UNCOMMON SENSE, COMMON NONSENSE

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Why some organisations consistently outperform others

Jules Goddard and Tony Eccles

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To my family,
with love
Jules

To Robertson,
my very dear son
Tony

“The day will come when the only battlefields will be markets open to commerce and minds open to ideas.” **Victor Hugo**

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Preface to the second edition

OUR AIM IN WRITING THIS BOOK was twofold: we wanted to produce something unusually accessible that would whet the appetites of managers who want to make a difference; and we hoped that our ide would serve as a catalyst of creative and bold action in an increasingly risk-averse world. The book has already taken hold in companies as diverse as Marriott, Toshiba, Rio Tinto, Roche, Tetra Pak, Deutsche Bank and Zurich.

We believe that most enterprises today are insufficiently entrepreneurial. The thread running throug the book is the critical role of imagination and initiative in business. The 67 short sections are writte more as a mosaic of ideas and provocations than as a single narrative. There is no right way to read t book; it is intended to be dipped into.

The book is structured around five themes.

Part 1 is about winning

It seeks to define what successful organisations have in common. As part of the answer, it points to the courage to “take the road less travelled”, to carve out a distinctive approach to competition, and not to be overawed by the risk of being contrarian. One of the great virtues of markets is that they disproportionately reward firms that have the creativity to see the world differently from their rivals as well as the courage to act on their unique point of view.

Every competitive industry is, in truth, a creative industry. Yet there is a popular tendency to limit th appellation “creative” to a small number of specialist sectors in a modern economy such as advertising, architecture, design, fashion, film, software, music, publishing and television. By implication, retailing, manufacturing, finance, consulting and education are not creative and have no need of creativity. This is nonsense.

Part 2 is about strategising

It aims to distil the skills required to win competitive battles. Strategic decision-making is modelled as a discovery process. We argue that strategy is less about the **application** of theory than the **activit** of theorising. All too often, however, strategic activity is equated with the drawing up of financial forecasts, the result being that there is an intrinsic bias in favour of efficiency gains and cost-cutting at the expense of revenue growth or marketmaking.

Strategic thinking – putting creativity to work in search of competitive advantage – seems in many organisations to have been captured by the need for elaborate planning rituals. In the majority of companies, for example, strategy can become in thrall to budgeting. If ever there were an example of how a sensible and measured need for bureaucracy had been corrupted to become a tiresome drill of box-ticking and form-filling, it is budgeting – the undisputed champion of managerial nonsense.

Jack Welch expressed the view that “the budget is the bane of corporate America”. In Europe, researc has found that companies spend an average of 25,000 person days on planning and performance measurement per $1 billion of turnover. And KPMG has shown that the budgeting process takes up 20–30% of managers’ and controllers’ time. By imprisoning resources over the full length of the planning period, budgeting has the effect of radically reducing a firm’s flexibility. Budgeting (and th whole apparatus of negotiating targets and outcomes in a world characterised increasingly by volatility) is a handicapping legacy from an earlier age.

Part 3 is about organising

It focuses particularly on the shortcomings of the standard management model, and the exaggerated faith that, even today, is so often placed in hierarchy and bureaucracy to accomplish the work of motivating and directing human capability. In truth, traditional managerialism is a broken social technology, unfit for the 21st century.

Business has much to learn from organisations such as science laboratories or art schools or symphony orchestras, which take a nobler view of human nature and adopt a less instrumental approach to human talent.

Consider the case of Max Perutz. For more than 30 years from its foundation in 1947, Perutz led the world-famous Laboratory of Molecular Biology in Cambridge, during which time it produced dozens of Fellows of the Royal Society, as well four Nobel prize winners, including Francis Crick and James Watson, the discoverers of the structure of DNA. What set the lab apart was Perutz's inspirational leadership. He understood clearly what brought out the best in creative people and what got in the way: "Creativity in science, as in the arts, cannot be organised", he claimed. "It arises spontaneously from individual talent. Well-run laboratories can foster it, but hierarchical organisation, inflexible, bureaucratic rules, and mountains of futile paperwork can kill it. Discoveries cannot be planned; they pop up, like Puck, in unexpected places."

What is true of science laboratories is just as true, we would claim, of today's business enterprises. Industry, quite as much as science, is deeply reliant upon creativity, and yet the institutional settings in which most companies place their people would strongly suggest otherwise.

Part 4 is about behaving

It adopts the perspective of the individual actor on the corporate stage and how personal influence ca be exerted in today's organisations, despite the forces that make this difficult. To work in a typical organisation today is to become subject to pressures and incentives that strongly bias behaviour in particular directions. There are pressures, for example, to play safe, to follow fashion, to procrastinat to emphasise obstacles, to prioritise the urgent above the important, to play politics, to avoid difficul conversations, to go with the flow, to avoid embarrassment or loss of face, to stay in control, to hold back on emotion, and so on. The problem is that if everyone were to become prey to these pressures, nothing of any strategic significance would ever happen and the organisation would be set up to fail. High-performing organisations rely upon their people – or at least a portion of them – to rise above these conservative and risk-averse forces and, through a kind of far-sighted, enlightened and brave disposition, combine their talents to make a positive difference. These few are the leaders of the organisation, at all levels. We define leadership as the ability to create a culture that can act as a bulwark – a countervailing force – against these biases and as a launch pad for advance.

Part 5 is about learning

It describes a new approach to executive education, managerial development and corporate renewal, based directly upon our ideas about winning, strategising, organising and behaving. This particular form of experiential learning, which we call the Discovery method, grew out of our disenchantment and impatience with didactic programmes taught in lecture theatres in business schools. We describe some vivid corporate examples of the Discovery method in use.

Jules Goddard and Tony Eccl
February 20

Introduction

> "Both the ideas that science generates and the way in which science is carried out are entirely counter-intuitive and against common sense." **Lewis Wolpert**

THIS IS A BOOK on corporate performance and organisational capability. It puts forward a new explanation for why some companies consistently outperform their rivals; it suggests that beliefs and assumptions rather than goals or values separate winners from losers; it argues that the model of management that prevails in most organisations is both antiquated and harmful; and it proposes a radically different method for how to lead and drive the work of an organisation effectively. It integrates a theory of corporate success with a model of strategic thinking and a method of operation effectiveness.

It is not a textbook. It is more like a handbook of innovative ideas and contrarian perspectives. It challenges the fashion for panaceas, formulae and notions of best practice, and it reflects a view that most business strategies are generic and banal, and most management theories are little more than sophistry or folk wisdom. It seeks to clear away the undergrowth that has made management and strategy far more difficult than they need to be. In a sense, it represents a return to core principles by setting out to reformulate an integrated model of the effective business. In this endeavour, we seek to engage the creativity of the reader.

Some of the arguments of the book are grounded in recent economic and psychological research, but most of them are the fruit of working closely with executive teams attending management-development programmes at London Business School, INSEAD and elsewhere over the past 25 years These workshops are hugely revealing of the joys and sorrows of modern managers and the problems they face. This book was written with these managers in mind.

Our approach to competitive strategy derives from a return to economic fundamentals – and, in particular, to the basic law of wealth creation. This is the principle of asymmetric knowledge – that i any situation when somebody in a market knows something that nobody else in the market knows, an then has the courage to act on that knowledge. We call this type of knowledge "uncommon sense". When such knowledge is acted upon illegally, it is called "insider trading". But when acted upon lawfully, it is called "entrepreneurship". Of course, not just any knowledge will do. It has to be knowledge that can be utilised and packaged in ways that create unique value for buyers. These are th conditions that define the moment of truth that we call "strategic discovery".

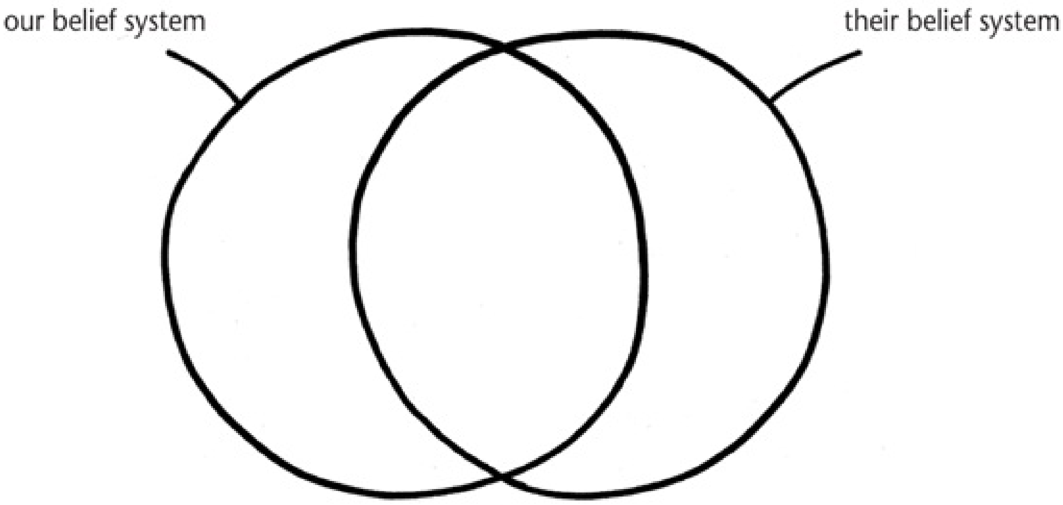
In the absence of knowledge asymmetries – and the acts of entrepreneurial courage that turn inert knowledge into incremental wealth – markets would lose their potency. As P.J. O'Rourke, an American satirist, observed:

> If everybody believed what everybody else believed, everybody would set the same price on everything. The middle-aged men on the stock exchange floor could quit hollering and go have lunch.

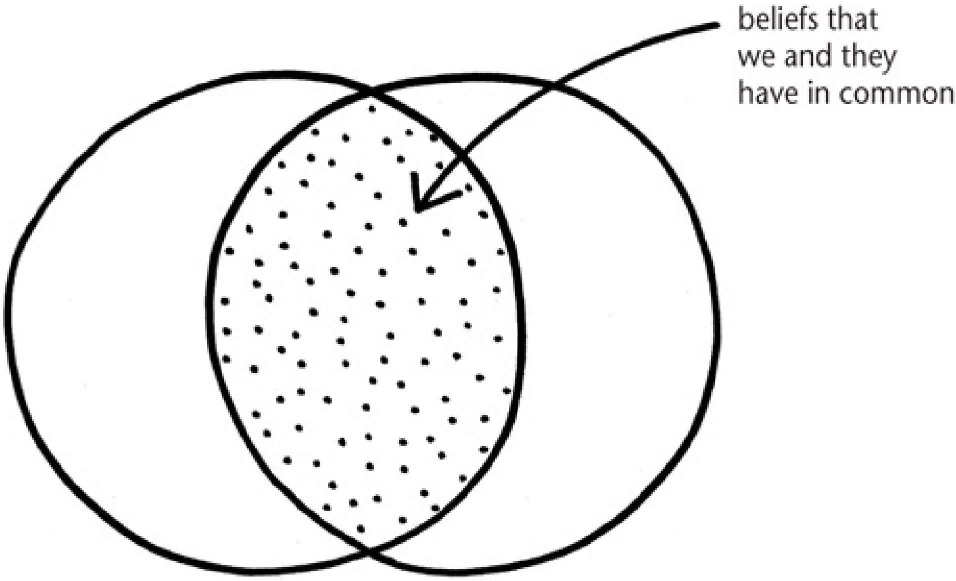
Markets are battles between belief systems. The winners are those whose beliefs are more grounded i "truth". The beneficiaries are the entrepreneurs and their customers who capture the value embedded in this new knowledge. Market competition is an exploratory process that rewards those who make such discoveries. As humans we are all fallible. Misconceptions, illusions, blind spots and false beliefs are part of the human condition. When the same sources of error unite all the competitors in a given space, they become what we call "common nonsense". An important aspect of strategy for the individual firm is the skill of identifying such nonsense and discarding it.

Adopting the perspective of a particular firm ("us") competing against other firms ("them"), we can, at the risk of oversimplification, summarise our main argument as follows.

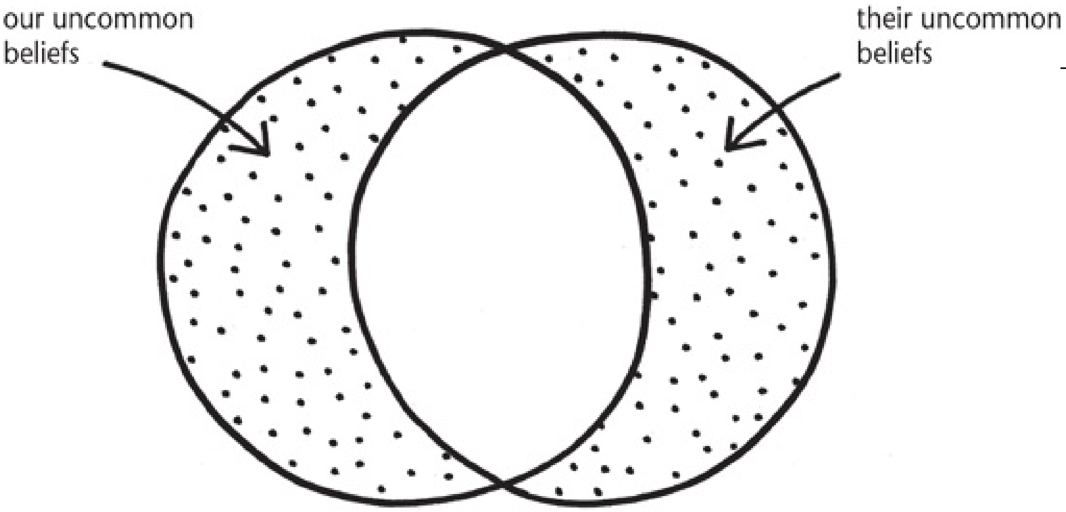
1. As competitors, we differ from each other, knowingly or tacitly, in the beliefs that drive our respective decisions and actions



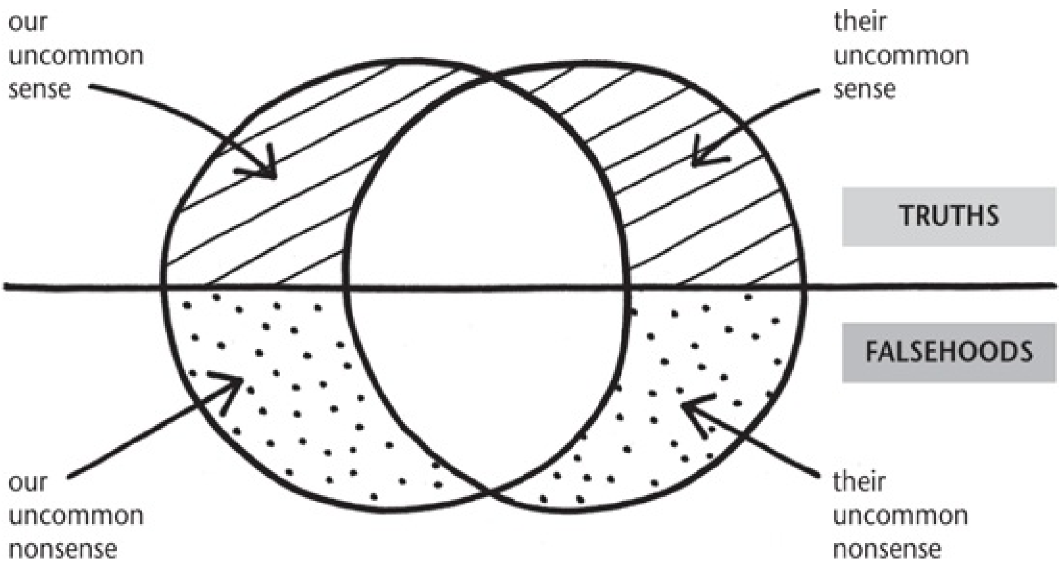
2. Because we inhabit the same reality, most of these beliefs will be shared between us and our competitors



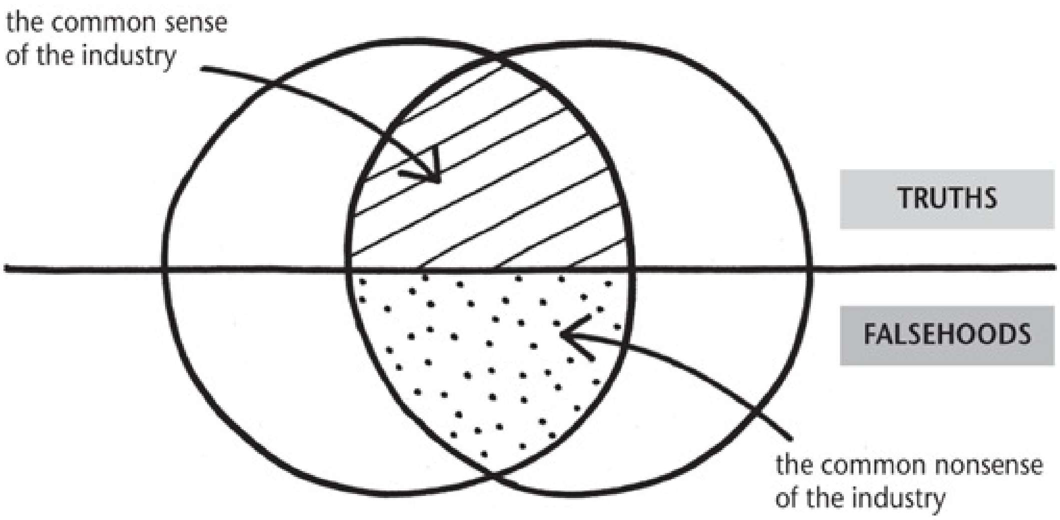
3. Only those beliefs that differentiate us and our competitors, including those beliefs that underpin the skills of implementation, can explain differences of performance between us



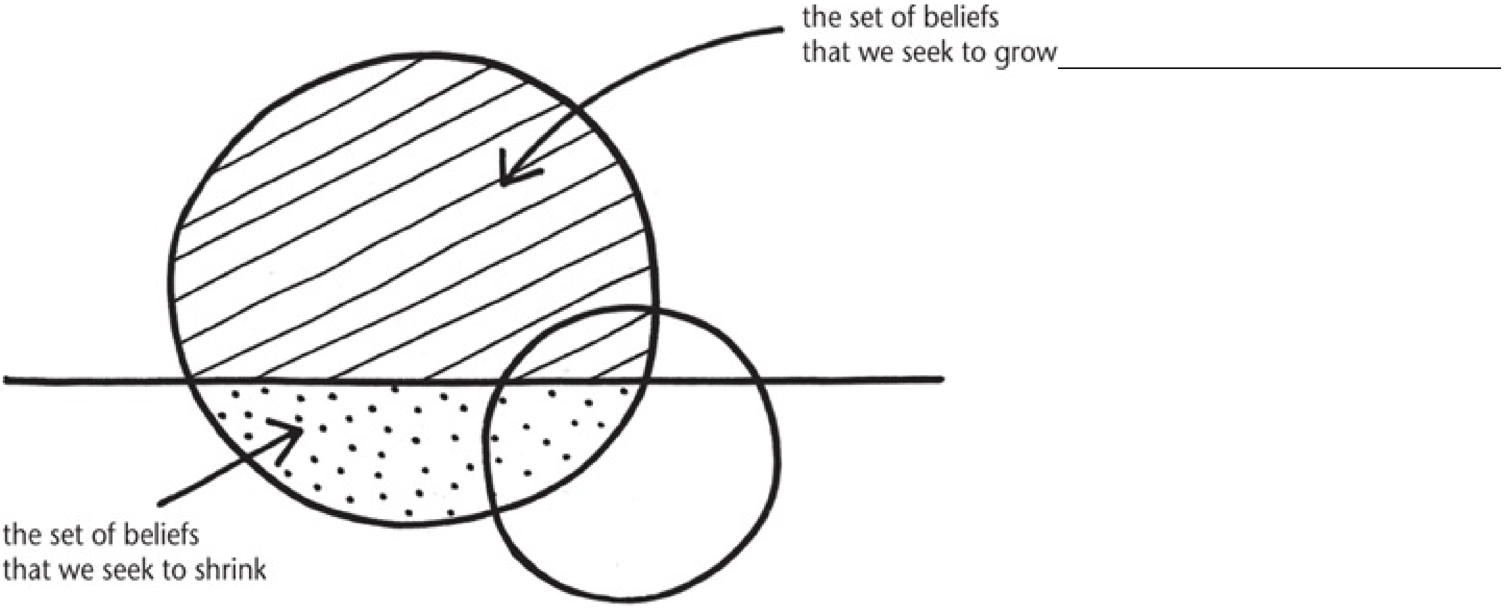
4. Winning strategies are based on belief systems that are closer to the truth than those of losing strategies



5. Beliefs that we and our competitors share, whether true or false, cannot be the cause of differentia performance between us



6. Strategising is therefore a discovery process, where the game is won by those who acquire sense and discard nonsense faster than their rivals



The standpoints that underpin the arguments in this book can be characterised as supporting:

- the Austrian rather than the neoclassical tradition of microeconomic theory – thus competition is modelled as a discovery process where the rewards flow to entrepreneurs possessing valuable new insights or unique data rather than as a state of equilibrium where the rewards go to those enjoying advantages of scale or experience;
- the assumption that markets are highly imperfect, offering abundant opportunity for discovery, enterprise and differentiation, rather than virtually perfect, demanding no more of management than the dutiful and careful administration of processes and systems;
- the idea that profit is a return on unique practices based on insights drawn from asymmetric market knowledge rather than on best practices based on the theories drawn from economics and social science generally;
- the notion of differentiation, but with reference more to states of knowledge (belief systems, empirical assumptions, statements of fact, mental models, and so on), which vary by truth content than to forms of ideology (value systems, corporate visions and objectives, statements of intent, end states, and so on), which, if they differ at all, vary only in rhetoric.

Expressed in terms of aphorisms, the book's thesis is that:

- market-based competition is a discovery process;
- asymmetric knowledge is the object of the search;
- the business strategist is the intrepid explorer;
- the effective organisation spurs such exploration.

The demands of management

Business success is both rare and difficult. Indeed, its very rarity argues strongly for just how difficult it actually is. Few companies consistently create significant wealth; over the years, most businesses just "tick over". Yet many management books give an impression that wealth creation is really quite simple – that it is just a matter of following a few principles of common sense and rules of thumb, recipes for success rather like cookbooks.

Creating wealth is subtler than business theory would typically suggest that it is. Common sense is an unr~~eliable guide to good managerial practice. If there is a unifying characteristic of all great bus~~iness strategies, it is their counter-intuitive character when they are first articulated and executed. (Only much later are they rationalised as being self-evidently sensible.) Writing generic prescriptions for businesses does a huge disservice to the true nature of enterprise and the demanding work done by managers.

In writing about management, it is all too easy to come across as patronising, or opinionated, or facil In a way, this comes with the territory. Writing such books seems to require an immodest measure of "know-it-all" expertise. We hope we have not fallen prey to these sins. In our view management is on of the most difficult and demanding jobs around.

PART 1

Winners and losers

"Dare to think for yourself." Kant

MOST THEORIES OF BUSINESS PERFORMANCE rest on the assumption that there is a "right way" to do things. The popularity of notions such as "excellence", "competence" and "best practice" testifies to the hold that this theory has on business managers. Corporate success is treated as a return on doing standard things well.

This may be true of craft skills, such as cookery, pottery and gardening. But it is decidedly not true o any competitive activity, such as sport, warfare or business. In a game of skill, there is no "right way of playing it. Nor can there ever be a standard way of winning. The point of a game is that it tests a particular kind of intelligence, not the possession of a universal theory or a winning formula. Chess masters do not achieve their mastery through the application of "best practice". They are their own masters.

To have designed a business that creates a sustainable stream of wealth, which is the ultimate test of successful enterprise, is to have created a singularity. Like a scientific discovery or a work of art, it i a unique, non-repeatable event. It resists generalisation or theoretical explanation. Trying to distil a winning strategy into a universal theory of business success is a doomed, albeit highly fashionable project. It can sometimes be emulated, but that provides no guarantee of comparable success. The winner may well go on winning.

Strategy is the art of first-hand thinking. It deals with one situation at a time. It finds its inspiration i what is unique to that situation. Strategic solutions do not generalise. They are built on insights, not rules or principles. Insights are small-scale, often short-lived discoveries. Something is noticed that had not been seen before. Entrepreneurship, the rare skill of marketmaking, is essentially the skill of producing just such insights and then having the courage and patience to apply them to the design of new products and services. Every great business started life as the embodiment of a particularly powerful insight. Businesses decline as the production of new insights dries up.

A theory of business therefore cannot be a substitute for insight. Any theory that puts forward a winning recipe for commercial success is a fraud. The most it can do is to offer a suggestive method or heuristic – either for recognising potent insights or for designing conditions conducive to discovering such insights. The same is true of any creative endeavour, whether in science or in art. There cannot be an algorithm for making scientific discoveries or creating artistic masterpieces. The so-called "scientific method" is not a method at all. It merely defines the criteria for what counts as a scientific proposition (such as testability and falsifiability); and it specifies ways of testing the truth of such propositions (such as experimentation). But the act of discovery itself remains immune from all attempts to systematise it.

Business, when it is operating well, is a highly creative activity that works to much the same "logic o discovery" as do science and art. All three bring something new into the world. In science, hypothese are tested for their fit with reality. In art, paintings, poems and compositions are tested for their abili to stand the test of time. In business, products and services are tested for their profitability in the marketplace.

This book aims to liberate the entrepreneurial imagination in managers by challenging orthodoxy and by proposing thought-provoking heresies.

Firms outperform their competitors by aiming to be different, not better

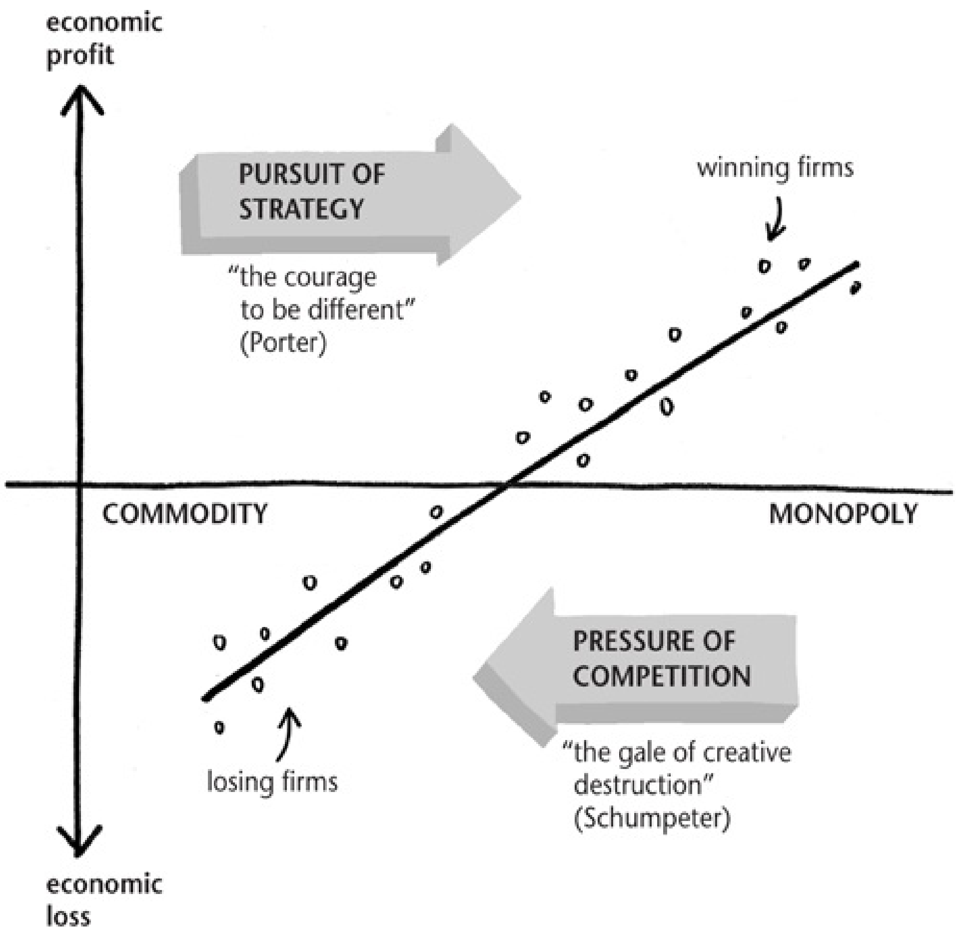
Antithesis: the search for excellence

> "Strategy is about setting yourself apart from the competition. It's not a matter of being better at what you do – it's a matter of being different at what you do." **Michael Porter**

> "You don't want to be the best of the best. You want to be the only one who does what you do." **Jerry Garcia**

WINNERS MAKE MARKETS. To make a market means to bring something new into existence. For the customer, it means creating a new category of choice, not simply another variant within an existing class of well-established products or services. Entrepreneurship, which is essentially the skill of combining insights in new ways to make a market, is the dynamic component of a market economy. It is the wellspring of economic development and wealth creation. The entrepreneur identifies these opportunities through a judicious mix of insight and foresight and then brings together the productive resources necessary to capture these opportunities. It is a form of discovery. Albert Szent-Gyorgy, an American biochemist, observed: "Discovery consists in seeing what everybody has seen and thinking what nobody has thought." Every wealth-creating idea begins life as a brave conjecture. Mark Casson, an economist, has argued:

> The entrepreneur believes that he is right, while everyone else is wrong. Thus the essence of entrepreneurship is being different – being different because one has a different perception of the situation. It is this that makes the entrepreneur so important.



Profit is the reward for daring to be unique

Aiming to be different from competitors does not, of course, guarantee success. All that can be said is that it is the necessary but not sufficient condition of success. Aiming merely to be better than competitors, however, is perilous. While not guaranteeing failure, it has the perverse effect of makin ~~competitors more alike, if only because each of them will tend to define “betterness” in identical~~ terms. So the more competitors pursue “betterness”, the more they will converge upon the same solutions.

In the modern world the forces of convergence are powerful. To the extent that we see the world alik we will make decisions alike. And this, of course, defeats the purpose of market competition. It is on through variety of interpretation, diversity of strategy and the testing of these interpretations and decisions in the cauldron of market competition that progress is made and markets justify the “waste that all experimentation entails. Convergent thinking often leads to the belief that economies of scale are the secret of success – yet scale, like reputation or relative cost advantage, is the result of success not its cause.

Managers are not paid to make the same decisions as their competitors, however skilful the reasonin that goes into these decisions. Managers are paid to carve out a distinctive approach to the future, to take the risk of being wrong, but at least to give imagination a free rein and the chance to outperform or even defeat competitors. Perversely, the more we try to be logical in our reasoning, and the more we endeavour to base our decisions upon established knowledge, and the closer we adhere to generic principles of strategy, the more likely we are to be driving the business into the middle ground of mediocrity. This is what makes business both frustrating and exciting and what draws intelligent people into it. Success in business rests on the intellectual courage to resist the obvious strategy, to see through the standard version, to go beyond the popular fad, and to steer one’s own course. To be too logical is to choose to be part of the herd. And markets do not reward herding behaviour.

Sometimes it is claimed that winners are simply better or faster or more thorough at implementation than their rivals. Every competitor may share the same broad strategic goals, but the different level o skill that they each bring to the achievement of these goals is what separates winners from losers. Ye implementation, no less than strategy, is itself based on a belief system. If implementation is to be th basis of competitive advantage, it will need to be grounded in a set of assumptions that subverts the standard method of implementation. Aiming to be “better at implementation” is no more a recipe for success than aiming to be better generally. The search for excellence is counterproductive. Doing the wrong things right, however well they are done, is inevitably a wealth-destructive practice.

Russell Ackoff, an organisational theorist, observed:

> The righter we do the wrong thing, the wronger we become. Therefore, when we correct a mistake doing the wrong thing we become wronger. It is better to do the right thing wrong than the wrong thing right.

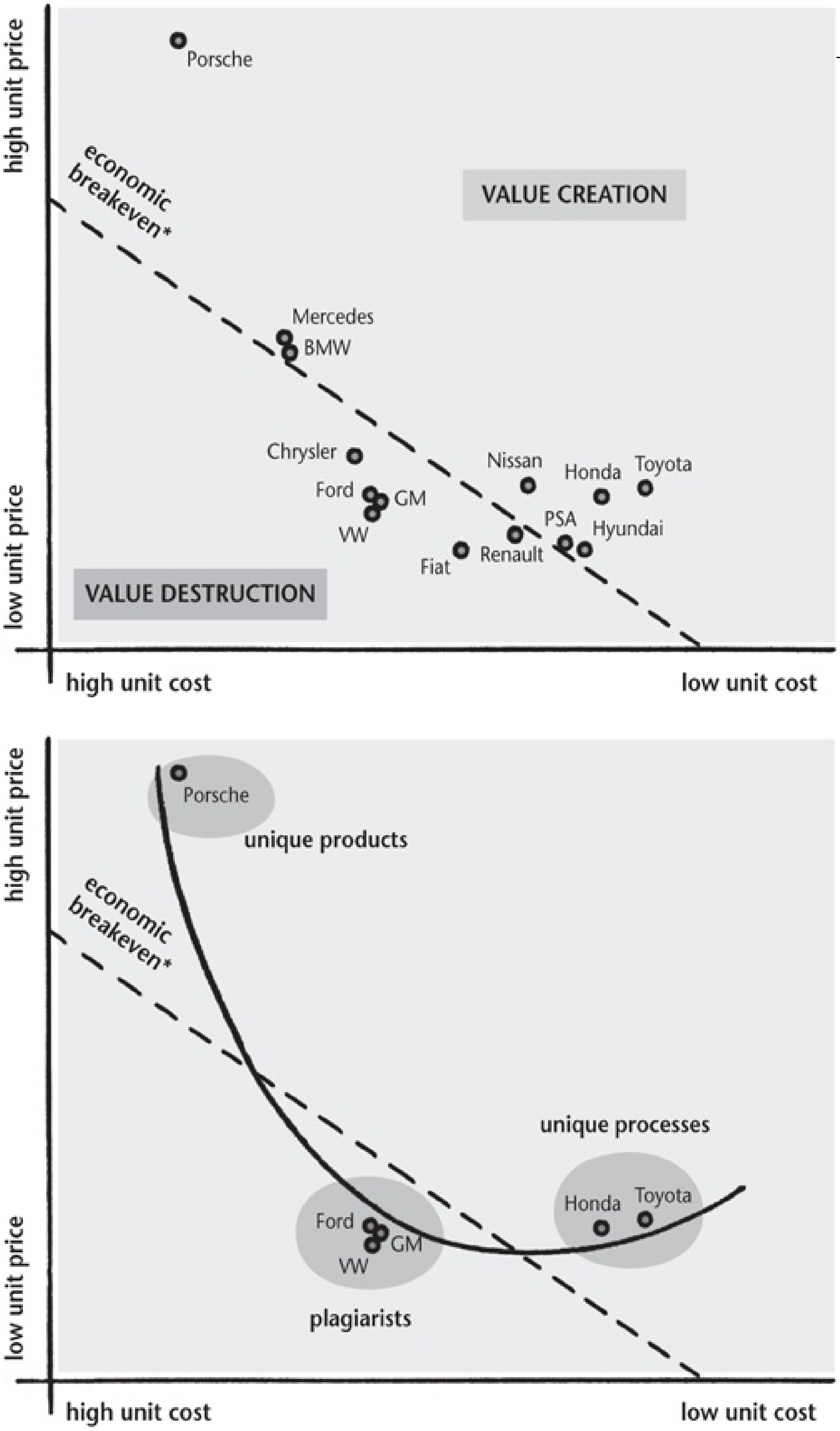
Winning is a singularity, whereas losing conforms to a pattern

Source of error: competitive plagiarism

> "The behaviour of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated." **Warren Buffett**

WINNERS COME IN TWO VARIETIES: those whose imagination and energy have won them a highly differentiated position in the external markets for customers, for capital or for talent; and those whos inventiveness and perseverance have brought them an equally original approach to the internal challenge of running an efficient operation. Between these two extremes of distinctive products and distinctive processes lie the vast majority of firms. These firms find themselves "stuck in the middle characterised by me-too products and me-too processes. Differentiated neither externally nor internally, their self-determined fate is to destroy economic value for as long as their strategy amoun to no more than plagiarising the policies and practices of those to either side of them.

It is a rare company that is strongly differentiated both internally and externally. Companies that make extraordinary products are generally run by design engineers whose appreciation of either the importance of profitability and financial prudence or the manufacturability and marketability of thei products is secondary to the integrity of the engineering. In the car industry, Porsche has long been a exemplary model of this philosophy. By contrast, companies famous for the leanness of their operations and the persistence of their continuous improvement are typically run by parsimonious manufacturing engineers whose patience for either bleeding-edge technology or fundamental researc and blue-sky thinking is equally strained. Toyota brilliantly expresses this philosophy of success.



*Long-term return on invested capital = weighted average cost of capital.

Economic profit and loss in the car industry, 2005

The u-shaped profit structure typical of most industries shows two distinctive classes of winners and a single class of losers
Source: Graeme Maxton and John Wormald, *Time for a Model Change*, Cambridge University Press, 2004

By contrast, the companies "stuck in the middle" are disproportionately run by self-styled "administrators", whose outlook makes them suspicious of anything parading as entrepreneurial, counterintuitive, experimental or contrarian. The mantra by which they live is more likely to include the watchwords of compliance, alignment, control and predictability. How often do we hear that companies – and investors – “hate surprises”, to which we are tempted to reply, “What, not even good ones?”

The chart shows that markets can be cruel masters. The price of wanting a safe life, at least in business, is the embarrassment of presiding over a failing firm. Paradoxically, many of these faltering businesses, such as General Motors, were themselves once highly distinctive makers of markets. But a loss of nerve at a critical stage in their history – usually associated with the professionalisation of their management and the standardisation of their practices – meant that they slid inexorably into sameness and mediocrity.