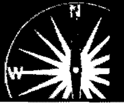


The Strategy Paradox

By Dr. Michael E. Raynor

Ed. Note: The book, The Strategy Paradox, *by Dr. Michael E. Raynor, was released in February 2007. In the edited excerpt below, presented with an introduction by the author, the role of the board of directors in managing strategic uncertainty is addressed.*

In *The Strategy Paradox* I have attempted to provide a linear exposition of what I had learned in the preceding decade about strategic uncertainty and how to manage it effectively. But although writing a book is the culmination of one learning process, it is also the beginning of another: With a specific point of view available for others to engage, it becomes possible to learn much more, much faster than before.

Of what I've learned so far, the most relevant finding is that the most useful ideas in the book are perhaps of most use to directors. Specifically, the notion of "Requisite Uncertainty" as an organizing principle for managing strategic risk appears to make sense to many and also provides a powerful tool for dealing with otherwise nearly intractable problems.

Requisite Uncertainty is an extension of the work of Elliot Jaques, who coined the term "Requisite Organization" to capture the underlying principle of a well-functioning vertical hierarchy whereby each level of the hierarchy should be concerned with questions that play out over different periods of time, with higher levels concerned with longer time horizons, and lower levels with shorter ones.

Director Summary: The board has a significant role to play in the company's overall strategy when it comes to risk and their fiduciary responsibilities to shareholders. There is a balancing act to this role vis-à-vis management, and the author recommends ways for directors to assess management's strategy and know when, and how, to assert oversight of strategic plans.

One implication of this finding that I explore in my book is that longer time horizons imply greater degrees of strategic uncertainty. This is very clearly at odds with much of the conventional wisdom in the strategy field: My research strongly suggests that the more senior the management level, the more one should be concerned with identifying, embracing, and managing uncertainty.

This conclusion has two important implications for boards. First, it means that directors should have the longest time horizon and be concerned with questions subject to the greatest degree of strategic uncertainty. Second, it means that how the board measures and rewards senior management, which is similarly concerned with uncertainty, must change dramatically. These are the issues explored in the edited excerpt below.

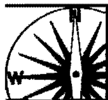
Chapter Six: It's About Time

The discussion so far has focused exclusively on the challenges facing managers. It is worth asking: What is the role of the board of directors in a company operating according to the principles of Requisite Uncertainty?

Most commentators frame questions of corporate governance in terms of agency theory. In one formulation, managers enrich themselves at the expense of essentially everyone else, gaming equity-linked compensation packages by artificially, and sometimes fraudulently, inflating the value of their companies. In another version, dominant shareholders exploit their control positions to extract value from a company via questionable and sometimes illegal transactions with other companies they also own or control. Either way, the objective is to build control systems that thwart such self-dealing.

Board Best Practices to Reduce Risk

Fortunately, there are well-known substantive measures that can reduce the frequency and severity of internal control lapses. In the case of Enron, for example, the board failed to detect and put a stop to unethical and illegal



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practices by members of the senior management team. The corrective measures required are at least conceptually straightforward and often consistent with generally accepted, if not legally mandated, governance best practices. They include: separating the chairman and the CEO positions; ensuring a significant majority of independent directors are on the board and that the audit and compensation committee have independent chairs; holding meetings of independent directors without management present; board-level review of corporate strategy and other significant decisions (e.g., acquisitions); and so on. Such measures by no means guarantee an absence of future control failures, but there is compelling evidence that these and other related practices will be rewarded with increased returns to shareholders.

At many other companies, on the other hand, the board's failure was far more subtle and difficult to pin down. Take, for example, Vivendi. Vivendi was pushed to the brink of bankruptcy as a consequence of the fallout from CEO Jean-Marie Messier's ultimately failed attempt to create a global media conglomerate. Much of the *post hoc* criticism smacks of hindsight bias. For example, the board is accused of failing to stop Messier from "overpaying" for acquisitions. But no one knew Vivendi paid too much until the strategy failed!

Board-level remedies for these kinds of lapses in strategic judgment typically focus on decision-making processes. There is a general consensus that directors do not and cannot know as much as management about the company, the industry, or the strategic challenges facing a company. Nevertheless, most informed observers feel that either the CEO should "make better use" of the board, or the board should be actively involved in strategic planning. At a minimum, this requires that directors engage the executive team, challenge key assumptions about the strategy, and contribute their insights and expertise.

This is surely excellent advice. It is clear that better decision-making processes lead to better decisions. However, better decision making does not remove or even mitigate the challenges posed by unpredictability and the limitations of corporate adaptability. Open and frank discussions between the board and management do not suspend the strategy paradox, they merely entrench it.

Separate Chair and CEO

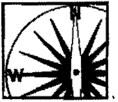
Consider, for example, corporate boards in the UK, where for decades the chairman and CEO roles have routinely been separated. In the UK, the chairman tends to be far more involved in the development of strategy than are independent board members of U.S. firms. The most observable consequence of this is that there is now one more qualified, experienced, and motivated person assisting the CEO in setting strategy.

There is no reason to think that this is bad. However, there is no evidence that British firms create better strategies or are any less vulnerable to strategic uncertainty as a result. In fact, the heavy involvement of an otherwise independent board member in strategy formulation can often lead to a form of "co-opting" or "groupthink," ironically undermining the independent review of strategic plans that the board is typically thought to provide. The challenge posed by the strategy paradox is not an agency problem because the strategy paradox is not a consequence of either criminality or decision-making bias. Resolving the strategy paradox means wrestling more effectively with the inescapable reality of an unpredictable and potentially radically changing future, and it requires a very different concept of strategic decision making.

The Longest Time Horizon

Under Requisite Uncertainty, the board grapples with the longest time horizon of all: the "going concern" assumption behind every healthy corporation. Practically speaking, the board does not address specific time frames, but can legitimately be said to be looking to the performance and survival of the firm *ad infinitum;* after all, the board's fiduciary responsibilities generally run to the shareholders and the corporation. It is legitimately—and perhaps primarily—the board's role to consider carefully the tradeoffs between risk and return implied by any strategy that management might propose. It is the board's responsibility to ensure the corporation's survival first, rather than the maximizing of returns.

When management prepares a strategy, the board's necessary involvement is not to engage the substance of that strategy, e.g., should a given acquisition go through or not, should a new market be entered or not, should a new product be developed or not. Such participation might very well be helpful, and best practice suggests that management should take advantage of the board insomuch as possible. But the board does not have privileged



insight into what the right commitments will be. Instead, it is the board's role to determine whether all the relevant strategic uncertainties have been identified, to insist that ways of managing that uncertainty have been developed, and that the associated costs of managing that uncertainty have been estimated.

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Assessing Management's Strategy

The board has four alternatives for assessing management's strategy:

1) It could conclude that management needs to *seek* greater risk in order to generate additional opportunities. Management might well have built a strategy that drifts toward the middle of its industry's strategic space, sacrificing returns in exchange for a greater possibility of survival. Since part of the board's fiduciary responsibility is to shareholders, and serving shareholders typically implies generating higher economic returns, there can be sound reasons for the board to insist that management pursue a riskier strategy.

2) It can *accept* the risks implied by management's strategy and that not all risks can be mitigated, not all opportunities pursued. The informed acceptance of risk is a valid business decision.

3) It could choose to *avoid* a given uncertainty. For example, entering a particular new market might offer enormous opportunity, but at commensurate strategic risk. If the board deems that level of risk too high, and unmanageable at acceptable cost, then the board can simply instruct that the new market not be entered. This decision would not be based on an assessment of the suitability of the strategy itself; that is, management might well have crafted the best possible way to enter this particular market, and is expected to generate acceptable returns. The issue is the risk incurred by seeking those returns.

4) Finally, and most powerfully, the board can insist that management *hedge* the uncertainty. That is, the board could require management to develop a way to mitigate the strategic risk while still preserving the ability to exploit the associated strategic opportunity.

By responding to strategic uncertainty with one or, (more likely), a combination of the above (seeking, accepting, avoiding or hedging) the board determines the company's overall exposure to strategic risk and opportunities. It is then management's role to create the exposure that the board has deemed appropriate.

This distinction is critical. The expectation should always be that "management knows more," and so the board cannot make substantive contributions to strategy. In fact, the board might not even know as much about the strategic uncertainties facing the corporation as management does or how best to address those uncertainties. But knowledge is not the issue here; it is fiduciary responsibility. In a world where managers are responding to high-powered incentives based on grants of stock or stock options, there is an asymmetry of risk between the corporation's various stakeholders and management. Management will have a bias toward far riskier investments than others, not as a consequence of malice or deceit, but because that is what the compensation systems reward. Every compensation scheme has frailties, and equity-based compensation skews the risk preferences of high-level managers. Conversely, long-term career managers more interested in the stability of their tenure and personal empire building may well need to be directed to generate greater corporate exposure to promising opportunities. Either way, what is required is a countervailing force, and for standard agency reasons, this force must be separate from, and senior to, the CEO. That can only be the board.

The board cannot decide "what should the company's strategy be," but it is uniquely positioned to determine how much exposure to risk and opportunity the corporation should have. The board determines the risk-return profile of the firm. This is materially different from helping management make better strategy. Instead, Requisite Uncertainty calls upon the board to define the parameters of risk and opportunity within which management must function. ■

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