Strategy according to Porter

By Terje Bjørnsen

In today's business world there are few words used in as often as "strategy". Easily attached to other words like "business", "resources", "finance", "customer" and sounding important makes it a popular word. "Strategy" has different meaning for different people. Although often used in a superficial way it has a deeper meaning not easily pinned down.

Financial Times reported in 1999 about a survey of mission statements in 55 global blue-chip companies [i]. It found that the main difference between them is one of length. This fit with my own experience. Strategy statements are often of little value because they usually state the obvious. "We will focus on the most profitable customers" or "we will offer the best price/performance" are typical generalities found in strategy plans.

This vagueness about strategy provides a fertile ground for writers. There are thousands of books written on this issue, and new theories and frameworks come and go almost like fashions. When I started to work with strategic issues in my first job the BCG-matrix was a key tool. Later on the "five-forces" and "value-chain" models dominated, and more recently other useful concepts like "value-networks" and approaches like the "resource based view" of strategy.

However, the most enlightening article I ever read about strategy is "What Is Strategy?" by Michael E. Porter [ii]. In my view this is one of the few articles that go to the core of the matter. It also shows what strategy is not, and provides an interesting attack on popular frameworks like "core competencies" and "key success factors".

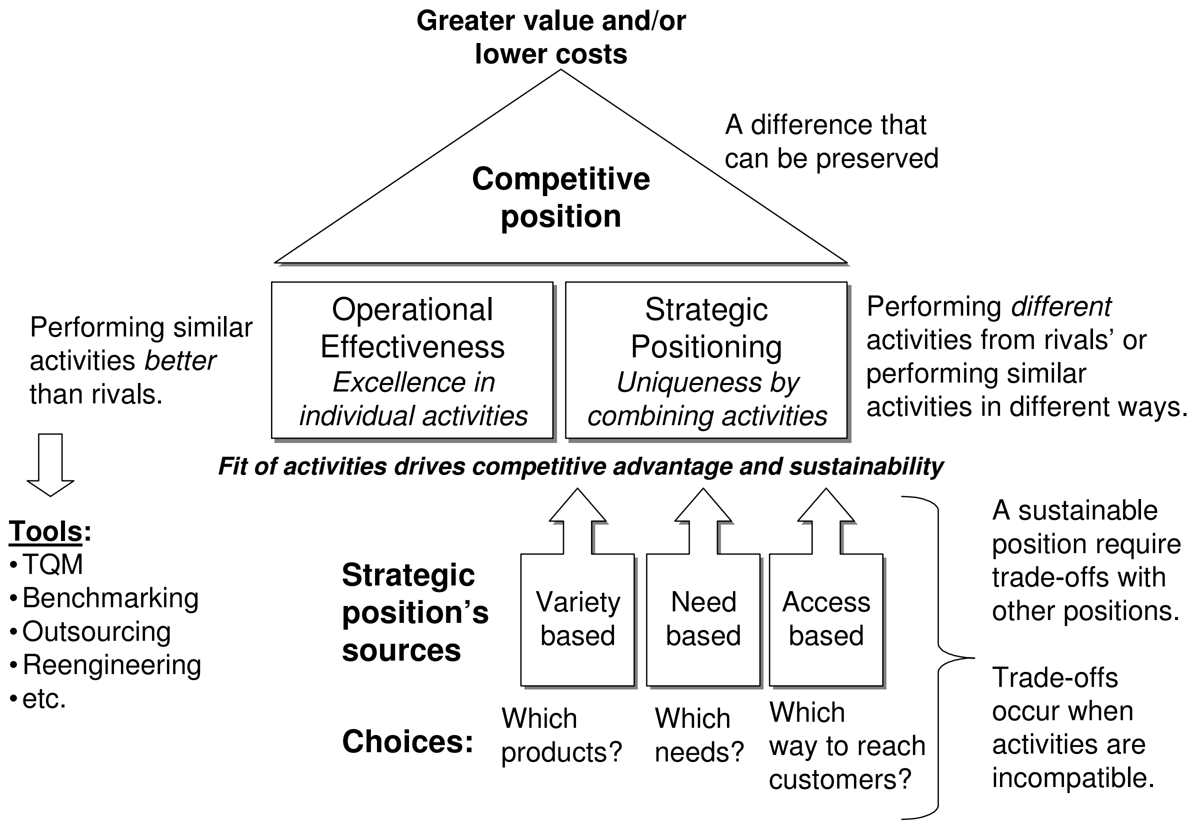
Strategy according to Michael Porter

Porter's starting point is the popular notion that in today's competitive society rivals can copy any market position and that competitive advantage is, at best, temporary. According to Porter these beliefs are half-truths and "leading more and more companies down the path of mutually destructive competition".

According to Porter the root of the problem is the failure to distinguish between operational effectiveness and strategy. Although both are essential to superior performance they work in very different ways. Operational effectiveness means performing similar activities *better* than rivals perform them. In contrast, strategic positioning means "performing *different* activities from rivals' or performing similar activities in *different ways"*.

By focusing on only operational effectiveness "companies will contest in a race down identical paths that no one can win ("zero-sum competition")". Competition based on operational effectiveness alone is therefore mutually destructive. The winner is most often those that outlast the others.

A company can outperform rivals only if it can establish a difference it can preserve, either by delivering greater value or by delivering similar value at lower cost, or both. All differences between companies in cost or price derive from the hundreds of activities required to create, produce, sell, and deliver their products or services. Differentiation arises from the both the choices of activities and how they are performed. *Activities are thus the basic units of competitive advantage*. Porter's framework is illustrated in the figure below.



Operational effectiveness

Operational effectiveness goes beyond efficiency and includes any practices that allow a company to better utilize its inputs. Differences in operational effectiveness are an important source of differences in profitability among competitors. They directly affect relative cost positions and levels of differentiation. Most of the tools and frameworks introduced the last decade have focused on improving operational effectiveness, e.g. Total Quality Management (TQM), benchmarking, outsourcing, reengineering, etc.

To illustrate this Porter introduces the *productivity frontier* that constitutes the sum of all existing best practices at any given time. By improving its operational effectiveness a company moves towards the frontier. The productivity frontier is constantly shifting outwards as new technologies, inputs and approaches are developed, thus raising the bar for everyone. Constant improvements in operational effectiveness are therefore necessary in order to achieve superior profitability, but it is usually not sufficient for two reasons: Firstly, new approaches and practices are easily imitated. Secondly, by using the same practices and benchmarking against each other companies become more alike. Substituting strategy with operational effectiveness will therefore usually lead companies towards lower profit margins.

Japanese companies in the 1970s and 1980s provide a good example of operational effectiveness type competition. Their industry leadership has typically been built on superior effectiveness, but this position has been eroded as competitors copied their approaches. Today Japanese firms typically struggle to keep sufficient margins.

Strategic positioning

In addition to operational effectiveness a company must establish a strategic position it can preserve. This is not easy and requires creativity and "deliberately choosing a different set of activities to deliver a unique mix of value". The essence of strategy is thus in the activities.

There are three distinct sources of strategic positions. These often overlap and are not mutually exclusive:

Variety-based positioning. This implies producing a subset of and industry's products or services. This makes economic sense when a company can best produce these using a distinctive set of activities. An example is Neutrogena Corporation who originally only provided Neutrogena "kind to skin" soap.

Needs-based positioning. This implies serving most or all the needs of particular group of customers using a tailored set of activities. Ikea, for instance, targets young furniture buyers who want style at low cost. The fundament of needs-based positioning is that there are groups of customers with different needs, and that the best set of activities to satisfy them *also* differs.

Access-based positioning. This implies segmenting customers who are accessible in different ways, typically as a function of geography or customer scale. Although their needs are similar to other customers, the best configuration of activities to reach them is different. One local example is Hjem Is (*Home Ice*) whose cars drives around selling ice-cream to customers on their doorsteps.

Although variety and access positioning do not rely on *any* customer differences, they often accompany needs differences.

Because a valuable position will attract imitators, choosing a unique position is not enough to guarantee a sustainable advantage. There also has to be trade-offs with other positions. Trade-offs arises when activities are incompatible; that is, "more of one thing necessitates less of another". There are three reasons why trade-offs arise:

1. Inconsistency in reputation or image.
2. Different positions require different sets of activities (different product configurations, different skills, different employee behaviour, and different management systems).
3. Limits on internal co-ordination and control. A company can not be all things to all customers.

Position trade-offs are essential to strategy because it necessitates choice and limits what a company can offer. A company trying to imitate a position will typically degrade the value of their existing activities. Thus choosing what not to do is at the core of strategy.

An example that comes to mind is Hennes & Mauritz (H&M) attempt to copy Lindex's position in the apparel market. H&M typically serve young people while Lindex serve the more mature women by also offering baby and children clothing. When H&M also introduced baby and children clothing some of its original young customers disappeared. They did not like to shop in the same stores as mothers.

Fit drives competitive advantage and sustainability

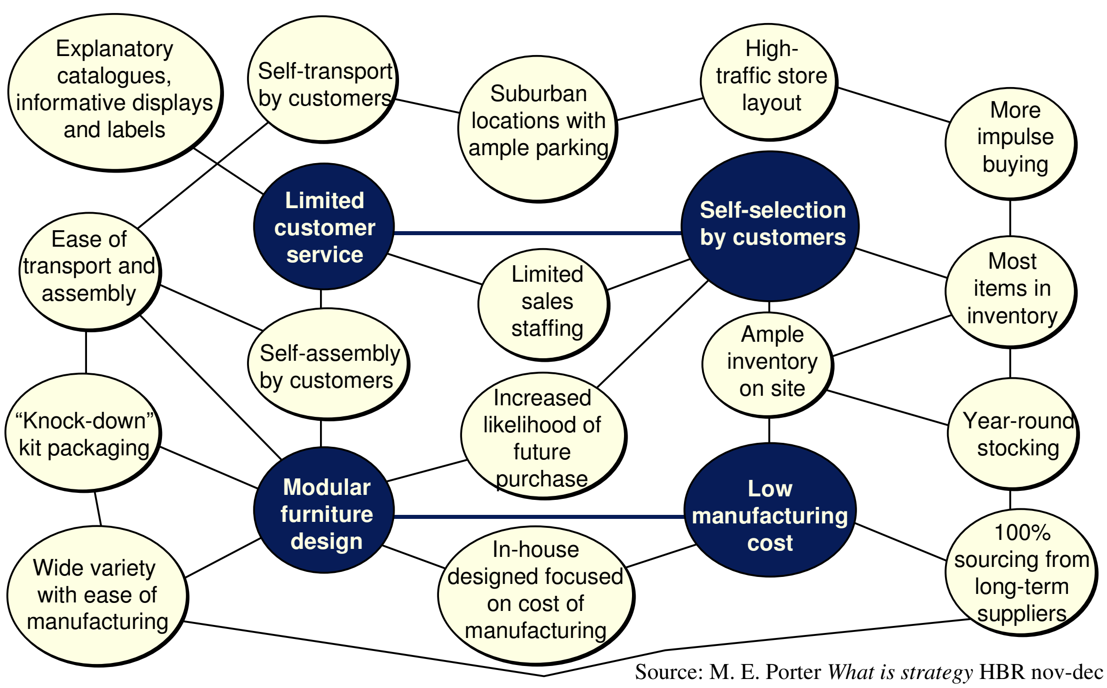
According to Porter, instead of looking at "core" competencies, "critical" resources and "key" success factors, managers should see the company as a whole by ensuring fit among all its activities. Porter exemplifies this by looking at companies' strategic position as a system of activities, and how these activities *fit* and reinforce each other. *It is this fit that drives competitive advantage and sustainability*. "Positions built on systems of activities are far more sustainable than those built on individual activities". It is the *entire system of activities* that give competitive advantage, not part of it like core competencies or critical resources.

Porter distinguishes among three types of fit:

1. *Simple consistency* between each activity (function) and the overall strategy.
2. *Second-order fit* implies that activities are reinforcing.
3. *Third-order* fit optimise effort across activities, and goes beyond reinforcement.

By building a company's position on activity systems with second- and third order fit, the competitive advantage will be more sustainable because such systems are harder to imitate from outside the company.

One of the examples Porter uses is Ikea whose strategic position is contained in a set of tailored activities or themes designed to deliver this position, see figure below.
Ikea's strategic position is supported by several high-order strategic themes (dark



Source: M. E. Porter *What is strategy* HBR nov-dec 1996 shaded) implemented through clusters of tightly linked activities (light shaded). A competitor of Ikea could probably imitate some of these activities, but not all. For example, a supplier of expensive design furniture would not be able to have ample inventory on site or make the customer assemble their furniture. There are trade-offs and any player will need to make choices among incompatible activities. When crafting a strategy all activities matter, looking only at core competencies or key success factors is to narrow.

Strategy is thus about combining reinforcing activities to establish a unique position. According to Porter most companies owe their initial success to a unique strategic position involving clear trade-offs. An entrepreneur must therefore make clear choices among incompatible activities. Porter very much supports the belief that strategy is intended: "Strategic competition can be thought of as the process of perceiving new positions that woe customers from established positions or draw new customers into the market".

Strengths and weaknesses

I think the main strength of this well-written article is that it manages to explain and clarify what strategy really is. It not only confirm that "strategy is choice" but outline why and what sort of choices managers must make, the sources of strategic positioning and the importance of fit among activities.

Porter also gives a clear diagnose of why the popular frameworks of the last decades not has produced any sustainable competitive advantage. The reason is that they are tools for improving operational effectiveness and are as such easily copied.
Porter's insights does not reduce the challenge of designing a good strategy, rather it makes clear what kind of features such a strategy must have in order to be good and sustainable.

Porter shows how subtle strategy can be, and it is a bit curious that he seems to firmly believe that management should plan strategy. I believe that Porter insights should be moderated by a bit of Mintzberg. In real life some of the reinforcing activities, and thus the strategy, will emerge or be found rather than being planned [iii]. Chance and luck plays a role. A firm's position can accidentally be improved beyond what was intended when a new activity is implemented. This may also explain why there are many similarities between Darwin's evolution theory and today's competitive markets [iv].

On the other hand, Mintzberg also supports Porter in that the subtleties of strategy require "craftsmanship" [v].

It is apparent that Porter has progressed beyond his earlier work on competitive strategy[vi] where he introduced the generic strategies (cost leadership, differentiation and focus). The connection between these two theories is that the bases for positioning – varieties, needs, and access – "carry the understanding of those generic strategies to a greater level of specificity". I find this argument not overly convincing. It is almost as he has invested too much to abandon the old theory.

All examples used by Porter to underpin his points are from traditional industries like airlines, insurance, furniture, staples, brokerage, etc. I am not so sure that strategic positioning would work to the same degree in competence industries like professional services.

Conclusions

Porter's theory resonance well with my own experience working with product marketing and strategy issues within the computer and telecom industries. All too often managers focus on operational efficiency rather than selecting (and choosing) which activities should be done and which should not be done.

This resistance in choosing often results in a poor ability to serve any customer segment. One typical example is the large company with broad product range and high quality service that in order to compete with cheap niche companies copy their products.

By understanding the deeper meaning of strategy managers should be able to construct a system of activities that reinforce each other and support desired position. The key point is to focus on these activities and realise that these are deliberate choices that may exclude other activities. Once these choices are made the company can focus more on the operational efficiency of these activities.

One additional benefit of this approach is that business plans now may become readable. All too often, such plans are foggy and contain only matter of course. Suddenly employees can see why the chosen activities are chosen and understand what kind of company they work in.

Terje Bjørnsen, 24. oktober 2004

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[i] Financial Times: *Full of sound and theory, but signifying nothing*; May 10th 1999

[ii] Michael E. Porter: *What Is Strategy?*; Harvard Business Review Nov-Dec 1996

[iii] Henry Mintzberg: *The Fall and Rise of Strategic Planning*; Harvard Business Review Jan-Feb 1994

[iv] Michael Hannan and John Freeman: *The population Ecology of Organisations;* American Journal of Sociology, March 1977

[v] Henry Mintzberg: *Crafting Strategy;* Harvard Business Review Jul-Aug 1987

[vi] Michael E. Porter: *Competitive Strategy;* The Free Press, 1985