially competing claims of all stakeholders whose joint effort creates value.

It's clear that the extreme approaches won't work. The flaws in a dogmatic adherence to the doctrine of "maximize shareholder value to the extent permitted by law" have become very apparent. On the other hand, the stakeholder approach has drawbacks as well. Stakeholder interests can diverge sharply, and managers who attempt to keep everyone happy when there is no sensible compromise can do more damage than those who put the shareholder first. Some Japanese firms are textbook cases of this problem. During the 1990s, for example, in their effort to avoid layoffs or even the collapse of insolvent banks, many Japanese banks refused to write off real estate loans that would never be paid back. Because of management's unwillingness to make difficult short-term choices, an enormous amount of economic value was destroyed. To succeed, a management code will have to steer a middle course between these two extremes so that we lose neither the value-creating impetus of the shareholder concept nor the accountability inherent in the stakeholder approach.

Whatever the approach, without a collective commitment to a code that enshrines the duties and obligations of management as trustees of society's economic resources, managers can no longer claim to be a positive social force, no matter how rich the financial rewards are for some or how many philanthropic foundations others construct. Without such a commitment, the public ceases to see managerial work as what the educator Howard Gardner describes as "good work."

What Should a Code Look Like?

In that spirit, we have written a code that might govern a formalized profession of management. The resolution of this code is inspired by the way doctors and lawyers, members of true professions, define their purpose. Doctors seek to further the health of their patients. In doing so, they not only honor the sanctity of each individual life; they also meet society's need for healthy citizens. A society of unhealthy, infirm citizens would inevitably be a weak society. Similarly, lawyers seek to ensure that justice is done by their clients. In doing so, they not only honor the rights of each individual to due process under the law; they also meet society's need to prevent lawlessness.

What is the parallel for managers? Modern societies have a huge interest in creating organizations that enjoy the public trust and are able to mobilize resources to create economic value greater than the opportunity cost of the resources used.

Managers, in our view, must be agents of society's interest in this endeavor. We further contend that society grants to corporations the status of legal persons in order to hold them accountable for their conduct, as any individual citizen would be.

We hope our formulation will appeal to proponents of the shareholder perspective because it explicitly affirms the importance of ensuring that the enterprise creates value. Firms that destroy value hurt not only their shareholders but the broader social trust in firms' ability to create value. Our code should also appeal to those who take a stakeholder perspective because it explicitly recognizes that to ensure ongoing legitimacy, an enterprise must meet the legitimate claims placed upon it. Moreover, our definition of value creation takes into account the opportunity cost of all the resources consumed by the firm, including public resources such as the natural environment. By turning managers into agents of *society's* interest in thriving economic enterprises, we get out of the bind of viewing them as agents of one narrowly defined master (shareholders) or many masters (stakeholders). Indeed in most modern corporations, the interests of stakeholders are inextricably intertwined. Employees, for instance, are shareholders (through investment in their pension funds) as well as customers. Given these multiple interests, a simple maximization principle is hardly helpful, because it is not readily implementable. If a manager downsizes an organization believing that this will maximize the interests of the firm's shareholders, the same action can easily hurt those shareholders who happen to be consumers or employees. It is thus best for managers to have a higher-order purpose – viewing society as their ultimate client and society's interest in vibrant, sustainable, value-creating enterprises as their foremost objective.

The specifics of our proposed code for management should be less controversial than the basic resolution. It is hard to argue that managers should not embrace the spirit rather than the letter of the laws that govern their enterprises. As Warren Buffett reminded Salomon Brothers' employees after he took over the troubled firm, there is plenty of money to be made by playing well within the lines. And the importance that managers should place on greater transparency and disclosure to all stakeholders was brought painfully home by the collapse of firms like Enron and WorldCom. As Supreme Court Justice Louis D. Brandeis put it: "Sunshine is the best disinfectant." The economic value of that sunshine is evident in the higher cost of capital in economies that lack it.

Who would argue with our requirement that managers provide fair opportunity to all, free from bias, as a measure of their respect for the basic equality of all human beings? Freedom of opportunity is not only emblematic of a just society; it is also at the heart of an economically vibrant society. Managers must wield their power with humility and respect – ensuring that the interests of those who do not have power are protected and the voices of those who may not enjoy decision rights are heard.

Our code underlines society's expectations that managers will bring their most informed judgment to bear on their decisions. Such informed judgment, which is essential to a professional ethic, can only be exercised by a discipline of lifelong learning and a willingness to listen to and learn from others. While we encourage managers to honor the lessons learned from those who came before them, we encourage them to be innovative, so that the process of creative destruction, which Schumpeter viewed as the vital force that sustains a dynamic capitalist society, continues.

Finally, our code reminds managers of their obligation to honor and further the reputation of the profession as a whole by their actions as managers as well as by their commitment to develop and enforce the code. Managers today are among the least trusted members of society. Regaining this trust for the profession of management must be regarded as an important responsibility for all individual managers.

If management were to be seen as a true profession, our expectations of the moral conduct of managers and their expectations of themselves would rise.

Would the Code Make a Difference?

Even if a code such as the one we have proposed were to garner sufficient support to be broadly adopted by the profession, you might argue that codes are merely motherhood and apple pie statements that carry no credible moral force to reliably shape behavior. Look at Enron, one might say: The company's code of ethics was widely lauded; now it has become a symbol of the firm's deceit. If a company, a relatively small and coherent social group, can't enforce such codes, why would one imagine that a larger collective such as a profession might be able to?

The answer can be found in the work of political scientist Robert Axelrod. His work suggests that a shared ethical orientation and set of common ideals at the professional level may be crucial in guiding the behavior of individuals at the company level. The ideals, or meta-norms as Axelrod calls them, emerge partly out of an inward sense of vocation – a conviction that one is doing work that is meaningful – but are also grounded in a commitment to peer sanctions and monitoring. For example, U.S. military cadets promise "not to lie, cheat, or steal"; they also promise "not to tolerate those who do." In this way, according to Axelrod, meta-norms contribute to the self-governance capability of a profession: Managers who swear to uphold a common professional code, understanding that if they violate the code they might suffer sanctions administered by their peers, are more likely to adhere to individual company codes.

Would instituting a code increase the likelihood that acts of gross management malfeasance would be brought to light? Many people would say no. Whistle-blowing or bringing attention to the misconduct of a peer is arguably even rarer in a true professional setting than in nonprofessional settings. In some professions, such as the police, exposing a colleague is almost taboo. Such arguments have merit, but when people fail to self-monitor, it doesn't negate the argument that they should. Indeed, when self-policing becomes weak, it is often time for the profession and its individual practitioners to recommit to their social contract – or risk losing society's trust, as the accounting profession discovered and the financial services industry is now discovering.

We believe that professionalizing management would greatly curb misconduct, because moral behavior is an integral part of professionals' identity – a self-image most want strongly to preserve. Though we are often shocked when doctors or lawyers misbehave or condone the misbehavior of their own, at least we are shocked. We expect better from them. In the case of comparable malfeasance in business, we are no longer even shocked that it occurs or that it is not more commonly reported. Although the implicit contracts that society has with true professions – we grant you privileges because we trust you to self-govern – aren't always upheld, they do establish a higher expectation of self-governance than in a non-professional setting, and thereby a higher degree of censure when expectations are violated. We know from social science that the behavior of human beings is greatly influenced by the expectations placed on them. If management were to be seen as a true profession, our expectations of the moral conduct of managers and their expectations of themselves would rise.

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We don't pretend that this essay or our code is anything like the last word on the topic. The debates about management education and the regulation of businesses will never go away, and in a constantly changing world there is no perfect solution. The U.S. constitution is arguably the finest and most durably written constitution that has ever existed. Yet its approval was the result of much wrangling and debate between two sharply opposed philosophies of government. Over the years, the document has evolved through the painstaking passage of amendments and the interpretation of the courts. The process of agreeing to and adapting a code of professional management is unlikely to be as contentious, but in a global world it could be even more difficult.

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"How could I have known the situation? That chart is directly behind me."

Leo Cullum


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SHAPING STRATEGY in a World of Constant Disruption

A company's bid to rally an industry ecosystem around a new competitive view is an uncertain gambit. But the right strategic approaches and the availability of modern digital infrastructures improve the odds for success.

by John Hagel III, John Seely Brown, and Lang Davison

GOOGLE GRABS HEADLINES by announcing forays into the telecom space, prompting competitive responses from AT&T, Verizon, and other leading network service providers. At the same time, Google continues to help shape the advertising business through AdSense. And Facebook and Salesforce.com – each in very different parts of the high-tech world – reveal they are opening up platforms for third-party developers.

These initiatives are examples of *shaping strategies*, which mobilize global ecosystems and transform industries and markets – often dramatically. A shaping strategy is no less than an effort to broadly redefine the terms of competition for a market sector through a positive, galvanizing message that promises benefits to all who adopt the new terms. What Bill Gates did

Jonathan Bartlett

with Microsoft in the early 1980s is a classic example. In essence, he said that computing power was moving inexorably from centralized mainframes to desktop machines. Companies that wanted to be leaders in the computer industry needed to be on the desktop.

It's one thing to coin a persuasive slogan – "The desktop is the future!" – and something else entirely to get others to invest in fulfilling its promise. In reality, shaping strategies are built upon deep structures, which we describe in this article. We also explain why the moment is ripe for pursuing and benefiting from shaping strategies, thanks to pervasive changes in the global digital infrastructure. And we show why players in a growing array of markets and industries (not just high-tech companies) can and should consider making the attempt.

Shaping strategies are not new. Indeed, the Medici family deployed successful shaping strategies in Renaissance Italy, most notably in banking. More recent examples can be found in industries as diverse as shipping, financial services, and apparel. What is new are powerful enabling infrastructures, which can strengthen the hand of shapers while reducing their exposure to risk. These relatively recent developments take the prospects for shaping success from the realms of the improbable and rare into the zone of the merely difficult.

At one level, of course, all successful strategies can be viewed as shaping strategies. Some corporate leaders reshape markets and industries using M&A-driven roll-up strategies, tapping into previously unseen economies of scale and scope. Disruptive innovation also reshapes markets, typically through negative incentives that say, in effect, "Change your ways now or else become marginalized, even die." The classic icons of recent strategy literature – companies like Dell and Southwest Airlines – exemplify successful disruptive innovation. These strategies can be very powerful when they work, but they also concentrate risk on the shaping company and thus become bet-the-ranch initiatives. By contrast, the shaping strategies outlined in this article mobilize legions of other players through positive incentives: Participants in the shaper's broad ecosystem can use the strategy to create and capture enormous value as they learn from – and share risk with – one another.

Let's look at the changes in infrastructure that are making these strategies more viable and attractive. Then we'll explore the key elements that must come together to execute positive shaping strategies. Finally, we'll examine how to develop these strategies using a pragmatic migration path that builds capability rapidly.

From Bedrock to Plasma – The Changing Infrastructure

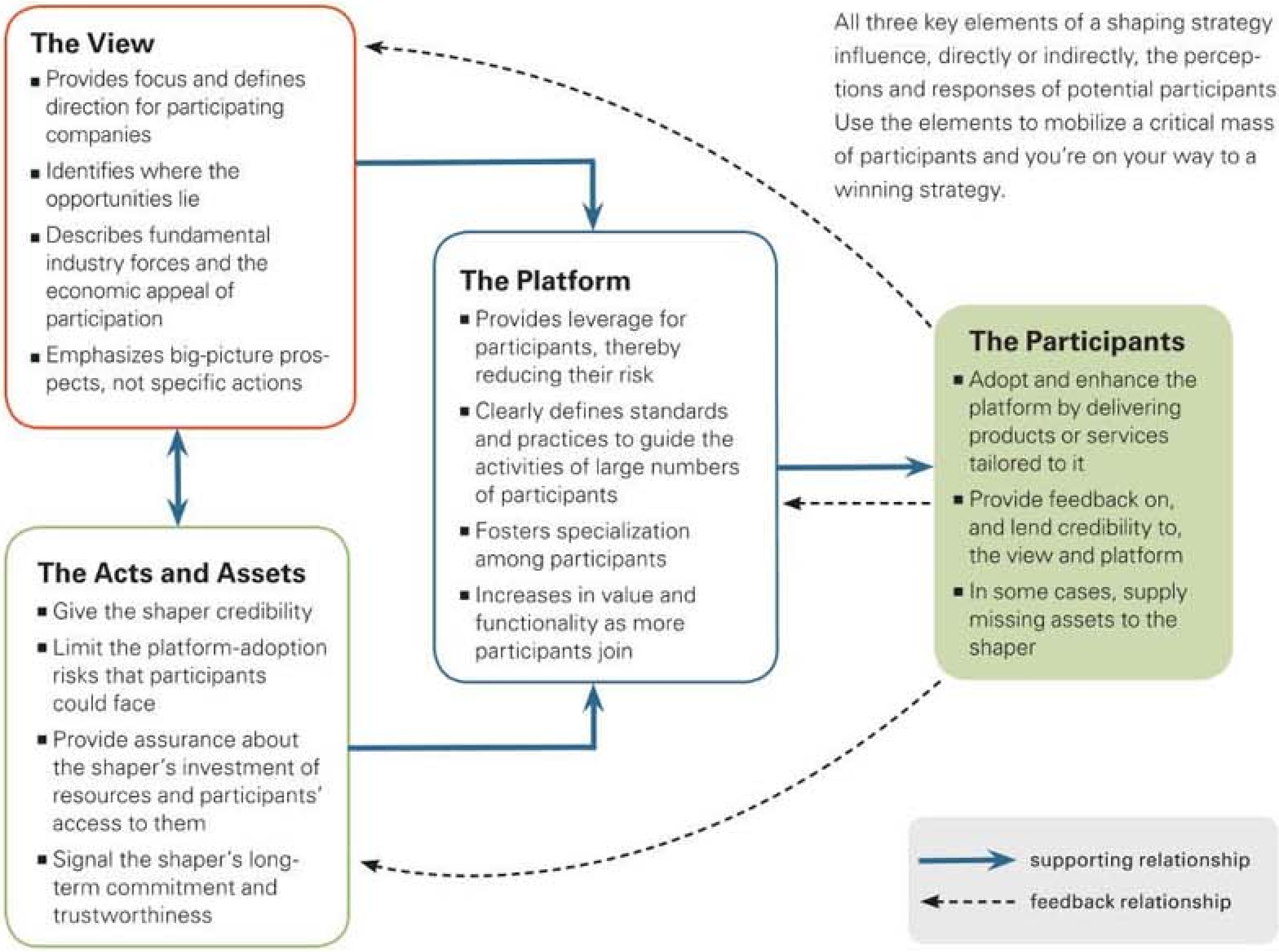
We live in an era of profound and accelerating change, keynoted by what historian Carlota Perez calls a new "techno-economic" paradigm. In her book *Technological Revolutions and Financial Capital,* she offers a compelling view of the role infrastructures play in shaping business activity. Major technological innovations like the steam engine, electricity, and the telephone brought forth powerful new infrastructures. Inevitably, these disruptive innovations transformed industry and commerce, but eventually they became stabilizing forces, once businesses learned to harness their capabilities and gained confidence in the new order.

That historical pattern – disruption followed by stabilization – has itself been disrupted. A new kind of infrastructure is evolving, built on the sustained exponential pace of performance improvements in computing, storage, and bandwidth. Because the underlying technologies are developing continuously and rapidly, there is no prospect for stabilization. Businesses and social institutions constantly find themselves racing to catch up with and learn the steadily improving foundational technologies.

This process creates ever-shifting eddies that reshape institutions, identities, practices, and relationships, making equilibrium a distant memory. The core technology infrastructures that once formed the bedrock have turned into plasma. No wonder executives around the world feel deepening stress as they survey the mutating business landscape. Their natural reaction is to focus on core markets, capabilities, and geographies; to seek more control over the assets and activities that are most valuable to that core; and to emphasize the short term and become more reactive. But these actions often compound the stress instead of easing it.

Today's new digital infrastructure in fact gives relatively small actions and investments an impact disproportionate

How to Formulate a Shaping Strategy



All three key elements of a shaping strategy influence, directly or indirectly, the perceptions and responses of potential participants. Use the elements to mobilize a critical mass of participants and you're on your way to a winning strategy.

to their size. To use a boxing metaphor, companies can now punch above their weight class. That shift would seem to favor new entrants over incumbents – but big companies can play this game, too. After all, they have enormous assets that can make them very credible shapers. To get there, executives will need to rethink their approaches to business strategy and embrace new management practices.

Rethinking the Substance of Strategy

Conventional wisdom holds that, in the absence of equilibrium, adaptation is the best strategy. According to this view, executives will succeed if they can sense and respond quickly to what's changing around them. However, as important as adaptation is, it misses the real opportunity.

Consider these examples, widely separated by time and by market: Malcolm McLean's efforts to evangelize containerized shipping in the 1950s and 1960s; Visa's redefinition of the credit card business in the 1970s (now called the "payments business"); Microsoft and Intel's turbocharging of the personal computer marketplace in the early 1980s; Li & Fung's new approaches to supply chain orchestration in the apparel industry in the 1980s and 1990s; and more recent influences by Google on the advertising business, by Facebook on social networking, and by Salesforce.com on enterprise software. In each case, as we explore later, the company aspired to do something far bolder than simply shape the performance of its own enterprises – it strove to shape global ecosystems and thereby fundamentally alter industries and markets.

Looking more closely, we can see that each exemplar's strategy successfully upended prevailing perceptions of risk and reward. That's no easy feat, particularly in uncertain times. Confronted by rapid change, executives instinctively magnify the apparent risks and discount potential rewards, a tendency documented in the behavioral economics literature, including Dan Lovallo's work on cognitive biases in strategic decisions (see, for example, "Deals Without Delusions," HBR December 2007). This calculus often leads to timid action or to inaction. The challenge for a would-be shaper is to rejigger the calculus by diminishing perceived risks and maximizing perceived rewards. In emotional terms, successful shapers reduce fear and magnify hope. Executed well, the approach motivates a large number of players to make significant investments and take aggressive action in order to accelerate movement toward a preferred outcome. It also provides the focus and incentives necessary to unleash distributed innovation as thousands of specialized participants experiment to meet shifting and emerging customer needs and business opportunities. While some strategies rely on the participation of many other companies (as with big-box retailing or Apple's iTunes network), shaping strategies uniquely seek to provide the incentives and capability for large-scale distributed innovation.

Not a Shaper? Be a Participant.

Not every company is cut out to be a shaper. Playing the shaper's role requires the right aspirations, mind-set, risk profile, and management capabilities – not to mention a powerful, farsighted CEO and board of directors. But many roles are available to companies that participate in *other* firms' shaping strategies. These participants must be able to assess the relative strengths of the shapers they might support, plus define their own roles within the shaping opportunity. Specifically, they need to determine which of three main roles – influencer, hedger, or disciple – best suits them.

The Three Elements of a Shaping Strategy

Changing the risk/reward calculus as you shape strategy in a time of rapid change involves three interrelated elements: a *shaping view*, which helps focus participants; a *shaping platform*, which provides leverage to reduce the investment and effort participants need to make; and specific *shaping acts and assets*, which persuade participants that the shaper is serious and can pull off the shaping initiatives. (See the exhibit "How to Formulate a Shaping Strategy.") The three shaping elements combine to help shapers quickly attract and mobilize a critical mass of participants. That unleashes powerful network effects, making shapers difficult to stop. Yet, as many failed shaping efforts reveal, reaching a critical mass can be extremely challenging. We'll use these three elements as a lens through which to scrutinize successful shapers, both past and present.

Shaping strategies have played out in a broad range of industries, as our examples show. Going forward, these strategies have particular value in industries with lots of potential participants and widespread uncertainty about the future, usually stemming from disruptions related to technology, public policy, or both. Health care, electronic payments, alternative energy technology, and media are industries that appear to be especially ripe for shaping strategies.

Success in pursuing a shaping strategy requires risk taking and unique insights, at both the micro and macro levels, regarding the changing business landscape. Shaping companies also need managers who can evangelize shaping views (internally *and* externally), bootstrap robust shaping platforms, and coordinate relationships with large numbers of third-party participants. These strategies can therefore present special design and execution challenges. In fact, very few companies have successfully put together all three elements of a potential shaping strategy. If your firm is truly not cut out to be a shaper, you can benefit by participating in other companies' shaping strategies. (See the exhibit "Not a Shaper? Be a Participant.") Whether you shape or just participate, it pays to understand the three key dimensions of a shaping strategy:

Five Tests of a Shaping View

- Does the view express a perspective on the long-term direction of a broad industry or market and highlight how it will change?
- Does it clearly identify attractive business opportunities for a wide range of participants?
- Does it tie these opportunities explicitly to broader economic, cultural, and technological forces at work on the business landscape?
- Is the view at a sufficiently high level to allow for unexpected developments, yet specific enough to direct and focus the thinking of executives faced with difficult choices?
- Has it been aggressively and continually communicated by senior management to external audiences and to employees?

Element 1: A Shaping View

The first step in shaping an industry or market to one's advantage is to change the way potential participants perceive market opportunities. By altering mind-sets, shapers can materially influence the perceived economic incentives to participate. They start with a clear and compelling long-term view of the relevant industry or market. The view makes sense of the fundamental forces at work, helps participants envision the rewards and act accordingly, and reduces perceived risk by making the positive outcomes appear inevitable. The shaping view is never very detailed; it leaves much room for refinement. But it is clear enough to help participants make difficult choices in the near term.

The classic shaping view articulated by Bill Gates in the early 1980s motivated many executives to make the trek to Redmond, Washington, during a time of great turmoil and uncertainty in the computer industry. They came away reassured that someone had a compelling

Influencer

Commits early and prominently to one shaping strategy

BENEFIT An influencer increases asset efficiency, builds capabilities, and gains a strong market position by influencing the shaper.

RISK The supported platform may not become the industry standard.

EXAMPLE Bank of America's early influence on the Visa shaping platform

Disciple

Commits exclusively to one shaping platform

BENEFIT A disciple has a clear strategic focus and direction; it does not invest in competing shaping strategies.

RISK The supported platform may not be adopted. If the exclusive bet fails, an investment in another shaper must be tried.

EXAMPLE Dell's exclusive commitment to the Wintel platform

Hedger

Develops its products or services to support multiple shaping platforms

BENEFIT A hedger's eggs are spread across several baskets – in several competing platforms.

RISK Higher costs can be incurred if effort is duplicated to meet multiple platform standards.

EXAMPLE Advertisers that participate in both Google and Microsoft advertising platforms

Before You Decide Not to Be a Shaper...

...consider that nearly any company can benefit from the attempt, even if unsuccessful. That's in sharp contrast to other strategic approaches. M&A-based shaping strategies often require huge capital outlays and can rise or fall on the accuracy of assumptions about economies of scale or scope. Disruptive innovation strategies often require significant investment at the outset and confidence that one company can deliver the full breadth of innovation. Although options exist to mitigate the risk of such strategies, incorrect assumptions about the timing or scope of adoption can leave losses in their wake. **The bottom line:** Even if you think you're not a real shaper, trying to undertake a shaping strategy still might make sense.

view of the industry's direction. Even more important, Gates's shaping view helped these executives understand where to invest. At a time when many options were competing for investment, an invitation to focus clearly on the highest-return opportunities proved extremely valuable. For Microsoft, this shaping view was incalculably important to the company's early success.

Microsoft's experience emphasizes an important distinction between a shaping view and the way businesses conventionally use the word "vision." Corporate visions tend to be too narrow – they describe only the direction of the company articulating the vision. Shaping views instead start with a clear perspective on the direction of the relevant market or industry and articulate the value-creation implications for all companies involved. Gates's shaping view certainly applied to Microsoft, but it also extended to anyone seeking to succeed in the computer industry. The creative acts in a shaping view are to imagine what an industry or market could look like and to challenge conventional assumptions about what success requires.

Corporate visions also tend to be too broad – they describe the future in terms so vague as to accommodate virtually any choice or action. While shaping views must be at a high-enough level to account for general business uncertainty and leave room for experimentation and innovation, they should also focus more tangibly on where to invest energy, attention, and capital.

Salesforce.com provides a relatively recent example of an effective shaping view. When founder Marc Benioff launched his company in 1999, he used speaking engagements at industry conferences not, as you might expect, to pitch his new business but to describe the fundamental forces he saw transforming the enterprise application arena. Two themes dominated his early talks: First, customers were gaining power, and companies that were becoming more responsive to them and better at managing customer relationships would win out as markets grew increasingly competitive. Second, the applications to support these customer-centric imperatives would best be delivered as network-based services, not as discrete software packages installed in the enterprise. By accessing the software as a service, companies could reduce their own investment in IT infrastructure and far more easily upgrade as new functionality became available.

At a time when the business model of incumbent application vendors was to install large enterprise software systems at customer sites, Benioff's outlook was startlingly different. When many wondered about the future of the enterprise software business, he pointed the way for specialized players to enter the market and gave existing players a new focus for their investments. It didn't hurt that Salesforce.com – which achieved an $8 billion market cap in less than a decade – just happened to have a new online service that supported sales force automation. But anyone who heard Benioff speak understood that it wasn't just a sales pitch. He had imagined a divergent view of the future, and he became a tireless evangelist on its behalf.

In those early talks, Benioff discussed at length the competitive dynamics of the broader business landscape and the underlying developments in the digital technology infrastructure that were reshaping the software business. Executives left believing that the future Benioff described was not merely provocative but inevitable. Uncertainty dissolved, perceptions of risk diminished, and the rewards for participating became far more tangible. The only question was whether to hop on the bandwagon right away and share in the early rewards, or wait and potentially find it harder to carve out an attractive position.

Element 2: A Shaping Platform

The second component of a shaping strategy is the shaping platform, a set of clearly defined standards and practices that helps organize and support the activities of many participants. Shaping platforms provide leverage; they enable participants to do more with less. Leverage is always valuable in times of high uncertainty because it reduces the investment and effort required to target potential rewards, and it often accelerates returns, thereby reducing risk.

Shaping platforms typically offer one of two forms of leverage. Some provide *development leverage* – often derived from new technologies – that reduces the investment required to build and deliver products or services. For example, Salesforce.com has a platform (Force.com) that enables third-party developers to easily create application services for the enterprise market; Facebook.com provides tools that permit developers to launch mini-applications, or "widgets," to engage the Facebook audience.

FIVE TESTS OF A SHAPING PLATFORM

- Does the platform promise financial benefits to potential participants, especially by reducing their cost of entry, accelerating the prospect of generating revenue, or both?
- Does it support a diverse set of participants and offer opportunities for creating value in many distinct niches?
- Can the platform scale up by accommodating large numbers of participants without adding unacceptable costs for the shaper?
- Is it likely to generate increasing returns as participation grows?
- Will its functionality continually evolve, providing an incentive for participants to engage regularly with the platform owner and share their own learning and plans?

Note that, in contrast to AdSense, other Google initiatives such as Google Earth offer development leverage and mobilize developers but lack an explicit and aggressively communicated shaping view of a broader market or industry. As such they are better characterized as platform strategies than as shaping strategies.

The second type of shaping platform provides *interaction leverage* by reducing the cost and effort required for a diverse array of participants to coordinate their activities. Although such a platform may have a technology component, the key value lies in a set of standardized protocols and practices designed to facilitate interaction. Google's AdSense platform, for example, uses technology to connect advertisers, content providers, and potential customers, but its real power resides in the protocols and practices that govern how ads are submitted, priced, presented, and paid for. It allows even the smallest advertisers and websites to invest minimal time and effort, with little oversight from Google, and still generate value for one another, thereby increasing the long tail's rewards for niche players. The genius and power of this shaping platform is that its scalability makes specialization by participants more and more economically attractive – AdSense can connect a maker of a product that appeals to the smallest of niches with the largest imaginable pool of prospective buyers of that product.

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Assess your company's readiness for the FAST approach with our questionnaire at **shapingstrategy.hbr.org**.

Malcolm McLean, the founder of Sea-Land and a successful shaper of the global shipping industry, achieved interaction leverage through a very different kind of shaping platform. By developing an innovative design for four-corner fittings and twist-lock mechanisms on shipping containers – and by making the design available industrywide – he encouraged a broader set of investments by port authorities, shippers, and crane companies that sped the adoption of containerized shipping.

Li & Fung provides an extreme example of a shaping platform that, to this day, relies primarily on telephone and fax – simple, low-cost technology easily available to its approximately 10,000 partners. A rich set of protocols coordinates complex supply chain activities across a global network that L&F configures and reconfigures to serve apparel and other consumer goods companies.

Sometimes a shaping platform can offer both development and interaction leverage, as Visa did in the early days of

Rethinking the Process of Strategy Development

Shaping strategies might, at first blush, appear intimidating. But they needn't require massive organizational change. A series of relatively straightforward steps can get you headed in the right direction and help determine whether a compelling shaping opportunity exists for your enterprise, industry, or marketplace. Your company's executive team should think FAST.

Focus

Imagine what relevant markets and industries might look like in five to 10 years. Borrowing from scenario planning, consider plausible alternative futures, estimating the likelihood of each scenario and projecting potential implications for the company and other participants. Engage in creative exercises and hold off-site retreats to explore initiatives that will improve the odds of realizing a future more favorable to your company.

Accelerate

Identify the two or three operating initiatives that, if carried out over six to 12 months, would most accelerate the movement toward your preferred future. Specify and agree on the resources essential to these two or three operating initiatives, and on the metrics of success.

Strengthen

Ask what major organizational objectives might prevent you from moving even further toward achieving your operational goals. Specifically, identify the two or three organizational obstacles that, if addressed, would most effectively speed the process.

Tie it all together

Integrate all the preceding activities and refine them based on what you learn along the way. The FAST approach favors incrementalism, but above all it values an alignment between near-term performance and long-term direction. Without the long view, surefooted small steps won't take you far.

A company need not be a shaper to adopt the FAST technique. A nonshaper can appropriate its long-term direction from a relevant shaper, bearing in mind that every company needs to be deliberate about the long-term role that it will play in the business landscape being shaped.

the payments business. One part of Visa's platform involved providing back-office credit-card-processing services for participating banks, using technology to link large numbers of participants. This significantly reduced the investment required for banks to enter the credit card business and freed them to focus on product design and marketing while the capital-intensive processing activities were performed by specialized third parties.

Another part of Visa's shaping platform supplied interaction leverage by defining a governance structure that allowed large numbers of banks to jointly own the new business entity while Visa still preserved its ability to move rapidly and flexibly. Within 90 days of its development in 1970, Visa had recruited 2,700 banks; within seven years, its cards were generating $20 billion in transactions and reshaping the emerging payments business in the process.

Shaping platforms provide powerful leverage, both for the shaper and participants. From the participants' perspective, a good platform increases functionality, decreases adoption costs, and accelerates revenue generation – effects that are amplified as participation grows. By encouraging distributed innovation among participants, platforms can assemble a rich ecosystem of diverse niches, allowing participants to specialize in the areas they know best and avoid head-on competition with everyone else on the same platform. Such diversity tends to emerge from platforms offering a wide range of functionality that can be accessed by large numbers of users with highly specific needs. The power of the Wintel platform, for instance, is that it has given rise to a virtually infinite variety of application and service niches that add value for end users while insulating most participants from direct competition with one another.

From the perspective of its owner, a shaping platform helps to concentrate the knowledge flows created as participants engage with the shaper. For example, SocialMedia Networks, an emerging shaper within the broader Facebook ecosystem, is pulling together a network of specialized application developers and advertisers. By aggregating performance data, SocialMedia offers its participants insight into how the structure of an application can enhance appeal to advertisers. As an illustration, by varying the sequence of what a user does and sees at different points while navigating an application, the developer can significantly increase the odds that the user will click on an ad. At the same time, SocialMedia helps to educate advertisers about how, in general, social media provide rich contexts for delivering messages to relevant audiences. In high-uncertainty environments, privileged access to such knowledge flows can become a major advantage – and a significant enabler of and catalyst for distributed innovation. SocialMedia's experience also demonstrates the fractal nature of shaping: Secondary and tertiary shapers can arise within environments that are being shaped more broadly.

Element 3: Shaping Acts and Assets

The shaping company's acts and assets themselves constitute the third element of a shaping strategy. Even the most compelling shaping view and most robust shaping platform can be undercut by would-be participants' lingering concerns that the shaper may lack the conviction or capability needed for success. Conversely, participants are also likely to worry that their own business niches might become vulnerable to competition from a powerful shaper. Selected bold acts by the shaping company and careful use of its assets can assuage those concerns.

Such acts irrefutably define the shaper's intentions. Consider the computer networking company Novell, which pursued a shaping strategy by selling off the hardware business that generated 80% of its revenues. Novell saw an opportunity in the early 1980s to shape the local area network business. LANs were an extremely important new technology category that emerged as PCs rapidly penetrated businesses and needed to be connected to one another and to the applications and information housed on corporate mainframes and servers. Novell had developed a robust operating system for local area networks and made its dramatic divestiture decision to accelerate adoption of that system.

The message to the rest of the emerging industry was clear: Novell was so committed to its network operating system that it was prepared to walk away from a significant portion of its revenue. This dramatic act communicated to other network hardware manufacturers that they could adopt Novell's system without worrying that Novell would compete with them in their core business. It effectively positioned Novell as a very successful shaper of an important technology arena, and its network operating system became the de facto standard for over a decade. The company ultimately diversified into other business areas, draining focus from its core operating system business. As a result, it lost its leadership position in local area networking – a cautionary tale to aspiring shapers that successful shaping requires tight commitment for the long term.

Malcolm McLean made a similar striking move in his effort to accelerate adoption of his shaping platform for the containerized-shipping industry. In the 1960s he released the patents to his four-corner fittings and twist-lock mechanisms – royalty-free – to the International Organization for Standardization. McLean could afford to be magnanimous with the intellectual property from his shaping platform because as the major shareholder of Sea-Land, he stood to profit handsomely from broader adoption of standards in that arena.

The assets of the shaping company also become a significant factor in persuading potential participants to invest in the shaping strategy. In this domain, large established companies have a potential advantage as shapers. Their massive assets can attest to the credibility of the shaping view and platform. Few would doubt that these companies have the resources to support a shaping strategy. On the other hand, a smaller new entrant faces a significant challenge on this front. Anyone considering investing in its strategy will understandably wrestle with the concern that it may not have the necessary assets. The risk of stranded investment becomes very real.

A smaller new entrant can gain access to needed assets through strategic relationships with larger, better-known companies. For example, Microsoft in its early days enhanced its credibility by negotiating an important relationship with Intel, the leading manufacturer of microprocessors. Somewhat later, Microsoft's deal with IBM to provide the PC operating system let the world know that this small company was a force to be reckoned with. More recently, Microsoft has played the reverse role with Facebook, giving credibility to the much smaller aspiring shaper by making a significant minority investment. In another recent example, Google – an established company but with minimal experience in the telephone industry – has gained credibility for

SIX TESTS OF A SHAPER'S ACTS AND ASSETS

Larger incumbents

- Given all your other business initiatives, how can you convince potential participants that you are in this venture for the long haul, even in the face of setbacks?

Smaller entrants

- How will you gain access to assets that will prove to potential participants that you have sufficient resources to pursue a successful shaping strategy?

All shapers

- What have you done to assure potential participants that you won't eventually compete with them?
- Do your senior management team, board members, and key investors have the tolerance for risk and the patience required to commit the assets and take the actions essential to being a successful shaper?
- Is your company capable of attracting and mobilizing enough participants to realize the full potential of shaping platforms?
- Does your leadership team – and especially the CEO – have a forceful enough personality to build a shaping narrative that is plausible, vivid, and alluring to participants?

its mobile phone platform, the Android operating system, by announcing the Open Handset Alliance. This consortium has enlisted such well-known telecommunications players as Sprint Nextel, T-Mobile, Motorola, and Samsung.

A shaping company can demonstrate to would-be participants its ability to successfully execute a shaping strategy in the following ways:

By achieving critical mass quickly. When executed well, shaping strategies aggregate a critical mass of participants that then unleashes powerful increasing returns. The challenge, of course, is getting to that critical point rapidly. Many efforts at shaping have foundered during this challenging initial phase. Strategic relationships with major incumbents in a market can accelerate the aggregation of participants.

By mobilizing the multitudes. Shaping companies need to develop the institutional arrangements and management practices that attract and mobilize masses of participants. To be sure, all firms work with partners to deliver more value to the marketplace. However, during the past couple of decades many companies have reduced the number of participants in their supply-chain and distribution operations in a quest for greater efficiency. This poses a nontrivial challenge to potential shapers as they focus on large-scale mobilization.

As the examples of Visa and Google's AdSense show, significant institutional innovation is needed to support successful shaping strategies – but it need not always take the same form. Visa created a scalable network that encompasses thousands of business partners to deliver performance-intensive financial services in high-security environments. AdSense designed a much looser economic web that relies primarily on financial incentives to attract advertisers and content providers, and which mobilizes hundreds of thousands of business participants on a global scale. Senior management teams need to be alert to the variety of available ecosystem models, the criteria for selecting the most appropriate type, and the best management practices for each. (See the exhibit "Rethinking the Process of Strategy Development.")

By shaping again and again. Once unleashed, increasing returns have traditionally been a powerful force, leading to virtually unshakable market positions and disproportionate generation of wealth relative to competitors. That was certainly the case in yesterday's world of punctuated equilibrium, where relatively long periods between disruptions allowed shapers to lock in a competitive advantage. However, in the sustained disequilibrium of today's business environment, a paradox emerges. Although it's now easier to develop and deploy shaping strategies, it's also more difficult to protect them once they're established. Successful strategy now requires a series of shaping initiatives over time, rather than one disruptive big-bang effort to be exploited thereafter.

...

Turbulent times demand that we learn how to shape the turbulence around us by creating an effective management ensemble that moves beyond adaptation to a shaping aspiration. More fundamentally, we need to understand how we can turn the instability created by digital infrastructures to our advantage by mobilizing many other participants to shape a more rewarding future.

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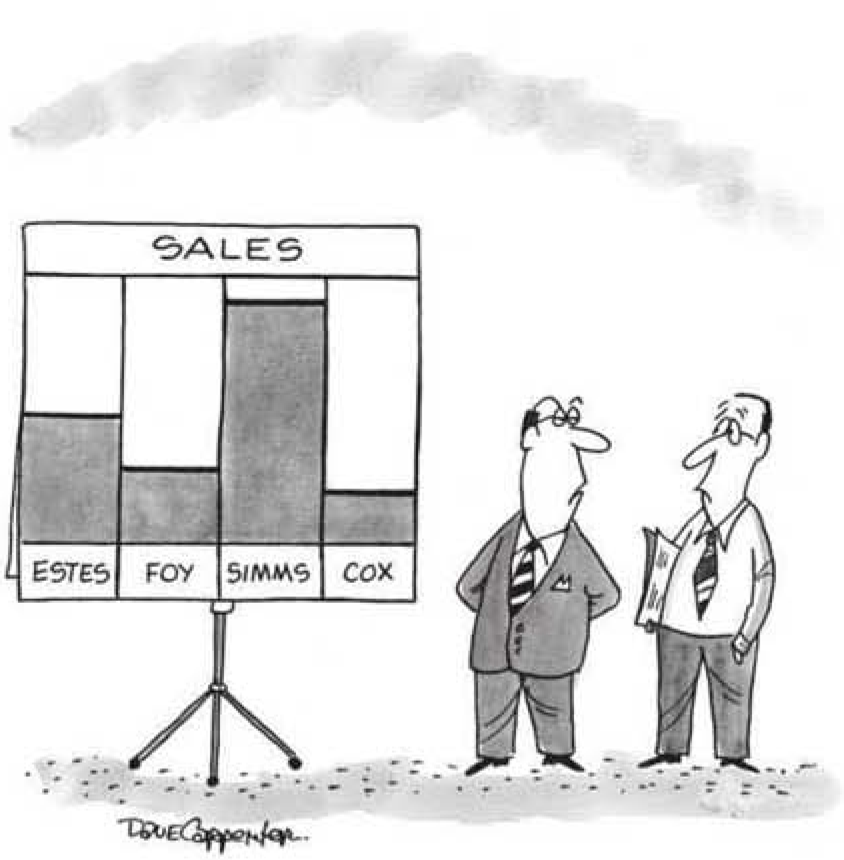
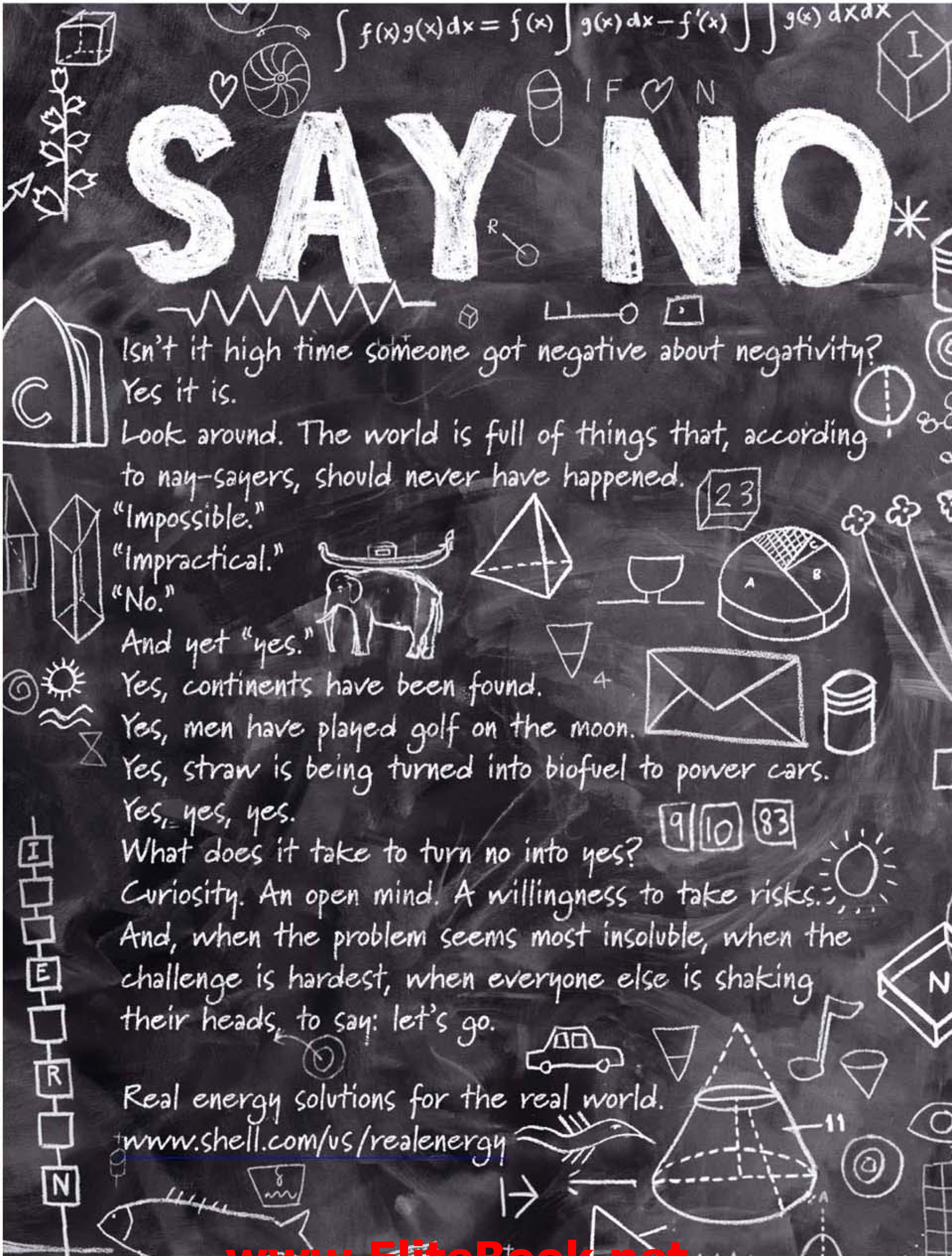


"You realize, Simms, this has put a real crimp in our plans to get rid of you?"

Dave Carpenter



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IF ♡ N
SAY NO
Isn't it high time someone got negative about negativity?
Yes it is.
Look around. The world is full of things that, according to nay-sayers, should never have happened.
"Impossible."
"Impractical."
"No."
And yet "yes."
Yes, continents have been found.
Yes, men have played golf on the moon.
Yes, straw is being turned into biofuel to power cars.
Yes, yes, yes.
What does it take to turn no into yes?
Curiosity. An open mind. A willingness to take risks.
And, when the problem seems most insoluble, when the challenge is hardest, when everyone else is shaking their heads, to say: let's go.
Real energy solutions for the real world.
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Companies often sell off businesses when times are hard. Smart CEOs approach divestiture more strategically.

HOW THE BEST DIVEST

by Michael C. Mankins, David Harding, and Rolf-Magnus Weddigen

MOST CORPORATIONS ARE GEARED UP TO BUY ASSETS, not sell them – the majority acquire three businesses for every one they divest. So when they decide to sell, many do it at the wrong time or in the wrong manner. Those are expensive mistakes.

Corporations that take a disciplined approach to divestiture not only sharpen their strategic focus on their core but also create nearly twice as much value for shareholders. That's what a Bain & Company study found in an analysis of 7,315 divestitures completed by 742 companies over a 20-year period: An investment of $100 dollars in the average company in 1987 would have been worth roughly $1,000 at the end of 2007, but a similar investment made in a portfolio of the "best divestors" would have been worth more than $1,800.

Neil Webb

For a good example of effective divestiture, look at the $16 billion forest-products company Weyerhaeuser. Since 2004, it has divested operations totaling more than $9 billion and used the capital raised and the management resources released to transform itself from a traditional pulp-and-paper company into a leader in timber, building materials, and real estate. In the process, Weyerhaeuser has produced some of the highest returns in its sector.

Weyerhaeuser is not alone. Our experience and research show that the most effective divestors follow four straightforward rules: They set up a dedicated team to focus on divesting. They avoid holding on to businesses that are not core to their portfolio – no matter how much cash they may generate. They make robust de-integration plans for the businesses they intend to sell. And they develop a compelling exit story to use internally and externally, taking the buyers' and employees' perspectives very much into account.

Used consistently, these disciplines produce an internal sell-side capability that enables divestors to generate superior returns for their shareholders. In the following pages, we'll explore each of these rules in more detail.

The Smart Way to Divest

RULE 1
Dedicate a team to divestment full-time, just as you do with acquisitions.

RULE 2
Establish objective criteria for determining divestment candidates – don't panic and sell for a song in bad times.

RULE 3
Work through all the details of the de-integration process before you divest.

RULE 4
Make sure you can clearly articulate how the deal will benefit the buyer and how you will motivate the unit's employees to stay on until the deal is done.

RULE 1 Establish a Dedicated Team

Most firms have sizable corporate development organizations, elaborate acquisition pipelines, and extensive relationships with investment banks, which all drive buy-side activity. In fact, as more companies – particularly private equity firms – have focused on deal-making disciplines, buy-side returns have improved over the past few years. Buyers are now just as likely as sellers to create value – which was far from the case during most of the 1980s and 1990s.

The best divestors approach divestitures with the same level of planning and rigor that their counterparts in corporate development bring to acquisitions. They have established sell-side teams, which are constantly screening their company's portfolio for divestiture candidates and are continually thinking through the timing and implementation steps needed to maximize value. In most cases, teams have standing members with unique skills – such as experience in separating accounting systems, specialized HR expertise, or the ability to set up detailed service-level agreements between the corporation and the divested businesses. They typically develop a divestiture pipeline by screening the company's portfolio (at least annually) and flagging those businesses that may be worth more to others than they are to the company's shareholders and are not core to its long-term strategy.

Textron has embraced this discipline. Ted French, Textron's CFO, has assembled a team with distinctive deal-execution capabilities. Team members maintain a detailed database of potential buyers for the company's businesses – both other corporations (often described as "strategic buyers") and private equity and other financial firms. They also keep data on virtually every transaction that has been completed or contemplated in the markets in which Textron competes. As a result, management has an excellent understanding of the needs of potential buyers and, therefore, the deals that can be done if Textron wishes to put a business up for sale. When an opportunity arises, Textron can act quickly and decisively, minimizing disruptions to its other business units and enabling executives in the target business to focus on making it worth as much as possible to potential buyers.

Since 2001, the Providence, Rhode Island–based conglomerate has sold 41 businesses with more than $4.4 billion in total revenue and acquired 24 businesses with $1.4 billion in sales. In the process, Textron's divestiture expertise has paid handsome dividends for the company's shareholders. Since 2001, the company has produced average shareholder returns that are more than 6% higher than those of its multi-industry peers.

Like Textron, most companies – even those with experienced sell-side teams – maintain relationships with investment banks, which can bring knowledge of potential buyers that even the most experienced seller may not have. They are often aware of potential buyers outside the seller's primary market, for instance, because they work with companies from many industries. Furthermore, the involvement of an experienced third party can be invaluable if a business needs to be split into pieces and sold to several buyers. Still, for the best divestors, investment banks play a clear supporting role. The company determines what businesses will be divested, when, to whom, and how.

RULE 2 Test for Fit and Value

Obviously, it makes the most sense to sell a business while potential acquirers can still extract value from the operations and take steps to reignite profitable growth. Yet our observation is that when faced with the three choices for dealing with an underperforming business – sell, milk, or transform – too many companies become de facto milkers. Unwilling to sell, but unable to support the level of investment required to

Companies should sell only those businesses that are not important to their core and have more value to other firms than to their own.

transform an underperforming business, these companies hold on, often for many years, until the unit has lost much of the value it once had.

To avoid the milking trap and identify the right divestiture targets, the best divestors apply two criteria – fit and value. To determine fit, management asks: Is keeping the business essential to positioning the company for long-term growth and profitability? To judge value, management must work out whether the business is worth more held in the company's portfolio than it is anywhere else.

It takes discipline to apply these tests consistently. In our experience, executives are moved to divest not when it's best for the company but as a reaction to the business cycle. They're most reluctant to sell assets when economic conditions are good and potential asking prices are at their highest, and they can't wait to sell when the economy slows, values fall, and buyers dry up.

By adopting the fit and value tests, companies become far better able to sell at the right time. The benefits of this approach are twofold: Divested assets usually fetch better prices because companies are able to sell on their own terms, and markets are more forgiving of such a strategic readjustment when investors expect the company will grow at a heady pace as a result. Weyerhaeuser's transformation of its pulp-and-paper portfolio at the peak of its business cycle is a clear example of this type of disciplined divesting.

To be a candidate for divestiture, a business must fall short on *both* criteria – that is, it must be neither core to the company's strategy nor naturally more valuable to the company than to anyone else. Some businesses may not be core but can still be managed more profitably by the company than by any other entity: Disney's repurchase of its North American retail stores from The Children's Place is a case in point. Some businesses that are worth more to others should nevertheless be retained to build or sustain a competitive advantage elsewhere in the portfolio: Coca-Cola's continued participation in its heritage fountain business, for example, creates distribution and other advantages for the company in its core soft drinks business.

In making divestiture selections, the best companies are studiously unsentimental, sometimes jettisoning businesses with long and storied histories. Take the case of Roche. Starting in 2000, the Swiss pharmaceutical giant sold off its flavors and fragrances, vitamins, and fine chemicals businesses to focus on extending the company's leadership positions in oncology and diagnostics. Parting with those businesses couldn't have been easy. Roche had been a major player in flavors and fragrances since 1963, and the company had pioneered the industrial synthesis of vitamin C back in 1933. In total, the divested businesses represented more than a quarter of Roche's revenue for most of the 1990s.

Continued growth in those businesses would have required substantial investment – which then-CEO Franz Humer and his team believed would be better used to build Roche's position through new medical technology and pharmaceutical innovation. In June 2000, the company spun off its flavors and fragrances interests to the company's shareholders to form Givaudan. In the fall of 2002, Roche announced that it would sell its vitamin and fine chemicals businesses to DSM for more than €2 billion. The idea was to channel the proceeds into expanding its core pharmaceuticals business in Japan, which it was already in the process of doing by acquiring a controlling interest in Chugai.

Private equity firms and conglomerates naturally place great emphasis on value when it comes to determining which businesses to keep. To identify which assets to sell, the management committee at Textron, for example, applies three tests of value to the company's diverse portfolio, which is composed of some 12 divisions and 72 strategic business units (SBUs). For Textron to retain an asset:

- The unit's long-term fundamentals must be sound. The team gauges this by assessing the attractiveness of each SBU's market and the unit's competitive strength within that market.
- Textron must be able to grow the unit's intrinsic value by 15% or more, annually. The team applies this screen by carefully scrutinizing each SBU's business plan each year and challenging its divisional management teams to assess the value-growth potential of each business objectively.
- The unit's revenues must reach a certain threshold. Textron seeks to hold a portfolio of relevant businesses, each with at least $1 billion in revenue. Businesses that are not generating $1 billion or more in sales – and are not likely to reach this watershed within the foreseeable future – are targets for divestiture.

Applying tests like these requires a deep understanding of each business's long-term profitability and growth prospects – as well as the value outsiders are placing (or might place) on similar assets. Private equity firms are masters of the value test, to the point where they occasionally swap businesses among themselves in lieu of cash transactions.

Making Separation Pay

Corporations are not private-equity firms – they are not in the business of buying and selling assets. But they need to be just as savvy about how to structure a divestiture deal and whom to sell to. Here's the best thinking about the "how" and the "who" of divesting.

The How

Once a company has decided that a unit is not vital to its core, it must determine how best to separate it out. That involves answering two important questions:

Do we sell for cash or stock? In most cases, selling a business for cash makes the most sense. There are instances, however, when spinning off a division to shareholders can be a better bet – either because the seller has no use for the cash proceeds (and doesn't want to hold them for fear of becoming a takeover target) or because a spin-off would produce higher after-tax proceeds.

Do we sell the whole business or a piece of it? Most of the time, it's easier to sell a whole business than to break it up into pieces, keeping some and selling others. In some cases, though, selling the whole business is not desirable or not feasible. That was so with Bell Canada's local wire-line business, where the real value lay in separating, and creating a different ownership structure for, the urban and the rural parts of the business.

The Who

Identifying the right buyer for divested assets involves answering two additional questions:

Who will pay the highest price? Typically, the company that makes the best offer is the one that views the property as the most strategic. But sellers can't assume that buyers will intuitively understand their own strategic advantages, nor can sellers count on investment banks to tout the deal's potential effectively. The key to maximizing the sale price is seeing the divested business through the buyer's eyes and tailoring the sales pitch accordingly. This "reverse due diligence" extends to identifying and quantifying potential cost and revenue synergies for potential buyers.

Is one buyer better than another from a strategic standpoint? In the vast majority of cases, selling to the highest bidder will create the most value for the divestor's shareholders. But not always. Had Ford sold its Jaguar and Land Rover brands to an automaker with a wide range of products that overlapped with Ford's core business in many markets, for example, rather than to the less-entrenched Tata Motors, the sale might have exacerbated competitive pressures on Ford's other auto lines. Thus, in deciding whom to sell to, divestors must be careful to account for the competitive threat posed by each potential buyer.

RULE 3 Plan for De-Integration

Once executives have decided to divest a unit, they must determine what type of separation will best meet the company's needs and then carefully think through the implementation steps required to generate the maximum value from the separation.

Divestitures can take two main forms. Many companies choose outright sale, either to strategic buyers or to private equity or other financial buyers. An example of the former is Ford's recent sale of its premium Land Rover and Jaguar auto lines to India's Tata Motors; examples of the latter include The Home Depot's sale in 2007 of HD Supply to a team of private equity firms for $8.5 billion and Weyerhaeuser's sale the same year of its Canadian wholesale building-products distribution centers to Platinum Equity. In other circumstances, a divestor will spin off or carve out the target as a separate entity, with its own shares, as Altria did with its majority interest in Kraft Foods. Each approach has benefits and costs, and the best divestors consider how to structure the deal and to whom they will sell as carefully as they do what units to sell off and when. The sidebar "Making Separation Pay" summarizes the trade-offs involved in those determinations.

Whatever form the divestiture takes, good divestors are meticulous about planning how it will unfold – just as savvy acquirers are diligent about postmerger integration. Divestors start by comprehensively defining the boundaries of any divested business, answering such questions as: Which products and regions will be included? Which customers? Which facilities? They determine which specific assets will be separated from the company and transferred to the divested unit. They have developed tried-and-true methods for dealing with shared overhead costs, common brands, and patents. Cross-company systems and processes are carefully unraveled (or even shared by both companies for a transition period) to ensure effective separation.

Establishing these boundaries is often not easy. Legacy businesses are frequently embedded deeply in the parent, and disentangling asset ownership can become very thorny very quickly. In some situations, moreover, effective divestitures involve retaining close links with the divestor. Bell Canada's recent spin-off of its regional small-business operations and the rural portions of DSL (its residential wire-line business), in the face of growing competition from cable providers, is a case in point.

The deal had many advantages for both the parent and the spin-off. The new company, Bell Aliant Regional Communications, would focus on rural territories, while Bell Canada would focus on national wireless, as well as on major urban markets where it could sell a broader range of products (voice, data, video, wireless). By combining the scale of Bell Canada's rural operations with those of Aliant (a company Bell Canada only partially owned), the deal would create sufficient scale in Bell Aliant's rural wire-line business. The arrangement would allow Bell Canada to focus on its higher growth wireless operations and reduce its exposure to the slower-growth wire-line business. The new company would attract a better market valuation than when it was buried within Bell Canada, especially merged with Aliant's wire-line business, releasing shareholder value for both Bell Canada and Aliant. Finally, the deal was structured to reap considerable tax advantages, and the proceeds allowed Bell Canada to reduce debt and make a special distribution to shareholders.

The deal made sense for the parties involved, but what about the government agencies and other large national customers that required service in rural areas? What about the shared network assets that underpin telephone service in both urban (Bell Canada) and rural (Aliant) areas? It was easy enough to sell the physical assets that would become Bell Aliant Regional Communications, but the networks that supported them couldn't be ripped out or re-created without prohibitive expense. And what was to become of installation and repair – especially in border areas?

Bell Canada carefully sorted through these particulars. Before announcing the deal, the divestiture team created a detailed plan whereby Bell Canada would continue to provide network functions, billing, call centers, dispatch centers, marketing, and corporate services such as finance, legal, and HR – some services in perpetuity and some for defined transition periods. Aliant would create its own sales force for small and midsize business, markets in which Bell Canada had done less well. Aliant would also gain the freedom to create new wire-line products. Comprehensive legal agreements formalized all of these important points, and a plan was in place well before the day of divestiture.

The plan has borne fruit. Since the beginning of 2007, Bell Aliant stock has outperformed other Canadian regional carriers'. Bell Canada's rigorous divestiture planning has enabled it to create a regionally focused carrier, which has grown by acquiring additional rural assets.

In planning a divestiture, it pays to time the deal to coincide with the use of the proceeds – ideally investing in such things as debt restructuring, share repurchase, or acquisition of a new business adjacent to the company's core. Groupe Danone, for example, announced it was in discussions to sell its biscuits

A good way to allocate value is to structure the deal so that both the buyer and the seller win only if the divested business is successful.

business to Kraft Foods for more than $7 billion in July 2007. Less than two weeks later, the company announced it would buy Royal Numico, the Dutch baby formula and nutrition-bar manufacturer, for $16.8 billion. This near-simultaneous sale and purchase enabled Danone to kill two birds with one stone: It used virtually all of the company's cash on hand, thereby reducing its appeal as a takeover target following the sale of its biscuits unit. It also vaulted itself into a leadership position in the world markets for baby food and clinical nutrition. "Numico has all the characteristics we like," said Antoine Giscard d'Estaing, Danone's then-CFO, on the day of the announcement, "health orientation, extremely good research and development, market leadership and exposure to high-growth markets." Investors viewed the deal favorably as well, quickly bidding up the value of Danone's shares.

RULE 4 Provide a Compelling Logic for Buyers and Employees

The best divestors clearly communicate what's in the deal for all involved. This entails having convincing – and honest – answers to four questions:

- What actions should be taken to improve the profitability of the divestiture candidate or fuel its growth?
- How long will it take the buyer to achieve the deal's full potential value? (The faster an acquirer can realize the increase in value, the more it will be willing to pay for the divested business.)
- How should the value that can be unlocked through divestiture be split between the buyer and the seller?
- How will we motivate and inspire the people in the business to keep it humming along until the deal closes (and beyond)?

Though not strictly a divestiture, Gillette's sale of itself to Procter & Gamble in October 2005 illustrates the payoff that both parties can realize from carefully addressing the first two questions. P&G had been interested in Gillette for years – viewing Gillette's franchise in razors and blades, and its emerging strength in toiletries, as an ideal extension to its own consumer products portfolio. Gillette resisted selling as late as 1999. But after Jim Kilts became Gillette's CEO in 2001, he and his executive team carefully analyzed the potential value to P&G of pushing Gillette's products through P&G's distribution network.

Gillette then provided P&G with a detailed plan for realizing potential synergies on both the cost and revenue side. So compelling was its presentation that it was able to negotiate a price ($57 billion) that allowed Gillette's shareholders to reap all of the potential cost synergies from the transaction. That's because the revenue synergies for P&G were demonstrably large enough to justify the premium it paid to acquire control.

In making a case to buyers, companies need to be forthright about the warts of the business they're selling. In 2007, when Raytheon sold its commercial aircraft unit, RAC (now Hawker Beechcraft), for $3.3 billion to two private equity firms, Onex and GS Capital, management made no effort to downplay the unit's poor performance. Raytheon was careful to acknowledge that any new owner would need to make significant investments in new products and was clear about the unit's poor strategic fit with Raytheon's core government and defense businesses. This honesty made Raytheon's recommendations for ways a buyer could turn the unit around more credible than they would otherwise have been.

A good way to address the question of allocating value is to structure the deal so that both the buyer and the seller win if the divested business is successful. For example, IRS rules allow for tax-free divestiture deals under a reverse Morris trust. The structure of these deals can be complex, but essentially they all amount to the seller's spinning off a business or division to its shareholders, after which the acquiring company merges with the separated entity. The result is that both groups of shareholders own the newly created company, so everyone wins only if it does well. Examples of reverse Morris trust deals include H.J. Heinz's spin-off of North American pet foods, StarKist, and a number of its other businesses to Del Monte in 2002; Disney's 2007 divestiture of ABC Radio to Citadel Broadcasting; and Kraft Foods' deal to divest Post cereals to Ralcorp the same year.

In the Heinz–Del Monte deal, Heinz shareholders ended up owning almost 75% of Del Monte, so the deal created value for Heinz only if Del Monte benefited from its acquisition. Accordingly, Heinz CEO William Johnson was right when he said in the press release announcing the deal: "This transformative transaction is a unique win-win proposition for both companies." Richard Wolford, the CEO of Del Monte, echoed the sound logic for the deal, maintaining: "As this combination develops, Del Monte will be a much stronger company. This will be a company that will have leading brands in a number of important grocery aisles." In short, these deals work because they really do work for both parties.

Of course, structuring the deal well is only part of a winning divestiture story. There is a human narrative that must be carefully managed, as well. Here, a creative approach to compensation and HR policies can help.

At Textron, for example, compensation packages for executives of divested units typically consist of three elements. A completion bonus is paid to the top one or two executives to encourage them to get the deal done successfully. Retention packages are provided to key executives to ensure that they stay put until after the deal is completed. And severance packages reduce the fear of the unknown for all employees. Severance packages typically guarantee compensation for one year after the close of any divestiture but can extend beyond that period. Finally, Textron prohibits its own organization from poaching talent from businesses being divested.

The underlying principle is simple, says CFO Ted French: "Maximize the value of the business first, even if that means that talented executives are separated from Textron. People are treated fairly and rewarded for their contributions. As a result, people really don't mind being sold by us. There are very few other companies that can make that claim."

Beyond developing a compelling logic for divesting a business as it currently exists, sellers can (and often should) take simple steps to boost its performance to produce a credible track record of results before a sale. When Pfizer decided to divest its Adams confectionery business, for instance, the company spent several months reducing the plethora of its offerings and renegotiating supply contracts. This effort improved the performance of the unit, making it more attractive to Cadbury Schweppes, which paid $4.2 billion for Adams in 2003. The combination of a good story and real progress paid off handsomely for Pfizer's shareholders.

...

Selling a business is rarely a one-off activity. Our research shows that companies that actively manage their divestiture portfolios in a selective and disciplined manner outperform competitors that sit on the sidelines. With time and practice, these companies create an institutional capacity to spot and take advantage of divestiture opportunities whenever they arise. The best have become what we call "divestiture ready" – able to consistently move at the right time and in the right way to create the most value for their shareholders.

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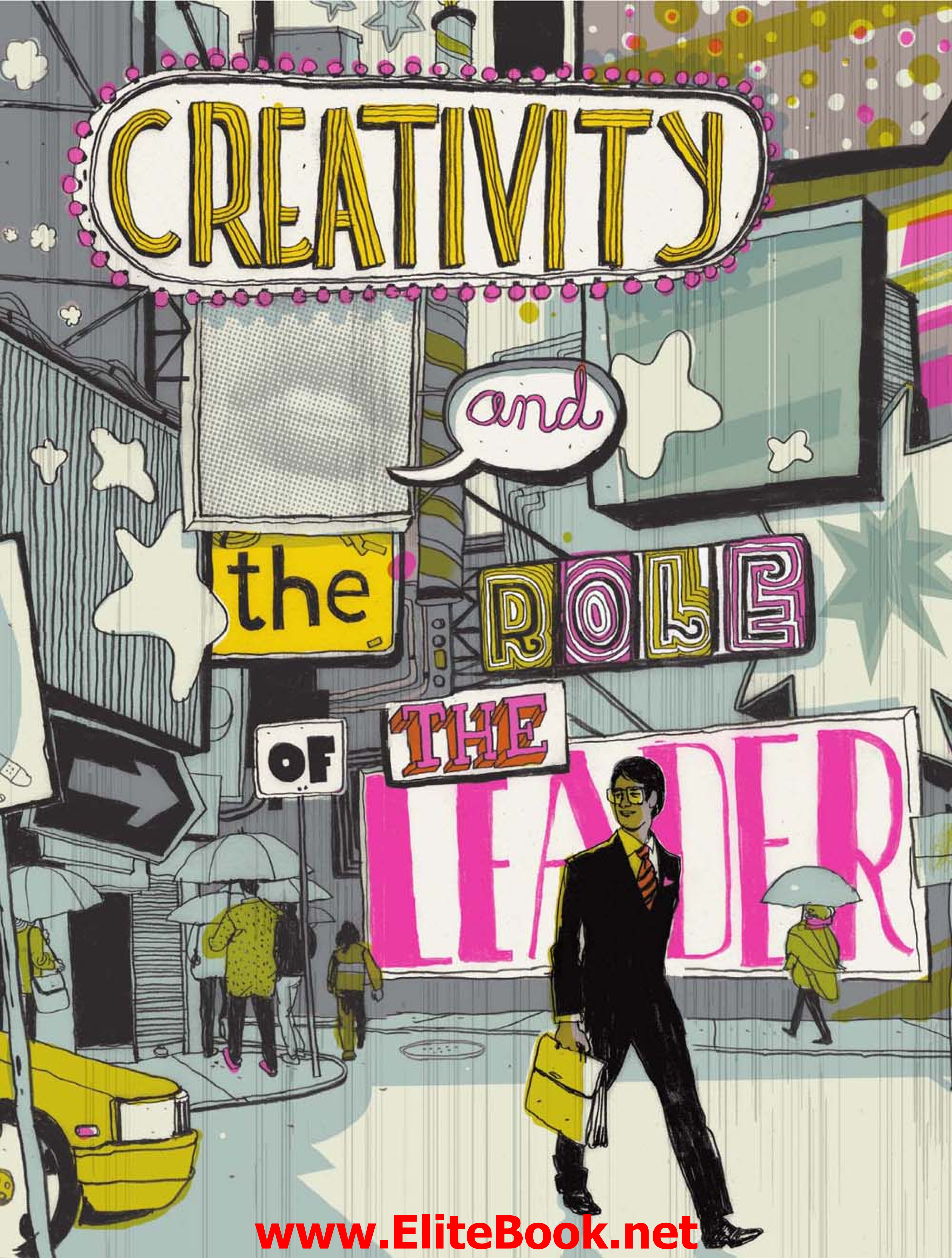
Roy Delgado

"I *hate* these annual performance reviews."


CREATIVITY
and
the ROLE
OF THE
LEADER

Josh Cochran

Your organization could use a bigger dose of creativity. Here's what to do about it.

by Teresa M. Amabile and Mukti Khaire

CREATIVITY has always been at the heart of business, but until now it hasn't been at the top of the management agenda. By definition the ability to create something novel and appropriate, creativity is essential to the entrepreneurship that gets new businesses started and that sustains the best companies after they have reached global scale. But perhaps because creativity was considered unmanageable – too elusive and intangible to pin down – or because concentrating on it produced a less immediate payoff than improving execution, it hasn't been the focus of most managers' attention.

Creativity has, however, long been a focus of academics in fields ranging from anthropology to neuroscience, and has enticed management scholars as well. Therefore, a substantial body of work on creativity has been available to any businessperson inclined to step back from the fray of daily management and engage in its questions. And that's suddenly very fortunate, because what used to be an intellectual interest for some thoughtful executives has now become an urgent concern for many. The shift to a more innovation-driven economy has been abrupt. Today, execution capabilities are widely shared and the life cycles of new offerings are short. As competition turns into a game of who can generate the best and greatest number of ideas, creativity scholars are being asked pointed questions about their research. What does it mean? How relevant is it? Does it offer guidance on the decisions that leaders in creativity-dependent businesses have to make?

To help make the connections between theory and practice, we recently convened a two-day colloquium at Harvard Business School, inviting business leaders from companies whose success depends on creativity – such as design consultancy IDEO, technology innovator E Ink, internet giant Google, and pharmaceutical leader Novartis. At the gathering, leading scholars presented their newest and most important research. In all, we brought together nearly 100 people who were deeply concerned with the workings of creativity in organizations and let the sparks fly.

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Join the conversation with the authors about the challenges of managing creativity at **leadingcreativity.hbr.org**

Over those two days, we saw a new agenda for business leadership begin to take shape. At first, we heard skepticism that creativity should be managed at all. Intuit cofounder Scott Cook, for example, wondered whether management was "a net positive or a net negative" for creativity. "If there is a bottleneck in organizational creativity," he asked, "might it be at the top of the bottle?" By the colloquium's end, however, most attendees agreed that there *is* a role for management in the creative process; it is just different from what the traditional work of management might suggest. The leadership imperatives we discussed, which we share in this article, reflect a viewpoint we came to hold in common: One doesn't manage creativity. One manages *for* creativity.

Drawing on the Right Minds

The first priority of leadership is to engage the right people, at the right times, to the right degree in creative work. That engagement starts when the leader recasts the role of employees. Rather than simply roll up their sleeves and execute top-down strategy, employees must contribute imagination. As Cook put it, "Traditional management prioritizes projects and assigns people to them. But increasingly, managers are not the source of the idea."

Tap ideas from all ranks. Cook told the story of an eye-opening analysis of innovations at Google: Its founders tracked the progress of ideas that they had backed versus ideas that had been executed in the ranks without support from above, and discovered a higher success rate in the latter category. Similarly, it was noted that Philip Rosedale, the founder and chairman of Linden Lab, the fast-growing company that manages Second Life, claims to give most workers enormous autonomy, and says the greatest successes come from workers' own initiatives.

Research by Israel Drori, a professor at the College of Management in Israel, and Benson Honig, a professor at Wilfrid Laurier University in Canada, highlights the hazards of not distributing creative responsibilities across the organization. They observed an internet start-up offering a new, sophisticated form of computer graphics from its inception in 1996 until its collapse, seven years later. While the venture enjoyed initial success, it was ultimately unsustainable because it depended too much on the genius of its award-winning artist-founder – and took organizational creativity for granted.

Encourage and enable collaboration. As leaders look beyond the top ranks for creative direction, they must combat what Diego Rodriguez, a partner at IDEO and the leader of its Palo Alto, California, office, calls the "lone inventor myth." Though past breakthroughs sometimes have come from a single genius, the reality today is that most innovations draw on many contributions. "Consider the examples of InnoCentive, of Mozilla, of Wikipedia," Rodriguez said. "All are contexts that bring in lots of contributors. And the fundamental structure of such networked organizations is not centralized and top-down. People don't do what they do because someone told them to do it. Contributing to an interdependent network is its own reward." Rodriguez argued forcefully that, even in today's highly networked world, organizations fail to take full advantage of internet technologies to tap into the creativity of many smart people working on the same problem. (For Scott Cook's thinking about tapping the input of people outside the organization, see "The Contribution Revolution," page 60.)

A study by Victor Seidel of the University of Oxford's Saïd Business School identified one practice that leaders would do well to promote: the use of "coordination totems" in the conceptualization of new products. Seidel looked at the problem of how to achieve collaboration on radical innovations; when no obvious antecedent exists, it's difficult for a vision to be shared. His analysis of six award-winning products (from three quite different industries) showed how product development teams used not only prototypes but also metaphors, analogies, and stories to coordinate their thinking.

Robert Sutton, a professor at Stanford University's School of Engineering, noted that most companies have hierarchical structures, and differences in status among people impede the exchange of ideas. How to remedy that? Sutton couldn't resist pointing out the huge inequalities in salaries at today's firms and suggested that if the field were more level, more people might speak up and be listened to. He urged leaders to define "superstars" in their organizations as those who help others succeed. Wryly, he recalled seeing powerful people hold forth in meetings even though others in the room had much better ideas for solving problems. It should be management's mission, he suggested, to "figure out how to get people to shut up at the right time."

Open the organization to diverse perspectives. Frans Johansson, author of *The Medici Effect,* described his finding –

How can organizations foster a culture of creativity

based on interviews with people doing highly creative work in many fields – that innovation is more likely when people of different disciplines, backgrounds, and areas of expertise share their thinking. Sometimes the complexity of a problem demands diversity; for example, it took a team of mathematicians, medical doctors, neuroscientists, and computer scientists at Brown University's brain science program to create a system in which a monkey could move a computer cursor with only its thoughts. Other times, the application of one field's methods or habits of mind to another field's problem produces the breakthrough.

Even within the mind of an individual, diversity enhances creativity, according to a study by Jeffrey Sanchez-Burks, a professor at the University of Michigan, his Michigan colleague Fiona Lee, and Chi-Ying Cheng of Columbia University. Their research focuses on people who have multiple social identities, such as people who are both Asian and American, or who are both women and engineers. Social identities often have distinct knowledge associated with them, and to the extent an individual is comfortable integrating multiple identities, his or her knowledge sets can combine productively. Indeed, through two experiments, these researchers found that people with higher levels of "identity integration" display higher levels of creativity when problems require that they draw on their different realms of knowledge. (One experiment asked Asian Americans to invent new forms of Asian American fusion cuisine, and the other asked female engineers to imagine new features for a cell phone for women.) This research sparked a great deal of personal interest and has implications for management. If managers cause people to suppress parts of their identity, they limit a potentially valuable source of creativity. If managers can encourage identity integration – think of female engineers working in an environment where they don't feel they have to dress like men – people may be more innovative.

Managers can also enhance diversity by looking outside the organization for sources of creativity. Collaboration need not be bounded by the walls of the firm, as Rodriguez noted, pointing again to networked organizations such as Wikipedia. Many, in fact, see the recent phenomenon of open-source development as the future of innovation.

For those who may worry that open-source innovation is still unproven and relevant only in software, Peter Meyer, an economist with the U.S. Bureau of Labor Statistics, put the matter in perspective. He analyzed the invention of the airplane, which, by today's definition, could easily be termed an open-source innovation. In the years before the commercial potential of aviation was recognized, the Wright brothers were just two of many enthusiasts who shared their discoveries and ideas freely and frequently in the manner of avid hobbyists. These "tinkerers," as Meyer characterized them, were motivated not by the desire to get rich but by the technical challenges and romance of the quest for human flight.

The openness of the network, Meyer showed, greatly assisted the development of the airplane; the Wright brothers participated actively in it from 1900 through 1902. However, as the Wrights realized how important their breakthroughs were likely to be in creating viable commercial and military aircraft, they focused on securing patents and finding ways to make money from their inventions. Collaborators became potential competitors, and secrecy the new norm among them. The dual implications of this research are intriguing. Open-source innovation, with its ability to tap the passion and ingenuity of tinkerers, offers enormous potential for creative output, and new industries with proprietary or secret technology can arise from it. But open-source processes may work only in certain kinds of endeavors or for limited windows of time.

Bringing Process to Bear – Carefully

Can creativity scale? That question was posed by Kim Scott, who had good reason to ask: She works at Google, where she is director of online sales and operations for AdSense, DoubleClick, and YouTube. She believes that creativity within an organization depends on vibrant, ongoing collaboration and free idea flow – which tend to dry up as a business adds people and projects. A former entrepreneur (Scott was involved in three start-ups before joining Google), she hates the fact that more layers of management often lead to more bureaucracy – and the end of entrepreneurial spirit, risk taking, and learning from mistakes. At the same time, she recognizes that it is not reasonable to have organizations so flat that managers are saddled with dozens of direct reports. "How do you get *lift* out of adding layers," she asked, "instead of *weight?*" One solution she offered is greater investment in infrastructure, whether high-tech or low-tech, that makes collaboration easier.

The classic response to increased scale in an operation is increased reliance on process – a standardization and continuous improvement of "the way we do it." Many at the colloquium, however, rejected the notion that creativity could be so straitjacketed. "If there is one device that has destroyed more innovation than any other, it is Six Sigma," stated Mark Fishman, MD, president of the Novartis Institutes for BioMedical Research. Bob Sutton echoed the sentiment, citing research showing that when organizations focus on process improvements too much, it hampers innovation over the long term. "The poster child here is Kodak, which kept making the process of manufacturing and distributing chemical-based film more efficient instead of devoting attention to making the shift to digital photography," he said. "In other words, it kept getting better and better at doing the wrong thing." For Kim Scott, the problem comes when an emphasis on efficiency causes managers to try to avoid duplication of effort. "In creative work," she noted, "you need to have people approaching a problem from different angles."

Map the phases of creative work. Process management, Mark Fishman explained, is appropriate in some phases of creative work but not others. The leader's job is to map out the stages of innovation and recognize the different processes, skill sets, and technology support that each requires. For instance, efficiency-minded management "has no place in the discovery phase," he said. While recognizing that pharmaceutical firms desire predictable output from their R&D operations, he reminded the group of a remark by Nobel laureate Peter Medawar: "To predict an idea is to have an idea." Because it's impossible to know in advance what the next big breakthrough will be, "you must accept that the discovery phase in pharmaceutical innovation is inherently muddleheaded." Worst of all, models like Six Sigma are geared toward reducing variability and achieving greater conformance to a desirable norm. But in the fuzzy initial stages of innovation, Fishman said, "you want people to work at the ends of the Gaussian distribution. Efficient models make good sense for the middle and end stages of the innovation process, when the game has moved from discovery to control and reliability." He offered three pieces of advice for leaders in creative settings: Know where you are in the game. Appreciate the different creative types among your people – and realize that some are better at certain phases than others. And be very tolerant of the subversive. Creative work must, like Mark Twain's character Huck Finn, avoid all "sivilizing" influences.

Is the creativity bottleneck at the top?

Manage the commercialization handoff. Few people have equal capabilities in idea generation and idea commercialization; that's why large corporations normally separate the two functions. The consensus is that, eventually, an innovation reaches a point where it will be best served by people who know how to take it to market. Unfortunately, since the passion for an idea is highest among its originators, projects often lose steam at the handoff. Management's job is to limit the loss of momentum with adroit timing and handling of the transition.

In entrepreneurial settings, idea originators are often forced to engage in commercial activity well beyond their comfort zones. Bob Litan, VP of research and policy at the Kauffman Foundation, which supports American entrepreneurship, noted how great a barrier that constitutes for many inventors. He described a program in which Kauffman links postdoctoral scientists to commercializers, rather than trying to teach inventors to spot market opportunities for their discoveries. Nonetheless, many inventors do successfully grow their businesses (think Google). These opposing models highlight the tension that always exists in the management of creatives: whether to round out their individual skill sets or allow them to run with their unique strengths and then balance them with complementary resources.

Provide paths through the bureaucracy. Colloquium participants were of one mind on the subject of bureaucracy: It stifles creativity. Clay Christensen, a professor at Harvard Business School, offered a useful analogy for understanding why. He likened the life of an idea in a large corporate setting to that of a bill going before the U.S. Congress. The idea is reshaped at various points along the way to suit the agendas of the people whose support is required in order for it to be funded. "You're not into it two weeks before you hear from sales or finance or engineering that they will block it unless you change it to fit their needs," he said. "These powerful constituencies inside the company collectively beat things into a shape that more closely conforms to the existing business model rather than to the opportunity in the market." What's the solution? Christensen advised managers to recognize what that process does to ideas and deliberately decide to contain it.

Kim Scott added that the manager must act as a shepherd – an analogy also used by Christy Jones, founder of Extend Fertility. Both believe that executives must protect those doing creative work from a hostile environment and clear paths for them around obstacles. In fact, Scott warned the managers in the room that, by creating the necessary new structures to support cross-unit collaboration, they might unwittingly create other forms of bureaucracy. Introduce any set of mandated protocols and checkpoints, she warned, "and Dilbert has entered the room." Other executives and researchers emphasized the need to create a culture in which creativity can thrive, repeatedly returning to the image of a gardener who prepares the creative soil and nurtures the seedlings of ideas.

Create a filtering mechanism. Not surprisingly, some pushback occurred. It all sounds very nice, someone pointed out, but gardens do have weeds; managers must not only water and fertilize, but also kill off the stuff that holds no potential. For every idea with real commercial promise, there are dozens that aren't worth pursuing. At what point and by whom should that determination be made?

One school of thought says that the people closest to the idea are best equipped to make the call – but only if their personal commitment to its success, and the professional ramifications, can be severed. Pharmaceutical giant Merck tries to accomplish this by offering "kill fees." As reported by *BusinessWeek*, Merck's R&D chief, Peter Kim, rewards stock options to "scientists who bail out on losing projects." Without such incentives, it's hard for people to throw in the towel. Indeed, Kim Scott admitted that "we set a goal at Google to cull a percentage of our projects this year, and it was a real challenge."

In a spirited discussion of how ideas should be winnowed, Johansson suggested that the filters must be diverse. Unless the people sitting in judgment represent a variety of disciplines, functions, and viewpoints, they are unlikely to make wise decisions. Russ Wilcox, cofounder and CEO of E Ink, suggested that the filtering might even take place outside the organization. Perhaps the best way to tap the wisdom of the broader market is to give it the power to turn thumbs up or thumbs down on new commercial possibilities. That approach resonated with the company founders present.

"The thrill of being an entrepreneur," one said, "is that you get your ideas out in the real world, and they live or die there as opposed to in committee. That committee is death to creativity." Bob Litan described two recent developments that allow for external vetting at an early stage: the increasing use of prediction markets, and the rise of business "accelerators" like Y Combinator and the Foundry, "which are essentially the American Idol approach to entrepreneurship."

Fanning the Flames of Motivation

Motivating people to perform at their peak is especially vital in creative work. An employee uninspired to wrap her mind around a problem is unlikely to come up with a novel solution. What spurs creativity, however, has long been a matter of debate.

Provide intellectual challenge. A convincing analysis was put forward by Henry Sauermann, then a doctoral candidate at Duke University (now at Georgia Tech), who presented new research done in collaboration with Duke professor Wesley Cohen. To discover the drivers of creative productivity, they looked at data on more than 11,000 R&D employees in manufacturing and service companies who had been routinely surveyed by the National Science Foundation. The surveys uncovered which workers were more intrinsically motivated – fired up, for example, by intellectual challenge or independence – and which were more extrinsically motivated, by such things as salary, benefits, and job security. The researchers looked at patents filed by each respondent as a reasonable proxy for innovative output. Their finding was clear: Early-stage researchers who were more motivated by intellectual challenge tended to be more productive. (Interestingly, this did not hold true among the group doing later-stage work.) A stronger desire for independence was also associated with somewhat higher productivity. It wasn't that extrinsic motives were unimportant; a person's greater emphasis on salary was also associated with greater productivity. The desire for intellectual challenge was, however, much more strongly linked to it.

Allow people to pursue their passions. If the keys to creative output are indeed intellectual challenge and independence, management must find ways to provide them. In large part, that demands awareness of individuals' interests and skills. Scott Cook pointed out that some people are simply more revolutionary in their thinking than others and therefore more suited to radical projects. "You're most interested in fundamental paradigm changes," he observed, "and yet you tend to staff your new projects with the people who did very well working on version 15 of the last big thing. You're crazy if you think you're going to get a big shift out of the version 15 team."

When people are well matched to a project, granting them independence holds less risk. Ideally, creative workers would be able to set their own agendas, at least in part. The prac-

A Manager's Guide to

If you're trying to enhance creativity...

...remember that you are not the sole fount of ideas.

Be the appreciative audience.

Ask the inspiring questions.

Allow ideas to bubble up from the workforce.

...enable collaboration.

Combat the lone inventor myth.

Define "superstar" as someone who helps others succeed.

Use "coordination totems" – metaphors, analogies, and stories – to help teams conceptualize together.

...enhance diversity.

Get people with different backgrounds and expertise to work together.

Encourage individuals to gain diverse experiences that will increase their creativity.

Open up the organization to outside creative contributors.

Increasing Innovation

...map the stages of creativity and tend to their different needs.

Avoid process management in the fuzzy front end.

Provide sufficient time and resources for exploration.

Manage the handoff to commercialization.

...accept the inevitability and utility of failure.

Create psychological safety to maximize learning from failure.

Recognize the different kinds of failure and how they can be useful.

Create good mechanisms for filtering ideas and killing dead-end projects.

...motivate with intellectual challenge.

Protect the front end from commercial pressure.

Clear paths through the bureaucracy for creative ideas.

Let people do "good work."

Show the higher purpose of projects whenever possible.

Grant as much independence as possible.

tice of letting researchers spend a significant percentage of their time on projects of their own choosing was famously employed by 3M in its high-growth era. Google's decision to do the same has yielded new offerings like Google Scholar. Fishman told us he encourages scientists at Novartis to spend a portion of their time working on drugs for "niche" diseases, where the intellectual rewards are often high. The screen for such projects consists of two questions – is it scientifically tractable, and does it meet an unmet medical need? Not "What is the market?" but "Is there a patient suffering who could be cured with today's knowledge?"

Be an appreciative audience. The fact that creative workers are intrinsically motivated does not mean that managers' behavior makes no difference. A good leader can do much to challenge and inspire creative work in progress. Mark Addicks, chief marketing officer at General Mills, believes that people are highly attuned to management's engagement with and attitude toward a project. "The way in which a leader asks a question can move a team very positively," he noted. Russ Wilcox of E Ink agrees with this emphasis on the manager's role as appreciative audience. "The greatest inventions in our company," he said, "are always done to impress someone else." Shikhar Ghosh, CEO of software maker Verilytics, reminded the group that the leader's impact cuts both ways; the wrong managerial behaviors, or simply careless neglect, can be tremendously demotivating. In line with research findings reported earlier in HBR (see "Inner Work Life: Understanding the Subtext of Business Performance," by Teresa M. Amabile and Steven J. Kramer, May 2007), Ghosh argued that employees doing creative work are more motivated by managerial behavior, even seemingly little things like a sincere word of public recognition, than by monetary rewards.

Embrace the certainty of failure. Arguably, the managerial reactions that speak loudest to creative workers are reactions to failure. Virtually everyone in the colloquium agreed that managers must decrease fear of failure and that the goal should be to experiment constantly, fail early and often, and learn as much as possible in the process.

Kim Scott observed that, ironically, the firms in Silicon Valley that have the hardest time managing creativity are the ones that have been most successful, because they develop an aversion to failure. How might that aversion develop? Research on firms in an emerging industry by Chad Navis of Emory University and Mary Ann Glynn, a professor at Boston College, suggests that there are particular periods of time when stakeholders become more sensitive to the prospect of failure. Navis and Glynn traced the first 15 years of the satellite radio industry through the stories of the only two U.S. companies in that sector – XM and Sirius. In the early years, both companies fought an uphill battle simply to establish the legitimacy of satellite radio. During that time, both firms focused on making progress toward a viable model, and their individual advantages went more or less unnoticed by

How can we best innovate in a networked world

outsiders. It was only after satellite radio became "real" – taken seriously by customers, analysts, advertisers, and other players – and the firms shifted their energies to competing against each other that every success or failure was put under the microscope by outsiders. Performance assessments shifted from the sector as a whole to the individual firms. Ironically, then, companies' success at establishing the economic viability of an activity can lead to increased scrutiny and therefore to the companies' increased sensitivity to failure – and desire to avoid it.

Fear of failure also seems to rise with the scale of a business. Not only do firms become more conservative as they grow, but fear also makes managers more likely to deny that failure has happened and more eager to erase all memory of it. Amy Edmondson, a professor at Harvard Business School, underscored what a lost opportunity that constitutes. Any business that experiments vigorously will experience failure – which, when it happens, should be mined to improve creative problem solving, team learning, and organizational performance.

How can an organization capitalize on failure? Above all, Edmondson said, its management must create an environment of psychological safety, convincing people that they will not be humiliated, much less punished, if they speak up with ideas, questions, or concerns, or make mistakes. Beyond that, she cautioned against any broad-brush approach. "We need to think about failure in a more fine-grained way," she said. Failures in organizations fall into three quite different types: unsuccessful trials, system breakdowns, and process deviations. All must be analyzed and dealt with, but the first category, which offers the richest potential for creative learning, involves overcoming deeply ingrained norms that stigmatize failure and thereby inhibit experimentation. (For more insight on learning from failure, see "Is Yours a Learning Organization?" by David A. Garvin, Amy C. Edmondson, and Francesca Gino, HBR March 2008.)

Provide the setting for "good work." The potential for passionate engagement in one's work is highest when the work itself is seen as noble, said Howard Gardner, a professor at the Harvard Graduate School of Education who has conducted research on "good work" with professors Mihaly Csikszentmihalyi of Claremont Graduate University and William Damon of Stanford. They define the term as work that is excellent technically, meaningful and engaging to the worker, and carried out in an ethical way. While managers can do much to ensure the first two requirements in a workplace, the third is more problematic – and not because businesspeople are inherently unethical. Ethics usually are upheld best in areas where a type of work has evolved into a profession – when similarly educated people agree to a set of standards above and beyond their enterprise or personal agendas. But even where such "domain principles" are in place, rules tend to be bent in situations where market forces are dominant. Gardner voiced skepticism that any big business, however socially responsible, could make up for the fact that management in general does not constitute a profession. "But maybe at any given time there are certain prototype organizations with an exemplary ethical compass that others want to emulate," he mused. "And perhaps that can set off a kind of contagion."

While Gardner did not name specific organizations, other attendees saw hopeful signs that such model organizations might emerge. Venture capitalist Randy Komisar, a partner at Kleiner Perkins, noted that his firm is now focusing part of its business on sustainability. And the report of an experiment in Peru generated considerable excitement. Peruvian economist Martin Valdivia and Yale economist Dean Karlan, working with a microfinance organization, bundled educational offerings with capital to enhance the commercial skills of the female entrepreneurs it funded. Using a randomized control trial, the researchers showed that the training made a substantial difference to the success of the ventures – and by extension, to the alleviation of poverty.

Pulling It Together

As the colloquium unfolded, most participants seemed to warm to the model of management that was emerging – perhaps because it sounded like just the kind of leadership we, wearing our creative worker hats, would appreciate having. One scholar, however, threw cold water on the proceedings by asking us to look at our model from the perspective of the leader. Theresa Lant of New York University asked, "Where is the glory in being a 'facilitator' as a manager? How do you get a management layer made up of real humans who aspire to that role and will do it?"

A possible answer was presented by Elizabeth Long Lingo of Vanderbilt University, who described her research (a joint project with professor Siobhán O'Mahony of the University of California, Davis) into the production of country music in Nashville. The music business requires the integration of many parties who are not part of the same firm (or even a team), including songwriters, publishers, artists, and label personnel. The person bringing it all together is the producer. He or she must exercise leadership in a highly ambiguous context, where there is no clear yardstick for how good the product is and there are no clear rules for who gets to control the output. The more effective producers create a shared purpose in these ambiguous circumstances while still letting others apply their distinctive expertise. For example, in the studio, producers may introduce "bad song" and "good song" samples to create a common aesthetic but still allow the space for experts to experiment with their own sound and forge their contribution to the project. These producers operate at the center of the storm without being the focus of attention and are proactive with a diverse group of experts without being overcontrolling. The glory comes from helping others realize their unique talents and reach a collective goal – a hit record.

Christy Jones noted that her business also depends on the cooperation of diverse players with various agendas to create value for her customers. "It takes inspiration first, and then someone to drive toward that vision with passion – shepherding it and cheerleading to keep it on top of others' priorities," she said.

Marrying Research to Practice

Not every issue relating to the management of creativity was resolved in our two-day colloquium. For example, as Fiona Murray of MIT's Sloan School observed, the group never reached a consensus on the question of market-based incentives. Some saw their encroachment as a problem for creativity and urged managers to shield creative workers from their pressures. IDEO, by contrast, strives to bring market forces to bear on its work by using them as a point of inspiration and then continually exposing prototypes to real-world scrutiny. Other fascinating questions were scarcely touched on. Jing Zhou of Rice University's Jones Graduate School of Management asked, "Are there cultural differences in managing creativity? Would the approaches that work in Western countries, such as the U.S., work as well in Eastern countries, like Korea?"

The group parted, however, with a sense that theory and practice would increasingly come together to advance the understanding of creativity in business. In that vein, participants had the fresh inspiration of a presentation by Jim March, professor emeritus at Stanford University. He pointed out that our understanding of how to manage creativity is impeded by the lack of a theory of novelty, and proposed the beginnings of one. Three conditions seemed to him to be necessary for novelty – slack, hubris, and optimism – which suggest mechanisms that organizations could employ. Slack in an organizational setting means sufficient time and resources for exploration. Increasing hubris means inspiring managers to take risks. Optimism takes hold when a vision of something truly different is made to seem more promising than the status quo.

March is unapologetically a scholar; he prefaced his remarks with the caveat that his theory "is possibly useful, even beautiful and just – but probably has more elements of beauty than usefulness." But those of us listening thought it useful indeed. If research is to inform the practice of management, and if practical challenges are to guide research agendas, then we must have frameworks and theories – call them coordination totems if you will – to collaborate around. And we must continue the shared conversation.

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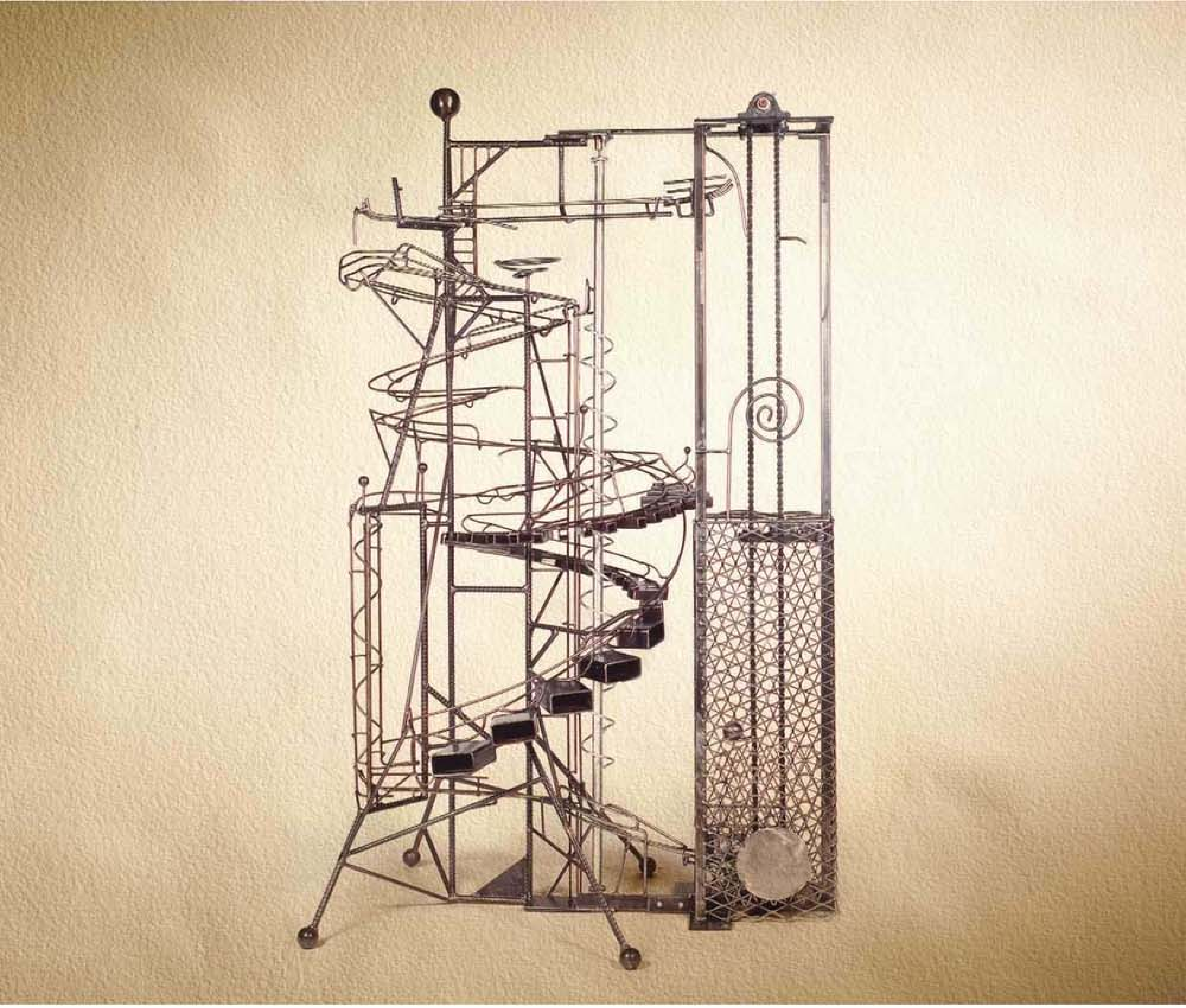
"How about we ditch intuition and try another approach."

Sidney Harris



BY IAN C. MACMILLAN
AND LARRY SELDEN

The Incumbent's Advantage

Big-company CEOs often complain about how hard it is to grow profits organically. In reality, they're sitting on a gold mine of unrealized potential in their current customer base.

CEOS OF LARGE COMPANIES often complain to us about how hard it is to grow profits organically. They worry that it's just a matter of time before they fall prey to invaders – and therefore assume that to grow robustly they will need to seek out new markets, territories, or acquisitions.

That kind of thinking is ludicrous – and strategically myopic. Market-leading companies can grow simply by tapping into and exploiting their current customer information, which already includes data about pretty much every kind of customer there is. The problem is that nearly all companies focus their strategies on defending products and territories rather than on what most successful invaders actually attack: *customer segments.*

If you run a market-leading company, you should never be blindsided by an invader. Locked within your own records is a huge, largely untapped asset that no attacker can hope to match: what we call the *incumbent's advantage.* The source of that advantage is threefold: First, you should have deeper insights into the various needs of the customers you serve than any potential invader does. Second, you should better understand the profitability of serving them and, therefore, be in a stronger position to invest resources to capture and retain the best of them. Third, and perhaps most important, your knowledge of the needs and profitability of your customer segments is far less susceptible to imitation than are the features and functions of your products.

Tomasz Walenta

To exploit the incumbent's advantage, however, you first need to shift your thinking. Specifically, you must view needs-based customer segments, not products and geographies, as the basic building blocks of your strategy – and you must have an accounting system that reports profitability accordingly. That system should treat sales, marketing, service, and R&D not as costs to be uniformly allocated across all customers but, rather, as investments specifically tailored to boosting the profit performance of attractive customer segments. After all, that's what invaders do when they pick off underserved groups of your customers. Why should you start prospecting in uncharted areas while leaving the gold on your own territory for others to mine?

To show you how to develop your incumbent's advantage and avoid falling prey to invaders, we use an example based on global building-materials company CEMEX (and simplified to protect the firm's confidentiality). It demonstrates how successive refinements in customer-needs segmentation clarify sources of profitability, creating a virtuous circle in which the incumbent makes ever more targeted investments of scarce corporate resources that simultaneously increase profits and raise entry barriers for potential invaders. Then we outline a systematic, discovery-driven approach to creating a customer-centric information base. We also explore how to organize business units so that they focus not on products but on the customer segments and subsegments where opportunities for your company – and for current rivals and would-be disrupters – truly lie.

ARTICLE AT A GLANCE

- **Market-leading companies get attacked when they focus on products and geographic locations rather than on what competitors and disrupters actually target – unmet customer needs.**
- **To fend off invaders, an incumbent should strategically analyze and reorganize its customer information base and align its corporate structures accordingly.**
- **Unrelenting attention to exploiting your incumbent's advantage is the key to growing profits organically.**

Extracting Gold from Concrete

One reason the incumbent's advantage is so potent is that few companies use it, and most that do are businesses that sell to consumers (such as Best Buy, Royal Bank of Canada, and Harrah's). Here we explore an example based on our research at CEMEX, which as a producer of commodity building materials might be considered an unlikely candidate for our approach.

Much has been made of CEMEX's growth, under the visionary leadership of CEO Lorenzo H. Zambrano, from a regional Mexican cement manufacturer to a global behemoth. Less well understood is how CEMEX has mined the profit potential of its customers by uncovering the full set of their needs, and how it has made decisions about its asset commitments and its investments in sales, marketing, customer service, and R&D resources based on the expected returns from specific customer segments. That is one of the prime reasons CEMEX is now the world's largest producer of ready-mix concrete.

In our simplified example, a company we call Mix C-Ment has developed a unique and patented additive to ready-mix concrete that allows the company to produce a more durable, lower-cost product than its competitors do. The more additive that is used, the cheaper the concrete and the greater its compressive strength. But there's a trade-off: More additive makes the concrete less "workable" (that means it's harder to prevent air pockets from forming in cavities where the concrete is poured, and the overall construction process takes longer). Many offerings involve such trade-offs, from the customer's point of view. The more cream and sugar that a dairy puts in its ice cream, for instance, the greater the fat and calorie content but the better the flavor and texture.

Trade-offs like these are opportunities for differentiation. However, in our example, Mix C-Ment is not in a position to uncover them because its mind-set is rooted in conventional cost accounting. In traditional product-oriented fashion, the company tracks data about the expenses associated with the production of different types of ready-mix concrete. But it doesn't collect differentiating data about the customers to whom it sells the product or about the sales, marketing, and other investments it makes in these customers.

As the market leader, Mix C-Ment sets its prices according to classic economic theory – only in terms of the cost to make the product and the relationship between price and demand for an "average" customer. In effect, it prices a single good to sell to the broad market. Using such product-based accounting, Mix C-Ment draws up a table showing that at $26 a ton, concrete containing 15% additive would generate a demand of 280 tons and yield the greatest profit: $60. (See the exhibit "Using Traditional Accounting to Sell Concrete.") The problem is that Mix C-Ment's executives don't know *why* its customers would want a particular mix at a given price. The company does not consider what value customers get from the product, what they'd be willing to pay for that value, or how much to invest in order to better deliver the value to each segment.

Profiting from initial customer research. Now let's see how Mix C-Ment, as the only supplier of its patented additive, can begin developing its incumbent's advantage. First, it needs to invest in research that exploits its unique access to its customer information. Say it spends $40 to learn why specific groups of customers are buying its product and what they would be willing to pay for different formulations of ready-mix concrete. The process of discovering this kind of information is not trivial, and

Using Traditional Accounting to Sell Concrete

Percent of additive	30%	25%	20%	15%	10%	5%
Price per ton	$20	$22	$24	$26	$28	$30
Demand (tons)	320	310	295	280	250	220
Revenues	$6,400	$6,820	$7,080	$7,280	$7,000	$6,600
Variable costs per ton	$15.0	$16.5	$18.0	$19.5	$21.0	$22.5
Total variable costs	$4,800	$5,115	$5,310	$5,460	$5,250	$4,950
Fixed costs						
Marketing support	$400	$400	$400	$400	$400	$400
Service	$600	$600	$600	$600	$600	$600
Other, incl. capital charges	$760	$760	$760	$760	$760	$760
Total costs	$6,560	$6,875	$7,070	$7,220	$7,010	$6,710
Profit (loss)	($160)	($55)	$10	**$60**	($10)	($110)

By selling the same product (concrete with 15% additive) to all customers, Mix C-Ment generates a profit of just $60.

we will discuss it in more detail later. For now, let's suppose this probing discussion with customers teases out two main customer segments:

- **Strength seekers,** who use ready-mix concrete for support columns and other load-bearing applications. They need the higher strength of the 15% additive mix and are less concerned about workability.
- **Workability seekers,** who pour cement for interior spaces such as walls and staircases. They can make do with the 15% additive mix, but what they really need is the workability of a 10% mix that enables them to pour the concrete faster and reduce rework from faulty pours. For these advantages, they'd be willing to pay a bit more – $28 a ton, rather than $26.

Now suppose the customer research further reveals that these two segments will each demand roughly 50% of the original 280 tons, leading Mix C-Ment to draw up its next table, "Differentiating Investments by Segment Profitability." This initial pass uncovers previously hidden profit potential in the company's customer base: It shows that Mix C-Ment can capture a profit of $90 rather than $60 – even taking into account the additional investment of $40 for customer research. Equally important, it's the first step in creating the advantage over potential disrupters: Had the company not done the segmentation analysis, revealed the needs of the workability segment, and better addressed them, it would have undershot the market and been vulnerable to competitive attacks from companies that specialize in producing a highly workable ready-mix concrete for building-construction uses.

Profiting from marketing investments. Mix C-Ment has not yet looked beyond the product needs of its customers and is simply allocating the marketing, service, and other fixed costs of the two segments according to tons sold. Let's say it spends another $40 on research to find out what level of marketing services each customer segment actually needs. Suppose that the strength seekers are happy to pay roughly the original price to get the right-strength concrete and need only modest marketing support. Allocating $200 in marketing to that segment is simply wasteful. The research reveals that the workability seekers, by contrast, need greater marketing support – to help them translate the improved workability into better construction bids. What's more, they'd be willing to pay for it.

In drawing up its next table, "Differentiating Investments in Marketing," Mix C-Ment finds that by transferring $100 in marketing resources from the strength seekers to the workability seekers, it earns a $120 profit, instead of the original $60, even after spending $80 on

Differentiating Investments by Segment Profitability

	Customer Segment		
	Strength seekers	**Workability seekers**	Total
Percent of additive	15%	10%	
Price per ton	$26	$28	
Demand (tons)	140	140	
Revenues	$3,640	$3,920	
Variable costs per ton	$19.5	$21.0	
Total variable costs	$2,730	$2,940	
Fixed costs			
Marketing support	$200	$200	
Service	$300	$300	
Other, incl. capital charges	$380	$380	
Customer research	$20	$20	$40
Total costs	$3,630	$3,840	
Profit	$10	$80	**$90**

By investing in research to find out what different customers need, Mix C-Ment can capture a profit of $90.

Differentiating Investments in Marketing

	Customer Segment		
	Strength seekers	Workability seekers	Total
Percent of additive	15%	10%	
Price per ton	$25.5	$29	
Demand (tons)	140	140	
Revenues	$3,570	$4,060	
Variable costs per ton	$19.5	$21.0	
Total variable costs	$2,730	$2,940	
Fixed costs			
Marketing support	**$100**	**$300**	
Service	$300	$300	
Other, incl. capital charges	$380	$380	
Customer research	$40	$40	$80
Total costs	$3,550	$3,960	
Profit	$20	$100	**$120**

By investing its marketing resources according to how much specific customer segments benefit from them (and are willing to pay for them), Mix C-Ment can generate $120 in profits.

Differentiating Investments in Technical Service

	Strength seekers		Workability seekers		
	High service	**Low service**	**High service**	**Low service**	Total
Percent of additive	15%	15%	10%	10%	
Price per ton	$27.5	$25	$30	$27.5	
Demand (tons)	70	70	70	70	
Revenues	$1,925	$1,750	$2,100	$1,925	
Variable costs per ton	$19.5	$19.5	$21.0	$21.0	
Total variable costs	$1,365	$1,365	$1,470	$1,470	
Fixed costs					
Marketing support	$50	$50	$150	$150	
Service	$225	$75	$225	$75	
Other, incl. capital charges	$190	$190	$190	$190	
Customer research	$30	$30	$30	$30	$120
Total costs	$1,860	$1,710	$2,065	$1,915	
Profit	$65	$40	$35	$10	**$150**

By investing its technical-service resources according to customer segments' needs, Mix C-Ment raises its profit prospects to $150.

customer research. As it focuses on specific customers' needs, Mix C-Ment shifts its perception of marketing support from an expense allocation that does not add value to a resource investment that creates value for both the customer and the company. And it has strengthened its incumbent's advantage in an additional way: Would-be attackers, which see only the price and features of Mix C-Ment's products and not its customer research, will have a hard time figuring out why the workability seekers are much less susceptible to lower-priced offerings. Of course, the more segmentation a company does, the more it will fine-tune its pricing, as reflected in the gradually evolving price-per-ton and revenue numbers in Mix C-Ment's tables.

Profiting from service investments. Suppose Mix C-Ment invests yet another $40 in customer research (for a total of $120) to consider its customers' needs for technical service. If those needs differentiate customers into, say, high- and low-service categories, four subsegments emerge: high-service strength seekers (builders of load-bearing columns for buildings and bridges), low-service strength seekers (those who construct roadbeds), high-service workability seekers (builders of staircases in buildings or walls for dams), and low-service workability seekers (those who lay road pavement and floors). The company has learned that high-service seekers will pay for that level of service and that low-service seekers are happy without it if they get a modestly lower price. In effect, an investment approach guided by customers' product, marketing-support, *and* technical-service requirements yields a profit of $150 – as evident in Mix C-Ment's final table, "Differentiating Investments in Technical Service." Compare that with the previous levels of profit: $60 (no segmentation), $90 (product-only segmentation), and $120 (segmentation by product and need for marketing support but not by need for technical service).

What's more, by identifying segments that were overshot – owing to the unimaginative, simplistic allocation of marketing and technical-services support – the company is able to offer lower-priced, stripped-down versions of its own products to highly targeted customer segments before a low-end disrupter does – avoiding what Clayton Christensen calls the "innovator's dilemma." The company can transform technical service, as it did marketing, from an allocated cost to a deliberately invested resource that is difficult for an attacker to identify.

Can you overdo segmentation? Mix C-Ment could segment still further. It might, for instance, delve more deeply into the technical-service needs of its workability and strength seekers and find sub-subsegments that require, say, design advice for complex projects such as dams, underwater seawalls, and structures that bear heavy loads. In these areas, Mix C-Ment's cumulative experience over many complex projects transcends the expertise of its individual customers. It could, therefore, offer hyperservice to customers with highly complex design challenges, enabling them to avoid significant exposure to expensive design and rework flaws. Such customers would be delighted to pay a premium for ready-mix concrete to get such a vital service.

But how far is it wise to go? In our experience, the answer depends on the hard economics – in other words, on weighing the costs and benefits of further segmentation until you hit decreasing marginal return. (To learn more

Using the Incumbent's Advantage Against Invaders

For any customer group that an invader goes after, the incumbent has four possible responses, depending on whether the targeted segment is profitable for the incumbent and whether the invader is succeeding.

Profitable Segment

Scenario: The invader has made inroads.

Response: The incumbent must assess why internal customer research failed to highlight the vulnerability in the first place. Then it should use its superior knowledge of these profitable customers to enhance its own offerings and deliver enough value to recapture the segment. It also needs to determine whether the attack might attract its other customer segments. In extreme cases, the incumbent can co-opt the invader, either through a joint venture or acquisition.

Scenario: The invasion has not been successful.

Response: This failure confirms the superiority of the incumbent's offering to customers. Even so, the company should figure out why the attempt failed in order to gain further insight into customer loyalty and ensure that other customer segments are not vulnerable.

Unprofitable Segment

Scenario: The invader has made inroads.

Response: The incumbent can encourage the invader to waste resources on the segment – for example, the incumbent might raise its prices. It should then thoroughly research those higher-profit subsegments that do not defect to figure out why they're loyal and invest additional resources to lock the challenger out.

Scenario: The invasion has not been successful.

Response: No action is needed.

about this process, see *Angel Customers and Demon Customers*, by Larry Selden and Geoffrey Colvin.) As a general strategy, we believe there are huge, constantly evolving opportunities in using your incumbent's advantage to preempt the competitive dynamics of your industry: You can regularly review and reanalyze customer needs to see how they're changing, then segment customers in order to meet those needs. Such a strategy allows you to be the first to spot – and snare – emerging new segments. We also recommend that in your annual segment-review process, you assess the profitability of each current subsegment and the potential profitability of new ones. The least profitable segments should be judiciously pruned from the portfolio in order to release resources to invest in those that pass financial muster.

Still, the apparently unprofitable segments should not be ignored, because they represent potential footholds for disrupters. Look again at the table "Differentiating Investments in Technical Service," specifically the column on low-service workability seekers. This subsegment is worth pruning. It consumes 25% of the capacity and incurs $1,915 in costs, yet it generates the lowest level of profits: $10. But dropping this segment would leave Mix C-Ment with a flank vulnerable to invasion, for it would lose the advantage of deeply understanding the subsegment and being privy to important changes in that subsegment's needs.

Instead of abandoning the subsegment entirely, we recommend, in the spirit of cost/benefit optimization, conducting more finely grained customer research to zero in on a profitable sub-subsegment, perhaps one that doesn't require so much marketing support. For example, Mix C-Ment could build and retain a profitable base in the sub-subsegment of low-service workability seekers who specialize in road floors. Supplying ready-mix concrete only to this smaller group would free up capacity, as well as marketing and technical resources, to invest elsewhere but would still leave Mix C-Ment able to monitor any incursions into the subsegment of low-service workability seekers. (See the sidebar "Using the Incumbent's Advantage Against Invaders.")

Identifying Your Most and Least Profitable Customers

It should be possible to collect and rank your customers according to a first-pass estimate of their profitability in 30 to 45 days. (If it doesn't happen by then, fire the people you assigned to the task and get folks who *can* do it.)

1 Identify all records on individual customers and use a relatively recent document-analysis process called "text mashing" to create a single customer-characteristics file, organized by customer ID. Text mashing is not especially difficult to learn, but if your IT people cannot do it, you can create your file manually, albeit more slowly, by compiling a representative sample of your customer documents.

2 Assemble your invoices for the past year. If you have a very large number of customers, use a subsample that is statistically representative of the entire base.

3 Calculate the "gross" profit contribution for each customer invoice by product and location. Typically, this calculation is initially based on existing product-profitability models and data.

4 Total up the profit contribution for each customer.

5 Rank customers in decreasing order of their total profit contribution and separate out the two top and two bottom deciles. (If your company is large, use a representative sample of these deciles.)

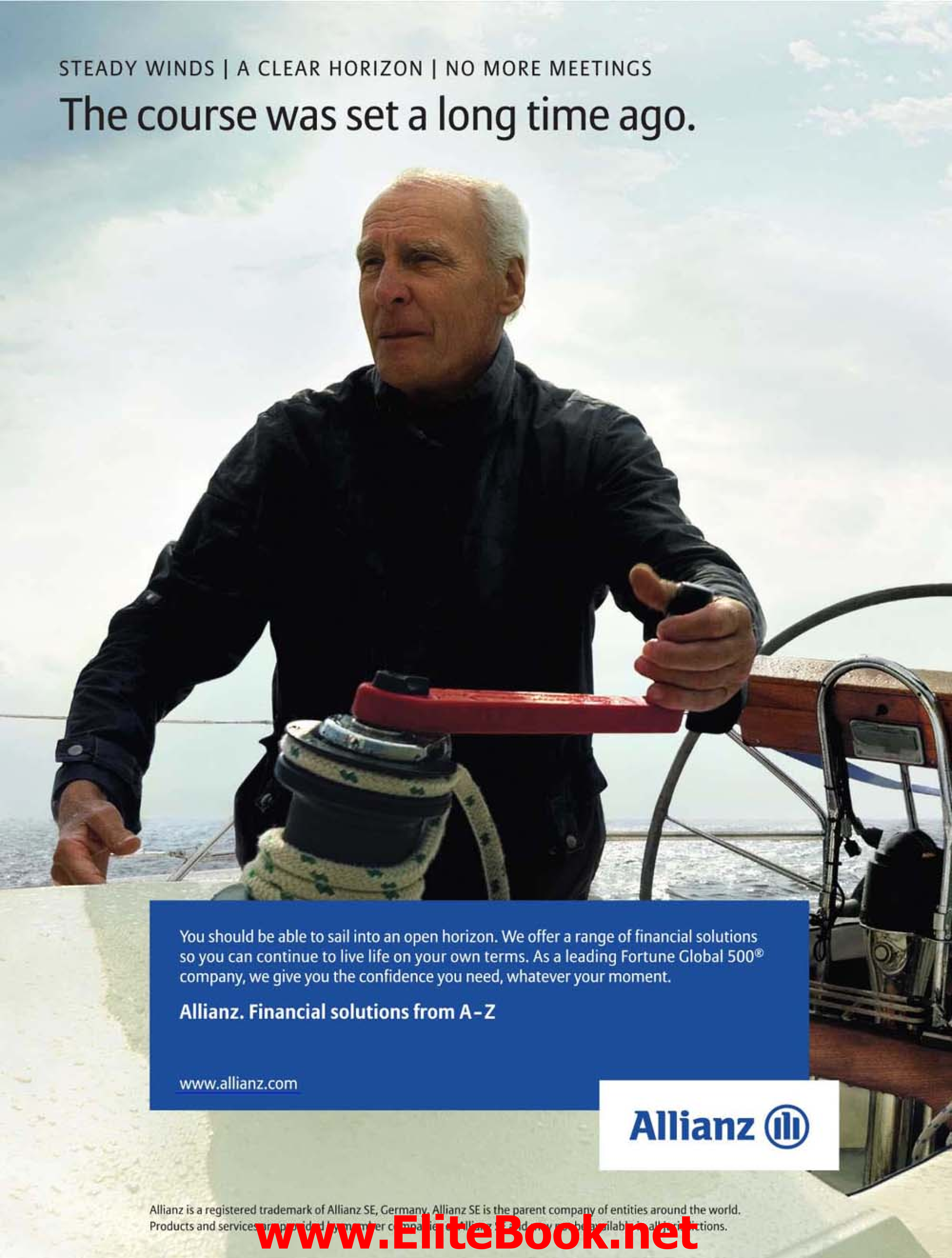
6 Extract these deciles from your mashed document (or your manually compiled file) to begin to analyze what customer characteristics make these your most and least profitable customers.

Building Your Incumbent's Advantage

In our simplified example, Mix C-Ment uncovers opportunities from the trade-offs involved within a single product category. The reality for most market-leading companies is, of course, more complex, involving myriad products, each with its own P&L, sales staff, and market-research data. This fragmented structure is what gives so much aid and comfort to disrupters: In a company beset with product managers, no one owns the customers, so the invader can – and often will – progressively take possession of vulnerable segments.

Particularly if an attack focuses on customers who buy more than one type of product, no single product manager may feel terribly threatened. Attackers targeting customer segments that cut across product groups might provoke a response from the individual salespeople covering specific products and accounts. But so long as accounts *not* under attack are growing and the sales force is hitting its overall targets, the cross-product competitive assault is hard to spot and easy to disregard. In fact, in many companies there's no way for managers of different products to compare notes and recognize that an invader is making serious inroads.

How, then, should such an incumbent start to uncover its advantage? The answers lie in how it exploits its informa-


STEADY WINDS | A CLEAR HORIZON | NO MORE MEETINGS
The course was set a long time ago.
You should be able to sail into an open horizon. We offer a range of financial solutions so you can continue to live life on your own terms. As a leading Fortune Global 500® company, we give you the confidence you need, whatever your moment.
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tion and how it begins to organize its corporate structures around customer segments' needs.

Creating your information advantage. Let's start with what not to do. First, don't build a customer-segment database from scratch. That's a massive undertaking, and all such efforts we're aware of have failed miserably. Apart from questions of size, expense, and complexity, you really can't know from the outset what the final database structure should be, and in today's dynamic markets it will be obsolete before it is completed. We suggest using a discovery-driven approach: Start with low-cost analyses of existing databases from which you can extract profits quickly; then move on to ever more refined and broader database assemblies, which also will pay for themselves handsomely along the way. Second, do not obsess over accuracy at the beginning. By the time your data are pristine, they will have become obsolete. In identifying your major customer segments, aim to be roughly right rather than precisely wrong. (For more about discovery-driven approaches to strategy, see "Discovery-Driven Planning," by Rita Gunther McGrath and Ian C. MacMillan, HBR July–August 1995.)

That said, we do recommend a specific place to focus your efforts: In our observation of dozens of companies, we have found that the most profitable top two deciles of customers generate more than 150% of the annual profits; the bottom two deciles lose an amount equal to the company's entire profits. To compensate for every top-20% customer who defects, we've found, a company may have to acquire roughly 10 to 25 new customers of average profitability. So it's critical to fully satisfy and retain everyone in the top two deciles. And getting the bottom tail to the point where you just break even would add 100% to the company profits! All of the action, then, is in the tails.

Initially build your candidate customer segments using the characteristics and behavior that you can extract from your own records. You could, for

example, pool all the information about which products your customers are buying, as well as where, when, and in what quantities. Then look at return, repair, and complaint records – as well as accounts-payable, service-call, and sales-call data – in order to see which customers are delivering the most to your total contribution, and which the least. Constructing a relatively simple customer-characteristics database in this way will allow you to rank your customers according to their profitability. (See the sidebar "Identifying Your Most and Least Profitable Customers.")

Next, focus on the top and bottom two deciles, following these steps:

1. Use regression analysis to uncover statistically significant relationships among customers' profitability; their behavior, such as purchase frequency, purchase combinations, returns, and service demands; and their demographic characteristics, such as age, income, and industry classification. (Your marketing and finance teams should be able to do this simple analysis for you.)

2. Have your teams perform a cluster analysis in order to group similar individuals into candidate customer segments, using the characteristics from the regression that are most closely associated with profitability in the most profitable cohort and with unprofitability in the least profitable cohort.

3. Identify actions that can reduce losses from profit-eating customers and can prevent defections by the most profitable customers. For instance, at a distribution company, we found a substantial group of unprofitable customers: small contractors who took months to pay, not because they wouldn't but because they couldn't – they frequently had to wait for their customers to pay them first. The distributor cut a deal with the contractors: a higher price in exchange for delayed payment, and a significant discount for early payment. The deal made everyone happier and more profitable.

4. Rank the actions you identify in step three in order of their potential to improve your company's profits. Then

give a designated manager a mandate to develop within 30 days, and implement within 60 days, a plan for the most promising actions.

5. Delve further by doing more-detailed research on what additional resources your candidate segments consume that were not part of the initial profit-contribution calculation. These resources include marketing, R&D, sales staff, service, and retail personnel.

6. Based on the insights you gain from steps one through five, identify preliminary needs-based customer segments. Consider these to be merely candidate segments until more-complete analysis, based on detailed customer interviews, validates your hypotheses about the segments' needs. Assign each candidate segment to a small cross-functional team charged with finding ways to significantly increase the segment's profit contribution – for example, by reconfiguring offerings, modifying delivery, altering price, or revising investment, marketing, and service resources.

7. As you better understand these candidate segments and they become more profitable, you can start to expand your customer-centric information system to include the middle deciles of customers. The gains you make will greatly outpace the costs you incur, especially in the early stages. Keep going as long as the cost/benefit balance remains in your favor.

Understanding the economics of your most and least profitable customers, and then assigning teams to find ways to quickly stem losses and retain the most profitable customers, will give you powerful insights into your incumbent's advantage. It will also lay the foundation for your customer-centric information base; that, in turn, will enable you to track the performance of your customer segments with the same level of detail you currently use to track your product groups and geographies.

Firms vary in the techniques they employ to scale up this type of information base. Some begin with a small pilot database similar to what we've just described, then steadily add in more customers and customer data from other sources, such as sales and service people in the field, distributors and other service providers, and interviews with customers from various segments. Others start with a simple proof of concept: bringing key players from across the organization together on a small scale to, first, judiciously identify one or two underserved candidate customer segments and to, then, target those segments with different combinations of product, service, and experience offerings. A crucial transition is the one from candidate customer segments to truly robust needs-based segments. If results are promising, management starts investing to create a customer-centric information system that can support a larger-scale effort.

Failing to capitalize on the incumbent's advantage is to invite almost certain competitive disruption.

However you build the system, its purpose should be to yield comprehensive customer-profitability analyses by assembling the required inputs for revenue, costs, and capital at the customer-segment level. Companies are accustomed to viewing sources of revenue by product or geography, not by customer segment. This lack of attention to segments is even more pronounced when it comes to customers' demands for marketing support and technical services, and segments are almost never a factor in analyzing capital and asset costs.

Different customer segments can have very different requirements for such capital items as inventory, systems, and equipment – with potentially dramatic effects on each segment's profitability. Invaders have great difficulty unearthing this type of information. And as our Mix C-Ment example shows, it's critical to shift from thinking in terms of cost allocation to viewing costs strategically as customer investments. Expenditures on market research, marketing, and service are true costs only when thoughtlessly allocated evenly across the board. Eventually it becomes clear that a wide range of costs can be profitably tracked – and strategically invested in different customer segments. Among these are call-center and website maintenance costs, which many firms have; claims-processing costs for insurers; defaults for credit card firms; warranties for manufacturers; and salespeople, stock clerks, and cashiers for retailers.

Organizing to exploit your advantage. After progressing from first-pass candidate customer segments to more rigorously identified needs-based segments and then using the latter to categorize your data, you can begin to build corresponding business units. Again, we are not recommending that you invent a whole new organizational structure – by the time the design is perfect, it will be obsolete. We're instead proposing a discovery-driven process that is similar, in its evolutionary nature, to the process of developing of a customer-centric information system.

Cross-functional teams that were assembled to build your initial information-advantage database can be used to form the core of an evolving customer-segment organizational structure. Initially, provide these teams with the budget and human resources to conduct experiments with pilot subgroups of customers in their segments. As the nature and needs of the segments become clearer, focus the teams on growing their profitability. Where segment teams' decisions conflict with those of traditional managers in the existing product-based organization, identify the root causes and be prepared to adjudicate disputes.

When the segments begin to generate meaningful profit growth, assign current product managers responsibility for supporting the segment teams. In time, a dynamic customer-centric information system and a segment-based corporate structure will emerge; together they will allow you and your executive team to make smarter resource investments, based on better information about the needs and performance of individual customer segments. The final result will be a mutually beneficial exchange of value between your firm and your key customer segments.

...

If you run a large company with major market share, you probably already have customers from practically every relevant segment. Not to know them, not to understand their unmet needs, and not to invest resources based on those needs is to cede one of your most important assets to potential challengers. The incumbent that uses customer research to plumb the needs of its key segments and then builds resource-investment programs to serve them will have a huge advantage over competitors and aspiring invaders. This opportunity to substantially grow profits is open to any major player in its targeted markets. Conversely, failing to capitalize on the incumbent's advantage is to invite, sooner or later, almost certain competitive disruption. Even if this attack doesn't happen on your watch, it is an unforgivable legacy to leave for your hapless successor.

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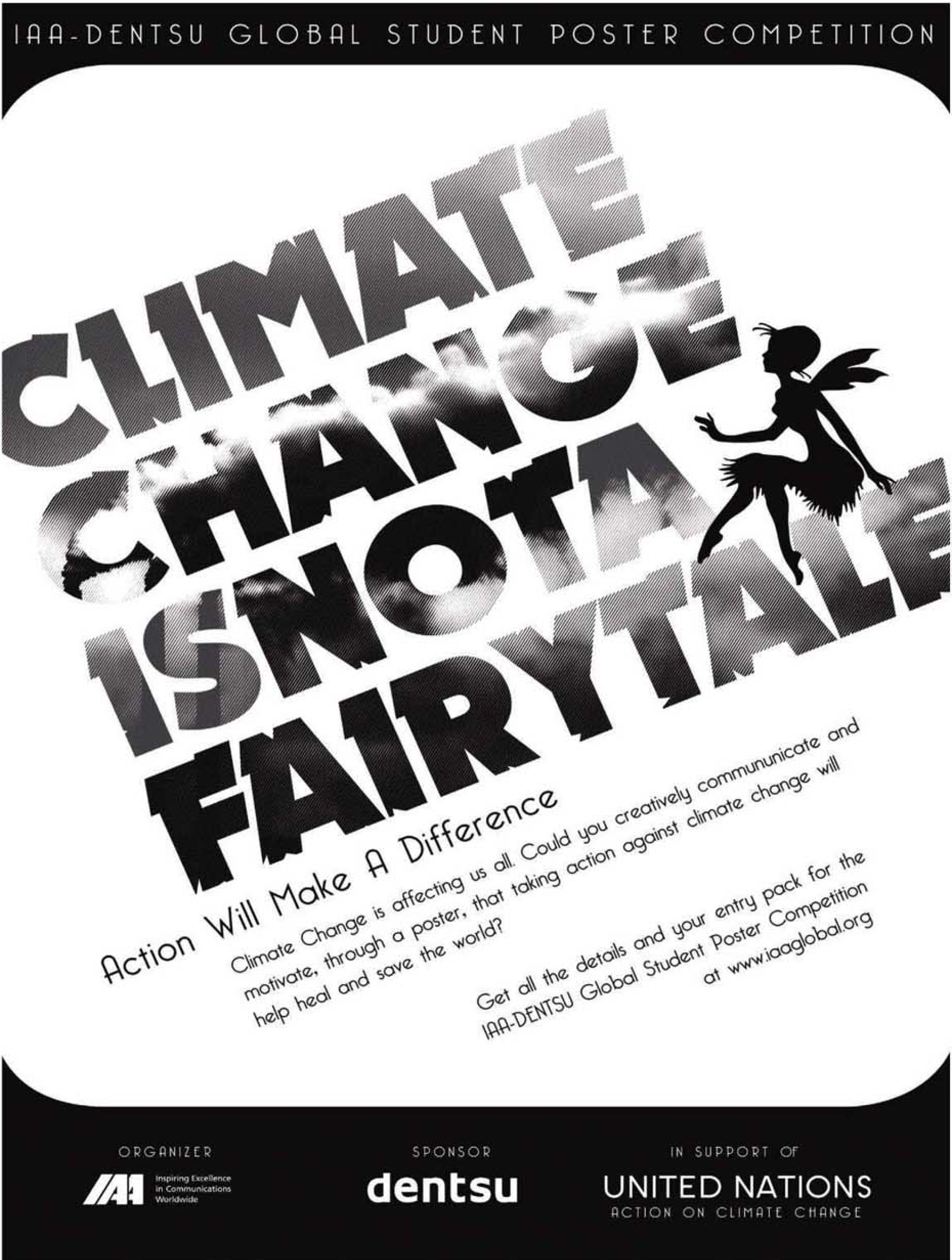
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HBR at Large

BY LEW McCREARY

What Was Privacy?

Privacy as we knew it is virtually gone. Why should you care? What should your business do about it?

AS BEST HE CAN, Logan Roots safeguards his privacy by living off the information grid. In a short article in *CSO* magazine (which serves an audience of top security executives), Roots defined privacy as "the freedom to selectively reveal one's self." He described going to great lengths to preserve that freedom by actively frustrating the mechanisms that collect those spores of fact most of us routinely release about ourselves.

"I pay in cash and use false names for as many goods and services as possible," Roots told *CSO* in 2003. "I'm even in a local pool of people who swap [grocery store] club cards....For the past few months I've been using the card of a person who died two years ago. I'm almost sad it's time to switch cards again. I love the dead thing so much."

Most answers to the question "What is privacy?" begin with the individual (usually a living one). Privacy is partly a form of self-possession – custody of the facts of one's life, from strings of digits to tastes and preferences. Matters of personal health and finance, everyone agrees, are in most instances nobody's business but our own – unless we decide otherwise. This version of privacy considers everything we know about ourselves and wish to control but that the continuous capture of our digital existence – the Google searches, the e-mail traffic, the commercial transactions, the cookie-tracked footprints of treks through cyberspace – makes increasingly uncontrollable. All of this behavioral cast-off is the raw material for a granular understanding of what we want or need (whether we know it or not), what we will or won't put up with, and what we might buy or undertake to do – now and in the future.

Today's highly efficient data-gathering and -disseminating mechanisms provoke another, rueful question: "What

Daniel Chang

was privacy?" The answer may be that people could once feel confident that what others might find out about them would be treated with reasonable care and consideration, and thus would probably do them no harm. They can no longer. Moreover, the frictionless ease with which government records can now be found online means that reckless-driving citations and SEC violations are accessible to just about anyone.

The face-off between information privacy and information exploitation is a storm ever in the making. Judicial remedies are unlikely to produce a satisfying or sensible balance between companies' economic prerogatives and customers' privacy interest. New technologies – too heedlessly adopted or opportunistically applied – will continue to threaten personal privacy. Business will have to find ways to address this uneasiness. If companies remain complacent, underestimating the degree to which privacy matters to customers, harsh regulation may be waiting in the wings. The best way out is for businesses and customers to negotiate directly over where to draw the lines.

The Shaming of "Dog Poop Girl"

In times past, information flowed fairly inefficiently to a manageably small circle of people. No longer. Daniel J. Solove, an expert in privacy law and an associate professor at George Washington University Law School, begins his 2007 book, *The Future of Reputation: Gossip, Rumor, and Privacy on the Internet,* with an anecdote about a woman in South Korea whose little dog pooped on a subway train. When fellow passengers demanded that she clean up the mess, she told them to mind their own business. One of them took pictures of her and posted them online. She was identified from the pictures, and her life and past were investigated. Eventually she became known throughout cyberspace as "dog poop girl." Solove writes, "Across the Internet, people made posters with the girl's photograph, fusing her picture with a variety of other images. The dog poop girl story quickly migrated to the mainstream media, becoming national news in South Korea. As a result of her public shaming and embarrassment, the dog poop girl dropped out of her university."

Solove's book goes on to chronicle issues of law, civility, and technological capability that are raised by this very modern tale. Among them is the question of whether any act that occurs in a public space strips the parties involved of a right to expect privacy. Solove argues for developing a new definition of privacy to account for the possibility that behavior by someone like dog poop girl can be spread beyond those immediately affected to reach millions of people worldwide. "The Internet," Solove writes, "is indeed a cruel historian. Who wants to go through life forever known as the dog poop girl?"

The intersection of private lives and public spaces brings to the fore a second version of privacy: that it is a feature of the social contract – one that every culture has negotiated for itself over time in order to preserve dignity, civility, and cohesion. In small towns or close-knit social circles, everyone may know quite a lot about everyone else, but all tacitly agree to pretend not to know certain things to which unusual sensitivity attaches.

The two views of privacy come together in David Weinberger, a fellow at the Berkman Center for Internet & Society at Harvard. Weinberger understands people's wish to control their personal information – "Politically, I'm in favor of it" – but he thinks that's only one piece

ARTICLE AT A GLANCE

- **Privacy is not a fixed value. It evolves under pressure from new technologies, shifting social priorities, and changes in generational norms of reticence and risk taking.**
- **Despite the evidence of self-exposure on such websites as Facebook and YouTube, it would be a mistake to think that people now place a low value on privacy.**
- **Businesses should pay close heed to their customers in developing guidelines and practices for the use of potentially sensitive personal information.**

BACKGROUND

Great and Not-So-Great Landmarks in Privacy History

Privacy Enhancement

- Fences, walls, shades, and blinds
- Cash, which confers the benefits of anonymity on commercial transactions
- Sealing wax
- Steganography – a variety of techniques (invisible ink is one) for hiding unencrypted text

- The Bill of Rights
- An 1890 article in the *Harvard Law Review* by Louis D. Brandeis and Samuel D. Warren. The authors argued that individuals have the right to an "inviolate personality" and a broader "right to be let alone." (Jeffrey Rosen discusses the article at length in his book *The Unwanted Gaze.*)
- The 1980 Organisation for Economic Cooperation and Development privacy guidelines: aimed at "harmonizing" the privacy laws of member nations so as not to disrupt the trans-border flow of information

of privacy, and a reductive one at that. "I don't like to talk about privacy that way," he says, "because it seems to reduce the public and the private to a matter of what information we give out."

Instead, he believes, something more basic is at work: "Namely, that we are fundamentally social creatures – insofar as we're creatures who talk and interact. We're inconceivable *not* being social." Thus norms around privacy dictate that "in some circumstances we're not allowed to notice, we're not allowed to eavesdrop, and in others we can."

Weinberger points to walking down the street and encountering people engaged in various sorts of social interaction, each of which "comes with its own set of norms about privacy, which competent, non-crazy citizens understand and obey." If two people are engaged in conversation, he says, "the norms are quite clear about whether you are allowed to listen to them or not." In fact, you *are* allowed to listen (you often can't help it) – "you're just not allowed to *notice* it."

Failure to comply with these norms can be hazardous. For example, on an airplane earlier this year I couldn't help noticing that the man across the aisle from me was having a high-testosterone business conversation on his cell phone (we were still at the gate). The passenger directly behind him bravely, if imprudently, interrupted to ask if maybe the guy could take it down a notch. "Hold on a second," said Testosterone Man into his phone. "I got some jerk talking to me." Then he spun around in his seat and instructed his fellow passenger to "sit the hell down and shut the hell up" (or words to that effect).

According to Weinberger, we are now in the midst of a widespread cultural adjustment involving privacy. New technologies upheave old norms, and new norms need to be negotiated – a process that takes time. If the social contract obliges us to ignore some of what we learn in public settings about others' private lives, new technologies can mightily complicate that obligation.

Who Speaks for Privacy?

When a hiring manager Googles a job candidate (see "We Googled You," HBR June 2007), Weinberger says, "Google will find every mention of the person, including stuff that if you were walking

required for economic development

- Electronic Communications Privacy Act of 1986: extends protection against warrantless wiretaps to computer communications. (Does not prohibit employers from freely accessing employee communications over corporate computer networks.)
- Employee Polygraph Protection Act of 1988: prohibits employers from subjecting current or prospective employees to lie-detection tests. (Government agencies and contractors and some others are exempt.)
- In March 1999 President Bill Clinton appointed Peter Swire, a professor at Ohio State University's law school, the federal government's first privacy official.
- In 2003 Nuala O'Connor Kelly was named the first chief privacy officer of the Department of Homeland Security. (She stepped down in 2005, winning praise from privacy advocates for having done her best despite obvious institutional constraints.)
- In June 2003 the Federal Communications Commission inaugurated the National Do Not Call Registry. To date, more

down the street and stumbled upon you would just ignore. Google does not do the ignoring for you. It's all presented and has equal weight: the Boy Scout merit award and the arrest for urinating in public. Because that's how information is – it's all just bits – and the software can't make those decisions for us."

Because Weinberger sees privacy through a social lens, his solution to the problem of Google's indiscriminate presentation of information is that consumers of search results should learn to ignore unwanted or immaterial information: "What I'm hoping is that businesses will develop more of a sense of forgiveness" and put the results in perspective. It's a learning process, he says, because the juxtapositions – merit badges, public urination – are potentially jarring. "We're so used to accepting a squeaky-clean, self-constructed résumé as a representation of a person, but that has little resemblance to the flawed, messy selves that we all in fact are. So here we have this disgorging of information that is without regard to seemliness."

>> **hbr.org**

Hear what HBR senior editor Lew McCreary has to say about privacy issues at **privacy.hbr.org**.

Jeffrey Rosen knows something about what's seemly and what's not. Rosen, like Daniel Solove, is a professor at George Washington University Law School. He writes about threats to privacy in his books *The Unwanted Gaze: The Destruction of Privacy in America* and *The Naked Crowd: Reclaiming Security and Freedom in an Anxious Age.* At the center of the former is his analysis of the Kenneth Starr investigation, which ultimately led to the impeachment, trial, and acquittal of President Bill Clinton. Rosen credits Starr with having focused attention anew on "how little our legal system cares about privacy today and how much more robustly intimate secrets were protected in the not-so-distant past." Starr, says Rosen, was operating according to relatively new norms suggesting that the private conduct of public figures is fair game for public exposure.

Rosen writes about literal exposure in *The Naked Crowd,* beginning that book with descriptions of two actual prototypes for a passenger screening machine: The "naked machine" sees through clothing to produce an anatomically exact image of the person being screened; the "blob machine" produces an amorphous, desexualized representation of the person. Both versions capably do what they were designed to do: detect concealed weapons and other security threats. Rosen insists not just that it's preferable to pick solutions that best protect privacy, but that privacy protection should be built into every process and technology. Indeed, the thesis of his book is that most if not all important security objectives can be achieved without unduly compromising privacy.

But someone will always have to speak for privacy, because it doesn't naturally rise to the top of most consideration sets, whether in government or in the private sector.

There's a reason for that. The privacy writer and researcher Alan F. Westin famously created a bell curve showing how concern about privacy has changed over time among three groups: fundamentalists (absolutists of the Logan Roots camp), pragmatists (those who worry about threats to privacy but believe that reasonable safeguards are in place or can be created), and the unconcerned (those who give privacy little thought). In Westin's surveys, fundamentalists made up only 15% to 25% of those polled.

"I guess if I have an evangelizing message for business," Rosen said in a recent interview, "it's that companies can't expect that the public debate will solve all their problems. They'd do better to behave proactively and devise data-sharing and -collection regimes that won't get them into trouble down the line – both because that's the responsible thing to do and because they really might be embarrassed if they don't."

Chief *What* Officer?

Some businesses internalized that message a long time ago. Harriet Pearson is IBM's chief privacy officer, a role she assumed in 2000, when Lou Gerstner was CEO. Gerstner was "convinced that as the Web emerged as a business platform, companies – particularly one such as IBM – had to lead on privacy," Pearson says. "We were at an inflection

than 157 million phone numbers have been listed.

- In July 2003 California Senate Bill 1386 mandated that security breaches compromising citizens' personal information be disclosed as soon as they are detected.
- In 2005 IBM announced a policy forswearing the use of employees' genetic information in hiring and benefits decisions.
In May 2008 legislation with provisions similar to IBM's was passed by Congress and signed into law by George W. Bush as the Genetic Information Nondiscrimination Act.

Privacy Erosion

- Spyglasses, binoculars, telephoto lenses, spy satellites – technological enablers of surveillance, reconnaissance, and espionage. (Critics today object to the fact that Google Earth and Google Maps now feature "Street View" photos of private homes, sometimes even revealing the occupants within.)
- In 1763 soldiers of King George III confiscated John Wilkes's private diaries from his London home. In *The Unwanted Gaze,* Rosen writes that this and other government invasions of privacy inspired the Bill of Rights' prohibition against unrea-

point with respect to the pervasiveness of technology in business processes, and he correctly judged that IBM needed to use its leadership on that issue to support our initiatives on e-commerce."

Pearson spent her early career as an engineer for Shell Oil, went to law school, practiced environmental law for a while after graduating, and joined IBM's government-affairs office in Washington in 1993. With no background in privacy issues, she delved into IBM's internal files on the subject and discovered that the company had hired the young Alan Westin in the 1960s to help it develop global privacy principles to govern human resources practice. As a result, at a relatively early date IBM "majored a lot on workforce privacy," Pearson says. "We were among the first to say that when we're interviewing an employee for a job, we have no reason to ask about their religion, what country club they belong to. Those questions used to be commonplace. And we said no, that's not relevant."

In 2005, under Chairman and CEO Sam Palmisano's leadership, IBM adopted a forward-looking global policy that forswore the use of employees' genetic profiles in making decisions about hiring or access to health insurance and other benefits. Pearson credits IBM's own "DNA" in issues of employee privacy and nondiscrimination for the logic behind its policy on genetic profiling. "There's a direct line that I can draw back to our history in the 1950s and 1960s that is consistent with who we are as a company," she says. (In May 2008 George Bush signed into law the Genetic Information Nondiscrimination Act. IBM's early support facilitated its passage.)

IBM's manifold adventures in new technology – including systems for accelerating genomic research and pharmacological innovation – enable it to foresee developments that have implications for privacy. Pearson says it's part of her job to scan company and industry horizons for potentially gnarly situations: "My business needs make me as likely, in one day, to be looking at genetics and RFID, and what they mean for privacy issues, as at data privacy and security issues associated with global business processes and the emergence of what's being called 'cloud computing.'"

IBM sees revenue potential in RFID but also understands that it's a controversial technology from a privacy standpoint, Pearson says. "So we have worked in a number of places – including technical standards, but also with policy folks here in DC – to create best practices for the implementation of RFID. And we've recommended these to our partners in business. Although we ultimately do not control how these technologies are implemented, we can sure influence our part of the ecosystem. It is in our interest to do this, just as I would argue that it is in the interest of enlightened business leaders to consider where their business models intersect with this human need – human expectation – for privacy, and the legal obligations that they may have, and figure out how to make the connection in a good way." (See the sidebar "Privacy Checklist for Business.")

All Google results are juxtaposed: the Boy Scout merit award and the arrest for urinating in public.

About seven years ago Pearson found herself at an informal gathering with half a dozen other privacy executives. The positions they occupied were in many cases newly created and not well defined (some had broad responsibilities, whereas others dealt mainly with compliance), and they all found it helpful to compare notes and share ideas. They decided to start an organization – now known as the International Association of Privacy Professionals (privacyassociation.org) – whose membership has since grown to more than 5,000.

That growth rate reflects more than just a greater appreciation of privacy

sonable search and seizure.

- Credit and debit cards, which engender digital records of individual transactions. Researchers are looking for ways to restore anonymity to these transactions, perhaps by using trusted third parties, as in the PayPal model.

- The invention of spam. The earliest known spam e-mail was sent to 393 recipients in 1978 over the internet's forebear, ARPANET. (The sender was publicizing the launch of a new Digital Equipment computer.) By some estimates, spammers now send in excess of 100 billion messages a day, but the once-exponential growth rate of spamming has tapered off in recent years.
- The internet, which was developed within a trusted community of academic researchers and established without privacy standards.
- In 1999 Scott McNealy, a cofounder of Sun Microsystems, was famously quoted in *Wired* as saying, "You have zero privacy anyway. Get over it."

YouTube and Facebook teem with private lives recast as performance art.

protection as a business responsibility: The stakes of failure have ratcheted up. "Before 2004," Pearson says, "you could collect people's information and do whatever you wanted to with it, within reason. If it fell off the backs of trucks, or if it got lost or penetrated, no harm, no foul. Nobody needed to know." Now almost *everybody* needs to know.

In 2003 California passed legislation mandating breach disclosure for businesses with customers living in the state. Companies were obligated to alert them to a breach at the earliest reasonable moment after it was discovered. Since then, most other states (close to 40 and counting) have adopted similar measures, adding to the corporate compliance burden and moving privacy protection to the foreground. "It has fundamentally shifted the risk equation," Pearson says of this spate of legislation. Apart from the costs of notification, mandatory disclosure exposes businesses to reputational damage that is no less real for being difficult to calculate.

Exhibitionism as Opportunity?

It would be hard to prove that people now assign a lower value to their privacy than they did in the past. But attitudes toward privacy are shifting, abetted by new technologies – some scary and others exhilarating – that generate new threats to privacy and new forms of online self-exposure that appear to disregard them. YouTube and Facebook teem with private lives recast as performance art. Is this a phenomenon that businesses can freely exploit?

If, says Pearson, "your bent is an operational and risk-management one," it becomes a question of "how to minimize your risk and balance that with your need to have this information." In other words, will pursuing a particular opportunity do the business more good than harm, or vice versa?

Jim Buckmaster, the CEO of the successful classifieds website Craigslist, describes erring on the side of almost total nonexploitation. "There's all kinds of things that we don't do," he says, "and the short answer to why we don't do them is that we're as close to 100% user driven as you can get. The reality is that users don't ask us to analyze their behavior patterns."

Buckmaster and Craigslist founder Craig Newmark have raised eyebrows by declaring that their company is uninterested in maximizing revenue. Defaulting to an extremely conservative position on privacy is thus fairly straightforward for them. "Most companies are trying to maximize revenue, and you can make money from people's personal information if you care to," Buckmaster says. "Since we're not trying to maximize revenue, we really have no incentive or interest in doing that. So we don't have the kind of conflict of interest that most companies do have."

The Craigslist perspective is useful mainly as a bracing counterpoint to normal: Few companies can duplicate Buckmaster's nullification of the usual risk-management calculation. Facebook, for example, ran afoul of this calculation late in 2007. Its default position was that the product preferences Facebook users expressed to their friends could be freely shared with advertisers. The company had guessed wrong about whether its users would mind; it had to change the default from yes to no and introduce more-aggressive privacy protection on the site. The lesson? When friends exchange information as a form of social lubricant, they see its appropriation for commercial purposes as an invasion of privacy.

A Generation Gap

What matters in the realm of privacy may be generationally colored, with attitudes shifting over time. I came to consider this possibility after a personal epiphany involving the proliferation of surveillance cameras. Several years ago

- The USA Patriot Act of 2001: made it easier for intelligence and law-enforcement agencies to monitor communications, conduct surveillance, regulate financial transactions, and tighten standards for admitting foreign nationals into the United States. The legislation, written and quickly passed in the long shadow of the 9/11 attacks, reflected a new emphasis on security as an urgent priority surpassing other social values.
- Any point of failure in a giant database makes it vulnerable to breaches. (After 9/11, Oracle CEO Larry Ellison offered to develop the software for a single identity-card database to help fight terrorism.)
- Retailer loyalty cards – the key to accumulating information on what you buy
- An increasingly pervasive surveillance culture. London alone has roughly 500,000 CCTV cameras – 42 of them reportedly within a block of the flat in which George Orwell wrote *1984*.
- Breaches at TJX and other companies, some of which had grossly inadequate security measures or had retained sensitive information that should have been purged


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my mother and I were watching a CNN segment that showed surveillance footage, taken in a Wal-Mart parking lot, of a woman smacking her child around in the backseat of her car. We both found the scene troubling, but for very different reasons. Whereas I was appalled at the woman's behavior, my mother was shocked that the camera was there to witness it. (I can't say I approve of the spread of cameras into public spaces, but I've come to accept them as accessories of modern life.)

My mother, animated by a libertarian streak, worried about cameras invading her privacy. I, like many parents, worry more about the apparent epidemic of self-exposure among younger citizens of the internet as they post their party videos and snapshots, thereby generating potentially troubling future Google search results. Can people invade their own privacy? When, not so many years from now, HR apparatchiks go fishing for the indiscretions of would-be hires, will they have developed the sophisticated forgiveness that David Weinberger proposes?

Harriet Pearson has a Facebook page. So do many of my colleagues. So do I, for that matter. To the dismay of my daughters and stepdaughters and their legions of college-age peers, elders have colonized growing outposts on social networks originally conceived exclusively for the young. The *Lord of the Flies* world of social networking is at last getting an influx of adult supervision. How will that accelerate – or at least affect – the emergence of social norms with respect to privacy?

It may be that Google-search forgiveness will come naturally only to the digital-native generation. The rest of us will have to unlearn older ways. Time will normalize the consequences of this social change as it has of all others. Meanwhile, small chattering tribes of "friends" will happily share the names of their favorite books, movies, bands and songs, brands of beer, lipsticks, condoms – and many other things worth caring about if you're a marketer looking

IN PRACTICE

Privacy Checklist for Business

by Harriet Pearson, *IBM's chief privacy officer and a vice president of its Legal and Regulatory Affairs group*

❑ **Align privacy with strategy.**
It is especially important for businesses that have highly valued brands or that compete in information-intensive industries (including health care, finance, and high tech) to take a leadership stance on privacy and data protection.

❑ **Look beyond rules to values.**
Embedding privacy and security values in your corporate culture will yield a bigger return than the most comprehensive set of rules. When values are developed from the bottom up, they will be lived, not just recited.

❑ **Anticipate issues.**
It should be someone's job to scan for products or practices in your business or industry that raise legitimate privacy concerns, and to collaborate with stakeholders to develop reasonable solutions. Be prepared to work across the industry as well as internally.

❑ **Create accountability.**
The role of a privacy or security officer is to unite and coordinate efforts across silos. All those involved in setting and implementing information policies, including the head of HR, the CIO, and the marketing VP, are potential participants – but someone has to be accountable.

❑ **Don't conflate security and privacy.**
Getting privacy right in a business context means meeting societal or regulatory expectations for what type of information is collected, how much, with whom it's shared, how it's used and protected, and how long it's retained. Resist the temptation to focus solely on data security.

❑ **Treat privacy as a social responsibility.**
In globally connected, information-rich societies, privacy and data protection belong on the corporate citizenship agenda alongside the environment, diversity, and other important issues.

❑ **Manage your data supply chain.**
Data-handling obligations flow with data that cross corporate or national boundaries. Business ecosystems that include global sources of talent and services need standards for data management that can rationalize an international patchwork of expectations and regulations.

❑ **Rely on technology when appropriate.**
It can't substitute for leadership, common sense, and good policies, but simple tools (automated checklists, encryption, audit logs) can do wonders to enable compliance. And emerging capabilities – face masking in digital surveillance systems, privacy-preserving data mining – can help resolve conflicts between information use and privacy.

❑ **Plan for disaster recovery.**
No information system is fail-safe. In case of a data loss or breach, have a rehearsed response that addresses technical, individual, legal, and other needs.

❑ **Heed both boomers and millennials.**
The under-25 crowd is not dismissive of privacy, but it does embrace online, collaborative work and play. Your privacy thinking must span a range of generational norms and expectations. One employee may freely post pictures and personal information online but recoil from having an employer or the government collect a biometric for identification, while another does just the opposite.

for insights or a "coolhunter" looking for undiscovered trends.

Jim Buckmaster finds the social-networking phenomenon inspiring in its adventurousness. "Kids are having a lot of fun with social networking. For a certain personality type, it may be easier to connect socially with the aid of an internet site than in the real world. In that sense, I think it's probably a great thing."

Nonetheless, Buckmaster likens teenagers' online excesses to the perennial problem of young drivers who flirt with disaster. "People's appreciation for risk doesn't fully develop until they're in their thirties or maybe forties. You see that all over the place. With respect to driving automobiles, there just isn't any way of getting around the fact that 16-, 17-, 18-year-olds are a lot more likely to get into a serious accident than someone who's 30 or 40. And part of that's due to their inability to appreciate risk." As young people age, Buckmaster believes, their attitudes toward risk will change.

"I don't know that one can be judgmental about it," Pearson says. "It's just that it's happening. From a businessperson's perspective, what does it mean? It's huge. If you're building business models to take advantage of online advertising, or trying to get closer to consumers, it's a huge opening." However, she hastens to add, potentially confounding privacy nuances need to be worked out.

Working Out the Nuances

Part of the solution lies in behavior (individual, corporate, social), and part is technical. The technical part, albeit daunting, is sure to be easier than – but not unrelated to – the behavioral part. When it comes to privacy, technology should focus on compensating for human beings' tendency to follow the paths of least resistance. The rap on internet security has always been that ordinary mortals of modest technical ability can't possibly implement it without the help of an IT department. Thus vast swaths of the online user base do without the robust protections – mainly encryption – that would shield their information from identity thieves.

IBM and a consortium of software vendors (working through the nonprofit Eclipse Foundation) are involved in an open-source project known as Higgins.

> Higgins enables users to have potentially anonymous online presences – think PayPal for identity.

Higgins enables users to have potentially anonymous online presences that mask their personal information while a reliable third party vouches for their legitimacy – think PayPal for identity. It's designed to be flexible – to go with you from site to site and be adjustable so that you can allow some sites to know more about you than others.

Amazon's algorithms have collected plenty of information about my taste in books, music, and DVDs. Can I trust its employees not to misuse what they know about me? I'd like to think I can, but I don't know for sure. Would I henceforth prefer a Higgins-like disguise when I shop there? Maybe so. But that won't expunge my legacy data from the many sites on which I have disclosed personal information – either indirectly or explicitly. That problem is perhaps less amenable to an elegant solution. The natural temptation for a business is to treat customer data as a serendipitous source of opportunity. But retaining customers' or any other sensitive personal information is potentially costly – and, as TJX and other companies have learned, potentially risky. (In December 2006 some 94 million payment card numbers of TJX customers were stolen by a small band of not particularly gifted hackers.)

Apart from the regulatory hammer of breach-disclosure legislation, what data safeguards can businesses expect to see develop? Privacy attitudes and initiatives may well change in the United States when a new administration takes office in January 2009. But no matter which candidate prevails, Pearson anticipates at least a push to make accessing patients' online medical records more difficult. Likewise, she says, the Privacy Act will probably be amended in an effort by government "to restrain itself from having so much free access to information."

The U.S. Federal Trade Commission has proposed voluntary guidelines to help protect consumers against unwanted privacy violations arising from ad targeting based on online-behavior analysis. Among other things, the guidelines propose that websites that collect data for this purpose should make it easy for users to opt out (as Facebook essentially did when it changed its default option); should provide adequate security for all collected data (and put time limits on its retention); and should collect sensitive data – about medical conditions, for example – only after getting consumers' express consent to receive related advertising. Being voluntary, the FTC guidelines are toothless – and they simply distill the commonsense principles adhered to by most responsible websites. Moreover, privacy researchers versed in the technical issues related to cookies note that security software can render the opt-out process unreliable – data may keep being gathered after consumers think they've turned off the faucet.

Privacy law in Europe is likely to be modified to reflect changing models of information collection and sharing. And we can expect privacy to grow in importance in China, India, and the Philippines – which are ever more tightly knit into the global information flow – as those societies come to grips with the demand for greater transparency as a condition of participation in international markets.

Why Privacy Matters

One might conclude that privacy divides the world into optimists and pessimists. Optimists trust that their information will be treated responsibly and with sensitivity; pessimists expect to be attacked by unethical or exploitative sharks. That notion points us back to David Weinberger. Privacy is less a matter of exerting control over our information than of expecting society to continually evolve solutions that allow us to live together in a more or less civilized state.

Privacy matters because the social fabric depends on it to a great extent. A sophisticated understanding of privacy helps to define the shifting boundaries between public and private spaces and purposes. For example, free speech trumps privacy until it strays into slander or libel, at which point a privacy interest arises. When the radio shock jock Don Imus made racial and derogatory remarks about the members of the Rutgers women's basketball team, a social norm quickly asserted itself. Imus was widely condemned, fired from his job, and shamed into issuing an abject, apparently sincere apology to the Rutgers team. No one was sued (though the threat of a lawsuit may have hung over Imus and his employer); the solution arose swiftly – almost organically – and neutralized some of the transgression's toxicity.

Optimists expect reasonable norms to emerge naturally; pessimists may demand legal or regulatory solutions. Whether or not customers clamor for greater privacy, whether or not draconian legislation waits in the wings, whether or not terabytes of customer data are a golden opportunity, businesses should care about privacy because the general trust in commercial interactions depends on it. If businesses are perceived – either individually or monolithically – as disregarding reasonable norms, customers will notice and react.

Over the years, the most curious thing to me about privacy has been that repeated demonstrations of its fragility have so far failed to provoke a larger, louder hue and cry. Despite ever more dramatic and astonishing examples of abuse, Westin's privacy fundamentalists have remained relatively constant at 15% to 25%, with the rest of us either optimistic or unconcerned. The thing about privacy, though, is that it's an abstraction – right up until your identity is stolen or your preferences are exploited. If Facebook's otherwise happily self-disclosing citizens can get riled up over a mercantile invasion of their data, who can't?

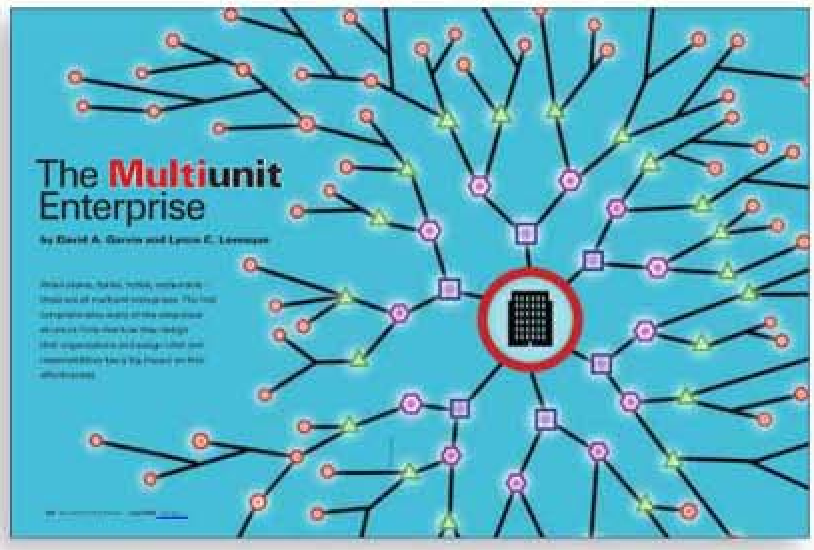
Lew McCreary *(lmccreary@harvardbusiness.org) is an HBR senior editor. He was formerly editor in chief of* CSO *magazine, which covers a wide variety of security and privacy issues.*

Reprint R0810J
To order, see page 143.

Letters to the Editor

The Multiunit Enterprise

In "The Multiunit Enterprise" (June 2008), David A. Garvin and Lynne C. Levesque offer advice on questions of practical importance to many managers. On one key point, however, the article's conclusions appear diametrically opposed to those of another article in the same issue: "The Secrets to Successful Strategy Execution," by Gary L. Neilson, Karla L. Martin, and Elizabeth Powers.



Neilson, Martin, and Powers claim that establishing clear decision rights is the most essential characteristic of companies that implement strategy well: "Everyone has a good idea of the decisions and actions for which he or she is responsible." Yet Garvin and Levesque have found that some multiunit enterprises have achieved success by deliberately overlapping managers' responsibilities: "Multiunit enterprises try to execute well by having managers at different tiers of the field organization focus on the same issues. This creates a multilayered net that prevents problems from slipping through."

In my experience, ambiguity over decision rights is indeed a prime cause of ineffective strategy execution. Why, then, have overlapping responsibilities worked so well for the companies that Garvin and Levesque researched? It seems unlikely that multiunit enterprises would somehow be unusually tolerant of decision rights ambiguity. Are the overlapping responsibilities so clearly defined that ambiguity simply doesn't arise? Is there perhaps some other explanation?

Michael Goold
Director
Ashridge Strategic Management Centre
London

Garvin and Levesque respond: We agree with Michael Goold about the importance of clear decision rights in strategic execution. His questions call for clarification of the difference between strategic and operational decision rights in multiunit enterprises.

In the organizations we studied, headquarters staff are fully responsible for the choice and content of any given strategic initiative, albeit with significant input from field managers. The responsibility for *implementing* that initiative, however, belongs to the field, and each level of management is accountable for its particular piece of the puzzle.

We welcome letters from all readers wishing to comment on articles in this issue. Early responses have the best chance of being published. Please be concise and include your title, company affiliation, location, and phone number. E-mail us at hbr_letters@harvardbusiness.org; send faxes to 617-783-7493; or write to The Editor, Harvard Business Review, *60 Harvard Way, Boston, MA 02163. HBR reserves the right to solicit and edit letters and to republish letters as reprints.*

Because the metrics (sales, net income, and so forth) at those operating levels are virtually identical, accountability may appear to overlap. But since the jobs of individual levels of management are kept distinct, the result is repeated oversight, timely problem solving, and disciplined execution – not ambiguity of decision rights.

Consider, for example, the responsibilities that were assigned to different levels of management after senior managers at Staples decided to expand the company's copy and print capabilities: Store managers were charged with ensuring that their copy and print centers were staffed, associates were trained, and profit metrics were met. District managers were held accountable for resolving short-term implementation problems, such as a scarcity of supplies across their geographical areas, by working with appropriate channels at headquarters. They too had profit metrics to meet, but at a higher, districtwide level. Regional and senior vice presidents, in addition to delivering on their own profit targets, were held accountable for informing headquarters of systemic problems so that processes associated with the initiative, such as marketing promotions, could be modified to improve implementation. All levels shared responsibility for the successful implementation of the initiative, but the jobs of each level were clearly differentiated. Furthermore, when each level of management concentrates on the same issues – even from decidedly different perspectives – messages are reinforced repeatedly. That reinforcement, in turn, focuses organizational attention and increases employees' commitment to the initiative's success.

Employee Motivation: A Powerful New Model

The authors of "Employee Motivation: A Powerful New Model" (July–August 2008) offer useful insights and an elegant model. Most writers, however, are trapped by the rewards aspect of employee motivation, and, alas, Nitin Nohria, Boris Groysberg, and Linda-Eling Lee are no exception.

It simply does not follow from the research they present that rewards are – or should be – the primary lever to satisfy the drive to acquire, even though rewards appear to make sense in the short term and have become accepted as the optimal method of motivating people.

For example, the primary actions the authors suggest for addressing the drive to acquire (such as tying rewards clearly to performance) undermine the actions that they suggest for the drive to bond (like collaboration). Why would I share my best practices with you if we're competing against each other for rewards linked to the best performance? Indeed, a preponderance of studies demonstrate that such rewards actually harm the organization, overall. (Even HBR's own articles do not provide much in the way of support for rewards.)

There are many less-damaging ways to satisfy the drive to acquire. Jeffrey Pfeffer and Robert I. Sutton, in their books *Hard Facts, Dangerous Half-Truths, and Total Nonsense* and *The Knowing-Doing Gap,* provide solid research on this topic, as does Alfie Kohn in his many works. W. Edwards Deming, Peter R. Scholtes, Daniel Kahneman, Amos Tversky, and others have also detailed the significant long-term problems with using the rewards lever.

Kelly Allan
Senior Partner
Kelly Allan Associates
Columbus, Ohio

Nohria, Groysberg, and Lee respond: Kelly Allan is right to point out that an exclusive focus on rewards tied to performance, especially monetary incentives, is not the best way to motivate employees – in fact, it can be damaging in the extreme. However, it is equally dangerous to deny the importance of rewards that fulfill the fundamental human drive to distinguish oneself through the acquisition of valued goods.

Rewards tied to performance, such as an athlete's Olympic medal or an employee's bonus for a job especially well done, have been ubiquitous in human societies. But, as our four-drive model highlights, people are also motivated by the drives to bond, comprehend, and defend, which can sometimes be at odds with the drive to acquire. Organizations can successfully respond to those other motivations, however, with levers that are not related to rewards.

This is not just a theoretical claim. We have compelling empirical evidence that organizations with rewards systems linked to performance can also create cultures that promote bonding, design jobs that enhance comprehension and meaning, and devise resource allocation processes that empower people to defend their interests. Indeed, it is companies that use multiple levers to meet all four drives that excel in motivating and engaging their employees.

Why Did We *Ever* Go Into HR?

Matthew D. Breitfelder and Daisy Wademan Dowling's optimism concerning the future of HR ("Why Did We *Ever* Go Into HR?" July–August 2008) defies rapidly accumulating evidence to the contrary. In real structural terms, the HR function is clearly losing its influential position.

Consider, for example, the dramatic decline in the number of HR directors on corporate boards over the past five years. In the UK in 2003, the FTSE 100 companies had 18 HR board members; in 2007, they had only five. In the United States in 2003, 81% of HR executives reported directly to the CEO; in 2006, only 63% did so.

Furthermore, there is little evidence that HR is gaining greater strategic influence anywhere else, either. In fact, CEOs around the world have become increasingly vocal in expressing their dismay over HR's ineffective contribution to key human capital issues such as recruitment, motivation, and development. Breitfelder and Dowling's experiences with HR are limited to some very specific sectors; it would be unfortunate if their views advanced an unbalanced appreciation of the current HR world.

Finally, both authors have been heavily involved in talent-management and leadership-development activities – traditional roles for HR specialists. Yet despite the investment of billions of dollars in a wide range of corporate talent-identification and leadership-development programs, there seems to be a dearth of ability to effectively handle – or even positively influence – critical corporate activity. Has any measurable value been gained through these investments? Surely it's appropriate for shareholders to ask such a question, and HR executives in the United States and Europe should be ready to respond to it. Invariably, however, they are too junior to do so!

Maurice Phelps
Maurice Phelps Associates
Reading, Oxfordshire, England

Breitfelder and Dowling rightly point out that the financial- and professional-services industries excel in attracting and retaining top people because those fields are talent intensive. From an executive search perspective, it seems that firms in the top tier of those sectors consistently lead others in HR best practices. When my colleagues and I have looked at companies below the highest level of those sectors, however, our experience has been quite different.

Obviously, talent management and a CEO focused on "people issues" are on *every* company's list of important success factors. But many companies still lag considerably in this area, ostensibly because of a lack of significant investment in talent development. We believe, however, that there is another factor at work as well: CEOs' fundamental disbelief in the power of superior human capital and talent management practices to "move the needle" for their businesses.

CEOs who have never witnessed great HR will probably be reluctant to invest in the promise of a changed human capital dynamic. Even CEOs who do believe in the value of HR may not have the patience or ability to finance the effort for an appropriate amount of time. Fortunately, Breitfelder and Dowling's combined academic and non-HR-related business skills and experiences significantly aid their organizational credibility and create a great template for all companies, regardless of size, to follow. In addition to adopting the authors' approach, however, firms serious about taking HR to the next level can enhance their potential for success with more rotations of line executives into HR; increased business training for HR professionals; greater CEO exposure to HR best practices; and a continued emphasis by the board of directors on talent management.

Alan J. Kaplan
President and CEO
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Wynnewood, Pennsylvania

The Biosphere Rules

I share the overall goal that Gregory C. Unruh puts forth in his article "The Biosphere Rules" (February 2008). We should aim for sustainability by rethinking material use, design, scale economies, and the buyer-supplier relationship. The "biosphere rules," however, are both confusing and wrong from a scientific point of view and do not contribute to the author's mission of promoting sustainability.

In rule #1, Unruh asserts that manufacturers have added new elements to nature's palette. That is incorrect. Thanks to human ingenuity, the two materials he mentions are actually made from only carbon and fluorine (Teflon) and carbon, hydrogen, oxygen, and nitrogen (Kevlar). They are, in fact, far less complex than nature's molecules, and they deliver functionality that does not exist in nature. Furthermore, the potato chip bag that Unruh mentions follows precisely nature's successful recipe of creating new functional units. Through trial and error, the units are assembled from simpler molecular components that are made up of nature's basic building blocks, the elements. As for nature's parsimony making recycling "easy" – has the author ever counted how many species of bacteria, worms, and larvae it takes to recycle the carcass of a rabbit? This recycling process is a great deal more intricate than any invented by humans.

Rule #2, in which Unruh states that the biosphere doesn't down-cycle materials, is also incorrect. For instance, nature completely down-cycles the author's hypothetical dead beaver by destroying the molecules that constitute it. A "reincarnated" eagle would never contain recycled material – such as muscle fibers or bones – from a deceased beaver, as Unruh's romantico-Buddhistic description implies. Nature's final recycling process for organic matter is simply oxidation, the conversion to carbon dioxide and water.

Finally, 5 billion tons of carpet waste seems to be three orders of magnitude too high.

The picture of innocent Mother Nature/Gaia, "powered by nothing more than rays of sunshine" and miraculously producing a tree or a cactus using "a simple palette of materials, drawn from air and water," better fits an esoteric journal than HBR.

Christian Miculka
Director, Drug Discovery
Intervet
Schwabenheim, Germany

Unruh responds: I appreciate Christian Miculka's contribution to the discussion – especially catching the carpet waste error (the unit of measure should be pounds, not tons). But in my opinion, he has missed the forest for the trees.

As I stated clearly in the article, we can't up-cycle the way nature does when it oxidizes muscle into elements such as carbon and hydrogen and reincarnates them into mollusks, eagles, or even HBR readers and authors. But that doesn't mean there is no lesson in it for us. Our inability to duplicate nature's up-cycling is precisely why our material proliferation confounds industrial recycling. Companies serious about recycling their own products have found materials parsimony essential to reducing costs and fostering scale economies.

Miculka's real criticism seems to be directed at my prose. Far from adoring, or even mentioning, Gaia in my article, however, I merely seek to identify the principles that underlie nature's sustainability – hardly an esoteric inquiry. A healthy respect for nature's technology has fostered discoveries in a variety of industries and even brought everyday products like Velcro to market. By studying how the biosphere has sustained its techniques for billions of years, we can help managers formulate sustainable strategies of their own. Romantic sounding or not, there is indeed something to learn from nature's ability to produce a tree out of thin air, over and over again.

When Winning Is Everything

In their article "When Winning Is Everything" (May 2008), Deepak Malhotra, Gillian Ku, and J. Keith Murnighan outline ways to avoid the very clear pitfalls associated with the primal urge to win at almost any cost. That competitive arousal, however, can also be used to advantage in certain situations, as I have discovered during my 25 years in both corporate environments and small businesses. The key is to define "winning" more broadly than just clinching the deal or succeeding in an acquisition. An effective approach for avoiding the traps the authors describe is to treat your rival in a way that improves your competitive position in future transactions. Then, even an outcome that would traditionally be seen as a loss can translate into success.

The first example the authors present illustrates that point clearly. Imagine that, after the Guidant recall took place and Boston Scientific jumped into the process, Johnson & Johnson had redefined winning as either acquiring

Guidant at a lower price than originally offered or burdening Boston Scientific to weaken its competitive position in the future. Under this view, J&J won despite losing the acquisition. Because the bidding war raised the cost of the acquisition, J&J's "failure" left Boston Scientific saddled with not only a highly inflated price for Guidant but also the expense of dealing with that company's growing financial and public relations woes.

When you realize that even by losing a bidding war you can still come out ahead, it becomes easier to avoid the competitive arousal trap.

Todd Snowden
President
Ascent Business Advisors
Flagstaff, Arizona

Malhotra, Ku, and Murnighan respond: Todd Snowden makes a nice point. Winning an auction but failing to achieve the overall goal is not a success. The fact that J&J did not submit the winning bid for the Guidant acquisition does not mean the company "lost." Indeed, to have narrowly defined winning as prevailing in the bidding war, regardless of how high it pushed the acquisition price, would have worked against J&J's long-term objectives. A simple maxim applies here: Companies should keep their eyes on the prize and focus their attention on achieving their ultimate goals – not on winning versus losing.

Snowden also seems to suggest that stimulating competitive arousal in a rival can be advantageous. In some cases, this argument holds true: J&J, for instance, clearly benefited when Boston Scientific "won" by paying too much for Guidant. In other situations, however, competitive arousal can hurt both sides. If you're negotiating with a vendor, client, or business partner, for example, and the people on the other side define winning solely as beating you, the tactics they choose to employ (such as walking away from a mutually rewarding deal) may destroy value for everyone.

Executive Summaries

OCTOBER 2008

> User contributions are fueling some of the world's fastest-growing and most competitively advantaged organizations – in some cases revolutionizing the economics of entire industries.
> –page 60

COVER STORY

60 | The Contribution Revolution: Letting Volunteers Build Your Business

Scott Cook

Many internet superstars owe much of their success to the active and passive contributions made by countless people from outside their organizations. Think, most obviously, of Facebook profiles, eBay goods, YouTube videos, Wikipedia entries, and, less obviously, of the aggregated buying behavior underlying Amazon recommendations and the donated use of personal-computer resources underpinning Skype's internet-based phone network. Cook, the founder of Intuit (maker of financial software products such as Quicken and TurboTax), challenges traditional companies to tap this emerging source of value by actively creating what he calls *user contribution systems*.

The *user* can be a customer, employee, sales prospect – or someone with no previous connection to the company at all. The *contribution* can be actively offered work, expertise, or information, as well as passive or even unknowing contributions, such as behavioral data that are gathered automatically as a by-product of a transaction or an activity. The *system* is the method, usually internet based, by which contributions are aggregated and made useful to others. Such a system creates value for a business as a consequence of the value it delivers to customers.

In this article, Cook describes the personal journey that led him to see the tremendous value in user contributions. He creates a taxonomy of the systems that can capture user contributions and shows the variety of ways in which companies from Honda to Procter & Gamble to Hyatt Hotels are leveraging them. And, drawing on his successes and failures in trying to put them to work at Intuit, he offers advice on how business leaders can catalyze action to create user contribution systems in their own organizations.

Reprint R0810C

FORETHOUGHT

26 | The Year of Marketing Dangerously

Christopher Meyer

Digital advertising is growing nearly four times as fast as advertising overall; alternative channels cost less than traditional ones; and management increasingly insists on proof of ROI. These converging forces spell the end for television advertising. **Reprint F0810A**

Getting Real About Virtual Worlds

Paul Hemp

Forward-looking companies are using virtual venues to mimic reality, helping employees and business partners collaborate and learn. Their increasingly user-friendly and graphically sophisticated platforms may become the next-generation means of communication. **Reprint F0810B**

How Wise Crowds Can Advance Philanthropy

Steven H. Goldberg

Every year in the United States billions of philanthropic dollars go to more than 1.5 million nonprofits – some of which use the money inefficiently. But the tools exist to create prediction markets that could guide donors toward the highest social return on investment. **Reprint F0810C**

The Best Advice I Ever Got

Michelle Peluso

The president and CEO of Travelocity remembers how her father built his environmental-engineering start-up into a business with 300 employees, in part through a striking degree of care for and interest in them as individuals. Peluso has 5,000 employees – and a global organization – but she's learned to scale up her father's techniques. **Reprint F0810D**

The Difference Between Chinese and Russian Entrepreneurs

Bat Batjargal

China's recent transformation is characterized by gradual institutionalization, and Russia's by what looks like rapid deinstitutionalization. The Chinese tend to think concretely, whereas the Russians lean toward abstractions. Understanding differences like these can help Westerners gain entry into each country's networks. **Reprint F0810E**

A Conversation with Dave Balter

The founder and CEO of BzzAgent, a word-of-mouth media company, believes strongly in radical corporate transparency. In practice that can mean frank self-examination in his blogs, publicly posting his company's sales presentations, and rotating an executive office space among employees at every level. **Reprint F0810F**

Protect Your Product's Look and Feel from Imitators

Betsy D. Gelb and Partha Krishnamurthy

Trade dress is the legal term for a nonfunctional design feature, such as the cowhide pattern on Gateway's computer boxes. Many companies don't know its value or assume that they could sue imitators. Here's a simple experiment to acquire the data needed for protection. **Reprint F0810G**

Reviews

Featuring *Failure to Communicate: How Conversations Go Wrong and What You Can Do to Right Them,* by Holly Weeks

MARKETING

HBR CASE STUDY

41 | Can Knockoffs Knock Out Your Business?

Paul F. Nunes and Narendra P. Mulani

Ruffin CEO Bill Bronson is on a mission. Counterfeits of his company's adventure gear and clothing are on the rise, and Bronson is hell-bent on stopping them. He has hired top-notch investigators to track down the criminals, invested in technology that will help distinguish his products from look-alikes, and pushed online vendors to stop selling fakes. All of that has cost a lot of money, however, and the problem seems to be getting worse. How far should Bronson take his campaign?

Giorgio Brandazza, a professor at SDA Bocconi School of Management, fought a similar battle as an executive at Calvin Klein. He advises Ruffin to mitigate the effects of copycats by building up the strength of its brand. For one thing, the company should increase its retail presence in countries where it is plagued by fakes. Single-brand stores will allow Ruffin to guarantee customers they're getting authentic goods, showcase its products in distinctive ways, and build strong relationships with consumers.

J. Merrick "Rick" Taggart, president of Victorinox Swiss Army in North America, recommends zeroing in on the worst counterfeiting offenders. A resource Ruffin should take advantage of, he says, is customs and border patrol officers; if the company frequently communicates with them about ports of entry and consignee and consignor data, these officials can more easily sniff out illegal activity.

The foundation for any good defense against counterfeiters, says Candace S. Cummings, general counsel of VF Corporation, is instituting tight controls over the company's supply chain and distribution process. That means, among other things, choosing manufacturing partners carefully and having strict contracts with distribution partners that, for example, prohibit products from going anywhere but outlets the company trusts.

Reprint R0810A
Reprint Case only R0810X
Reprint Commentary only R0810Z

GOVERNANCE

FIRST PERSON

53 | Evaluating the CEO

Stephen P. Kaufman

After Kaufman became a CEO, he was struck by how perfunctory the board was in its feedback on his performance. The chair of the compensation committee would pop by his office following the year-end board meeting, congratulate him on the company's making its numbers, and then hand him an envelope containing the details of his comp package before walking out the door. The entire exchange would last no more than 10 minutes.

That sort of review was a big contrast from the intense evaluations Kaufman received as a senior executive – assessments based on input from many sources and on multiple dimensions of his performance. As chief executive, all of sudden his total worth was summed up in just three or four financial measures.

Although CEOs should have autonomy, reducing performance management to only financial measures makes little sense. All the financial incentives in the world won't transform CEOs into better decision makers. And bad decisions can bring companies down. Boards have an obligation to shareholders to ensure that companies are led well, and the sooner they can spot problems with leaders' performance, the better.

With that in mind, Kaufman encouraged Arrow Electronics, where he was CEO for 14 years, to adopt a formal process that obliged independent directors to talk to executives and observe operations firsthand. Directors considered CEO performance in five key areas: leadership, strategy, people management, operating metrics, and relationships with external constituencies. As a result, they picked up on problems Kaufman might not have noticed, provided counsel that made him a stronger leader – and avoided disasters along the way.

Reprint R0810B; HBR Article Collection "How Leaders Can Assess Their Performance" 12163

GENERAL MANAGEMENT

70 | It's Time to Make Management a True Profession

Rakesh Khurana and Nitin Nohria

In the face of the recent institutional breakdown of trust in business, managers are losing legitimacy. To regain public trust, management needs to become a true profession in much the way medicine and law have, argue Khurana and Nohria of Harvard Business School.

True professions have codes, and the meaning and consequences of those codes are taught as part of the formal education required of their members. Through these codes, professional institutions forge an implicit social contract with society: Trust us to control and exercise jurisdiction over an important occupational category, and, in return, we will ensure that the members of our profession are worthy of your trust – that they will not only be competent to perform the tasks entrusted to them, but that they will also conduct themselves with high standards and great integrity.

The authors believe that enforcing educational standards and a code of ethics is unlikely to choke entrepreneurial creativity. Indeed, if the field of medicine is any indication, a code may even stimulate creativity. The main challenge in writing a code lies in reaching a broad consensus on the aims and social purpose of management. There are two deeply divided schools of thought. One school argues that management's aim should simply be to maximize shareholder wealth; the other argues that management's purpose is to balance the claims of all the firm's stakeholders. Any code will have to steer a middle course in order to accommodate both the value-creating impetus of the shareholder value concept and the accountability inherent in the stakeholder approach.

Reprint R0810D

STRATEGY & COMPETITION

80 Shaping Strategy in a World of Constant Disruption

John Hagel III, John Seely Brown, and Lang Davison

Redefining the terms of competition for a market sector, an industry, or an entire global ecosystem is a tall order. It means attracting thousands of participants, galvanizing their efforts, and retaining their commitment for the long haul. Hagel, Brown, and Davison, of the Deloitte Center for Edge Innovation, provide a blueprint for this daunting task of *shaping strategy* as technology-driven infrastructures constantly change.

The authors discuss three elements that, no matter the industry, are vital in shaping strategy. A *shaping view,* or rallying cry to potential participants, clarifies the market opportunity, makes sense of fundamental forces, identifies rewards, and highlights the shared nature of risk. Bill Gates, of course, succeeded with his view of desktop computing, and more recently Salesforce.com's Marc Benioff has held out a new model for delivering enterprise software. A *shaping platform,* like that of Google's AdSense, clearly defines standards and practices that help organize and support the activities of many participants, enabling them to do more with less. Specific *shaping acts and assets* convince participants that the shaper has the muscle to pull off its initiatives, as Facebook has done by showcasing its relationship with Microsoft. The three elements together allow a shaper to quickly mobilize a critical mass of participants and, thereby, unleash powerful network effects that can yield big rewards during periods of rapid change.

Almost any company will benefit from an attempt to shape strategy, say the authors, but they recognize that not every business is ultimately a shaper. By participating in other firms' shaping strategies, they show, a company can still find plenty of opportunities to create value.

Reprint R0810E

STRATEGY & COMPETITION

92 How the Best Divest

Michael C. Mankins, David Harding, and Rolf-Magnus Weddigen

Most corporations are not as skilled at selling off assets as they are at buying them, often divesting at the wrong time or in the wrong way. Either is a very expensive mistake.

A Bain & Company study has found that over the last 20 years, corporations that took a disciplined approach to divestiture created nearly twice as much value for shareholders as the average firm. In this article, Bain partners Mankins, Harding, and Weddigen set out the four straightforward rules those effective divestors follow.

First: Just as they have acquisition teams, smart divestors have full-time divestiture groups, which continually screen their companies' portfolios for likely businesses to sell off and think through the timing and implementation steps needed to maximize value in each particular case.

Second: They choose their divestiture candidates objectively. Too many firms rush to sell in economic downturns, when prices are low. Thoughtful divestors will sell *only* those businesses that do not fit with the corporation's core *and* are not worth more to themselves than they are to any other company.

Third: Successful divestors consider how to structure a deal and to whom they will sell as carefully as they consider what units to sell and when. And they are as meticulous about planning the implementation of a deal as savvy acquirers are about postmerger integration.

Fourth: They make a compelling case for how, and how quickly, the deal will benefit the buyer, and they make sure the selling unit's employees will be motivated to stay on and realize that value.

Using these four rules, companies as diverse as Textron, Weyerhaeuser, Ford, Groupe Danone, and Roche have become "divestiture ready": consistently able to sell at the right time and in the right way to create the most value for their shareholders.

Reprint R0810F

INNOVATION & CREATIVITY

100 | Creativity and the Role of the Leader

Teresa M. Amabile and Mukti Khaire

In today's innovation-driven economy, understanding how to generate great ideas has become an urgent managerial priority. Suddenly, the spotlight has turned on the academics who've studied creativity for decades. How relevant is their research to the practical challenges leaders face?

To connect theory and practice, Harvard Business School professors Amabile and Khaire convened a two-day colloquium of leading creativity scholars and executives from companies such as Google, IDEO, Novartis, Intuit, and E Ink. In this article, the authors present highlights of the research presented and the discussion of its implications.

At the event, a new leadership agenda began to take shape, one rooted in the awareness that you can't manage creativity – you can only manage *for* creativity. A number of themes emerged: The leader's job is not to be the source of ideas but to encourage and champion ideas. Leaders must tap the imagination of employees at all ranks and ask inspiring questions. They also need to help their organizations incorporate diverse perspectives, which spur creative insights, and facilitate creative collaboration by, for instance, harnessing new technologies.

The participants shared tactics for enabling discoveries, as well as thoughts on how to bring process to bear on creativity without straitjacketing it. They pointed out that process management isn't appropriate in all stages of creative work; leaders should apply it thoughtfully and manage the handoff from idea generators to commercializers deftly. The discussion also examined the need to clear paths through bureaucracy, weed out weak ideas, and maximize the organization's learning from failure. Though points of view varied, the theories and frameworks explored advance the understanding of creativity in business and offer executives a playbook for increasing innovation.

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STRATEGY & COMPETITION

TOOL KIT

111 | The Incumbent's Advantage

Ian C. MacMillan and Larry Selden

If you run a big company, you might think it's nearly impossible to grow profits organically. Think again, say MacMillan, of the University of Pennsylvania's Wharton School, and Selden, of Columbia Business School. Locked inside your firm's customer records is a wealth of information about what your customers need and how to make more of them profitable to you. Tapped strategically, this information can generate enormous value for your company and give you a big leg up on potential invaders. The authors call it the *incumbent's advantage*.

Using the hypothetical example of Mix C-Ment, based on the real experience of concrete manufacturer CEMEX, the authors walk through a step-by-step tutorial on strategic customer segmentation. They demonstrate how investing in and applying research about particular customers' needs for tailored products, marketing support, and technical services can greatly increase profits. But that requires seeing these offerings not as mere allocated costs but as deliberately invested resources.

To exploit your incumbent's advantage, build a modest customer-characteristics database and rank your customers according to profitability. Then analyze in detail the needs and behavior of the most and least profitable 20% – and strategically use what you find.

This customer-centric approach to your information should have as its counterpart a corporate structure in which cross-functional teams assigned to specific customer segments make smart resource investments using your evolving knowledge about each segment's needs and performance. Getting your customer information and your organization to work together in this way is the key to preserving your firm's dominance while increasing profits at every step of the process.

Reprint R0810H

ETHICS & SOCIETY

HBR AT LARGE

123 | What Was Privacy?

Lew McCreary

Why is that question in the past tense? Because individuals can no longer feel confident that the details of their lives – from identifying numbers to cultural preferences – will be treated with discretion rather than exploited. Even as Facebook users happily share the names of their favorite books, movies, songs, and brands, they often regard marketers' use of that information as an invasion of privacy.

In this wide-ranging essay, McCreary, a senior editor at HBR, examines numerous facets of the privacy issue, from Google searches, public shaming on the internet, and cell phone etiquette to passenger screening devices, public surveillance cameras, and corporate chief privacy officers. He notes that IBM has been a leader on privacy; its policy forswearing the use of employees' genetic information in hiring and benefits decisions predated the federal Genetic Information Nondiscrimination Act by three years. Now IBM is involved in an open-source project known as Higgins to provide users with transportable, potentially anonymous online presences. Craigslist, whose CEO calls it "as close to 100% user driven as you can get," has taken an extremely conservative position on privacy – perhaps easier for a company with a declared lack of interest in maximizing revenue. But TJX and other corporate victims of security breaches have discovered that retaining consumers' transaction information can be both costly and risky.

Companies that underestimate the importance of privacy to their customers or fail to protect it may eventually face harsh regulation, reputational damage, or both. The best thing they can do, says the author, is negotiate directly with those customers over where to draw the line.

Reprint R0810J

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Training Daze

PEOPLE LEARN from experience. The point of training is to compress a lot of experience into a short time to make students more productive more quickly. So why does so much training fail to improve performance?

Motivation is part of the problem, but there is a second, thornier issue. In "Deep Smarts" (HBR September 2004), Dorothy Leonard and Walter Swap focus on the expertise that longtime employees acquire by dealing with complex situations over many years. As the article says, "Your best employees' deepest knowledge can't be transferred onto a series of PowerPoint slides or downloaded into a data repository. It has to be passed on in person – slowly, patiently, and systematically."

What will work, then? Let students tackle real-world problems or convincing simulations, and coach them beforehand, throughout, and afterward to squeeze out the relevant insights. Leonard and Swap acknowledge that this approach takes time – and money. But in situations where knowledge is vital, they ask, "How can companies afford *not* to invest in it?"

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To remain competitive,
businesses require access to capital and the
strategic advice to use it wisely.
So, who are they going to turn to?
Merrill Lynch connects capital to opportunity. Recently, for example, we advised a major airline on a merger to dramatically improve their cost structure and liquidity, while balancing their global network and expanding into markets unreachable through organic growth. We also recently served as joint-lead on the largest US IPO in history, demonstrating our ability to raise capital for clients during volatile markets. Our 94-year history of leadership in the financial industry has been a source of confidence for our clients in both good and challenging markets. winningsolutions.ml.com
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