In an interview Michael Porter turns the tables on his own class strategic thinking—that the external environment determines strategy, and strategy determines structure—and suggests that strategy is greatly affected by organizational issues, and may even be determined or impeded by it.

A Conversation with Michael E. Porter: A "Significant Extension" Toward Operational Improvement and Positioning

INTERVIEWED BY RICHARD M. HODGETTS

Michael E. Porter is the C. Roland Christensen Professor of Business Administration at the Harvard Business School and a leading authority on competitive strategy and international competitiveness. He joined the Harvard Business School faculty in 1973 and became one of the youngest tenured professors in the School's history. His ideas have now become the foundation for one of the required courses at the School. Among the Harvard Business School's most popular teachers, Professor Porter teaches strategy and has created and leads a workshop at the School for newly appointed chief executive officers of billion dollar corporations. He also speaks widely on competitive strategy and international competitiveness to business and government audiences throughout the world.

In addition, he is the author of 15 books and over 50 articles. His Competitive Strategy: Techniques for Analyzing Industries and Competitors (1980) is widely recognized as the leading work in its field. A companion book, Competitive Advantage: Creating and Sustaining Superior Performance, was published in 1985 and The Competitive Advantage of Nations (1990) developed a new theory of how nations, states, and regions compete. His most recent research represents a return to his roots in company strategy. This interview focuses on some of these new ideas, and it was conducted by Richard M. Hodgetts, book review editor for Organizational Dynamics and a frequent contributor to the journal.
HODGETTS: Michael, as you know, this issue of Organizational Dynamics is focusing on new developments affecting management in the 21st century. As you talk to organizational leaders and strategists throughout the world, and begin pulling together what's happening, has your thinking been changing in any way? How have you been reformulating your ideas of what effective strategists do?

PORTER: I have become increasingly intrigued with the intersection of organization and strategy. We have tended to think that organization should follow and support strategy, and that is true. The more I've thought about it, however, the more I've come to realize that the challenge of developing a strategy is greatly affected by organizational issues. In short, I used to think that the biggest challenge in developing strategy was understanding the external environment, properly gauging how industry structure was changing, understanding the way competitors were moving, and so on. I still believe that these challenges are difficult and complex, and require strategy tools and techniques. But the challenges go way beyond the external environment per se.

HODGETTS: So you're now beginning to expand your emphasis to include organizational considerations?

PORTER: Yes, I've come to see that in many ways an equally formidable challenge in developing a sound strategy comes from within. There is a host of internal factors that constrain or divert managers from formulating effective strategies and making the choices on which every strategy depends.

HODGETTS: Is this a total change in your thinking?

PORTER: No, but it is a significant extension. I was trained to think in terms of the classic Alfred Chandler—a company had a strategy and that strategy should then determine the kind of organizational structure, incentives, norms, and so forth that enterprises would adopt. There was always the acknowledgment of a feedback from structure to strategy, but this was a dotted line. I've come to see that, in many companies, what actually happens occurs in reverse order.

HODGETTS: Could you give us an example?

PORTER: The ways managers think about competition, the ways they measure their results, the structure in place, the incentives that are used to motivate people—all of these actually drive the choice of strategy or, more commonly, the choice of a nonstrategy. This became increasingly evident as I began to draw the distinction between strategic positioning and operational improvement. In my earlier work, it was clear that implementation was important and could be better or worse, but I saw strategy as the dominant driver of differences between companies. Now I've come to see that the distinction between strategy and implementation is the wrong distinction. There really is no meaningful distinction between strategy and implementation, because a strategy involves very fine grained choices about how to configure particular activities and the overall value chains. The relevant distinction is not between strategy and implementation but between operational (or best practice) improvement and positioning.
HODGETTS: Exactly what is that distinction?

PORTER: Operational improvement involves incorporating practices that would be good for any company—doing the same thing as rivals but doing it better. Strategy is the pursuit of a unique way of competing, not because it is the universally best way of competing but because it allows a company to uniquely tailor the activities in its value chain. Strategy is choosing to deliver a particular kind of value, rather than just trying to deliver the same kind of value better.

HODGETTS: Are you saying that best practices can be a part of strategy, but that strategy cannot be tied exclusively to best practices?

PORTER: Let me put it this way. Best practice improvement and strategy are not mutually exclusive. Both must be present. Best practice improvement is a hard game to win—it's very hard to sustain an advantage here because rivals are also motivated to do it. The real advantage normally comes in differences in strategic position supported by tailored activities, tradeoffs, and fit. As this distinction has become more clear to me, I have come to see that the vast majority of what managers do is best practice improvement—trying to find universally good or the universally best ways of competing. This effort gained tremendous momentum during the 1980s and 1990s, crowding out strategy in many companies. Organizational issues reinforced this tendency.

HODGETTS: What kind of issues did it create that impacted on strategy?

PORTER: A number of organizational realities work against strategy. One is cognitive limits. These relate to how managers think about competition and the limitations faced by individuals and teams in solving complex problems. Many managers have developed a kind of inappropriate view of competition—they see it as essentially best practices improvement. They believe that there is a single best way of competing. So they frame their challenge as finding the best technology or the customer needs. They strive to be the first to discover that best way of doing things, and to get there first. Unfortunately, this way of thinking makes it almost impossible to get a competitive advantage that you can sustain. What it leads to are temporary advantages that will easily be copied.

HODGETTS: Why do you think managers think this way?

PORTER: This view of competition has been partly fostered by the literature. In describing the "new economy," authors claim that no advantage can be sustained. Or, because changes are so rapid, a company should not make choices but remain nimble and flexible and learn more rapidly. While there are important truths here, they are partial truths and lead to best practices competition.

But best practice competition creates a self-fulfilling prophecy. Rivals do the same things, offer the same products and the same services. Advantages then cannot be sustained. Customers are forced to choose on prices because there is no other basis on which to choose among companies. This undermines prices in the industry. So your view of competition shapes how you think about strategy.

HODGETTS: Are there other cognitive issues?

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PORTER: The other issue is something that Henry Mintzberg and others have been talking about, which I have become more sympathetic to from a descriptive point of view, but not, I must emphasize, from a normative point of view. Creating a strategy involves a good deal of complexity. The discovery of a unique position with tailored activities supported by tradeoffs and involving fit among the activities is an inherently complicated conceptual problem. Strategy involves the cognitive problem of seeing the whole in an integrated way where there are many activity parts. “Solving” a problem of this complexity is challenging. If we contrast this to best practices improvement, it is clear that best practice improvement is cognitively easy – it is possible to break up the problem into discrete parts (each activity), delegate to this level, and ask managers to scour the world for improvements and incorporate them into their function. So you can see why cognitive limits tend to foster incrementalism.

Mintzberg and others have suggested that managers cannot handle the cognitive problem of strategy. Therefore they don’t really set strategy at all but make logical, incremental improvements. This is true in many organizations. Using my theory, we can extend this to realize that incremental improvements will most likely be in operational effectiveness. However, logical incrementalism will tend to be destructive to a company’s competitive position. Since the set of activities in a strategy fit together and reinforce each other, logical incrementalism is unlikely to result in a strategy. Strategy requires that many things must be changed at once to attain a strategic position. Why don’t companies avoid the pull of logical incrementalism? Part of the answer is cognitive limits—the way people think. This is particularly likely to happen if managers are not equipped with the appropriate strategy tools.

HODGETTS: What other organizational issues work against strategy?

PORTER: A second set of issues revolve around measurement. Most companies don’t measure their performance very well. For example, the big message of economic value added (EVA) is that a company has to account for the cost of capital in measuring its performance. If a company just looks at return on sales, it will get a distorted view of its true success. This is just one of a whole series of measurement problems that undermine sound strategies and tend to encourage best practice competition and competitive convergence.

HODGETTS: What are some others?

PORTER: A major problem is poor allocation of overhead, which afflicts most companies and obscures the profitability of individual product lines or individual customer accounts. By using measures like revenues or units, companies tend to bias profits upward for smaller product lines and customer accounts. Normal accounting understates the amount of actual effort (and real cost) that difficult customers or product lines requiring a lot of effort represent. The activity-based cost literature has highlighted this issue and made it obvious that most companies’ measurement is distorted. The result is that companies make a profit on a relatively small part of what they do, and then they erode that profit on most of the other things they do.

These flaws in measurement work against strategy. With a faulty measurement system, you think you are improving profitability by expanding the product line and “spreading overhead.” An accurate measurement system would reveal that
the company makes most of its profit from those product areas where it is really
distinctive, and broadening the strategy will actually erode profits rather than
raise them. Current measurement systems work against strategic choices.

HODGETTS: You said earlier that there were three classes of organizational barriers to strategy.
You have talked about cognitive and measurement issues. What's the third one?

PORTER: The third area is organizational structure and incentives. Again, there are a set of
forces working against strategic choice and in favor of best practices competition.
Strategy, at its core, involves choices and tradeoffs that are often viewed as risky
because the company must set itself apart from industry rivals — and if the choices
are poor ones, then managers look silly if rivals are doing well. This creates a series
of principal-agent problems both with shareholders and within the firm that tend
to lead both senior-level management as well as departmental managers within
the firm to pick the safe course, which is following or slightly leading best prac-
tices within the industry. This is the safe way of doing things because it eases the
monitoring task versus making judgments about appropriateness of strategic dif-
fferences. So there is a principal-agent “bias” working against strategy.

The more authority to make decisions is pushed down, the greater the risk of
best practice improvement at the function/subunit basis. For example, if the gen-
eral manager delegates to the marketing department the task of improving mar-
eting, the marketing department will tend to look for best practices in marketing
and try to emulate them. The R&D group will do the same thing, the production
group will do the same thing, and so on. The company will end up with a homo-
genous way of competing because it will be the sum of best practices in all the
functional groups.

It is difficult to have a strategy unless the general manager enforces the per-
spective of the whole. Usually it is a general manager who must help the market-
ing department understand that the company's approach to marketing should be
different from best practices because of its particular positioning. Delegation
works against strategy, although it is extremely helpful in fostering operational
improvement.

HODGETTS: Do these issues permeate the entire organization?

PORTER: They do. In fact, we can go down another level and find that individuals often
have a vested interest against strategy and in favor of best practices. How do most
individuals measure themselves? Typically, they identify with a profession—
being an engineer, a salesperson, an advertiser, or an IT person. Individuals look
to reference groups for measuring how well they are doing. But these reference
groups are dominated by best practices. In IT, if the best practice companies are
moving to web-based order processing, their professional stature will be bound up
in bringing such concepts into their company—reinforcing best practice competi-
tion.

There is also a more subtle argument in which individual incentives work against
strategy. A competitive unique position tends to create a situation where particu-
lar individual skills are most valuable within a particular company and less val-
uable in another company with a different strategy. In some sense, then, the more
unique the strategy of the company, the less bargaining power individuals have
and the less marketable they are, except to a competitor trying to copy the
strategy. We’ve had this situation at the Harvard Business School for years, flowing from our unique positioning—we expect our faculty to write case studies and do a lot of course development. But the tension is that the faculty member wants or needs to go somewhere else, the heavy investment in cases will be irrelevant and all the skills developed will not be viewed as valuable. In contrast, writing journal articles (like professors do at most schools) will be widely viewed as valuable.

It’s the same issue in companies. Individuals have a vested interest, to some extent, in working against strategy. This is especially true as tenure within a given company shortens. In places like Silicon Valley, known for its rapid turnover, we should expect to find a lot of imitation and best practice competition.

HODGETTS: So you have been modifying and expanding your view of strategy?

PORTER: Given that so many cognitive, measurement, organizational, and incentive issues are lined up against strategy, the companies that have good strategies tend to share a number of characteristics. They are often led by very strong people with a clear sense of the strategy and the confidence, commitment, and strength to overcome all of these forces. They are also organizations which often deliberately recruit outside the industry. These ideas carry strong implications for the role and behavior of leaders that I hope to develop. There are many other implications for how to modify measurement systems, organizational practices, and incentive systems to provide room for strategic choices.

This whole discussion was triggered by drawing the basic distinction between operational effectiveness and strategy, and defining strategy much more precisely than we have before. There has been a tendency to see strategy in terms of a grand design. Implementation, the nitty-gritty, was different. And what I have attempted to do in my new work is to make strategy very concrete. My definition of strategy is integrally connected in a fine-grained way to activities and to what firms do. Armed with this thinking, it will be possible to revisit some of the principles of organizational design and ways of structuring incentives. Many of the issues I raise have been recognized in one way or another in the organizational literature but not well integrated with strategy.

HODGETTS: In being different, as you’ve implied, companies have to make tradeoffs. Does your research lead you to believe that instead of making many of these hard tradeoffs, many companies try to straddle and do too many things?

PORTER: What you mention is very common. There are several reasons why companies straddle. First, straddling is perceived as less risky, and hedging bets. Second, many managers remembering the notion that “quality is free” think that they should not make tradeoffs. They pursue lowest cost and highest quality at the same time. My research suggests that a company can improve both simultaneously, but at the end of the day it is very rare that the company can be both lowest cost and highest quality unless the competition is inept. Whenever a company tries to straddle, it becomes vulnerable. Straddling is common for many of the organizational reasons I have talked about.

HODGETTS: When companies decide that they are not going to straddle, is it more difficult for them to go upscale, improving their image and higher quality goods and services, or are they more inclined to move down?
PORTER: If a company has a strong brand image and a good reputation for quality, it is often easier to migrate down. Having said that, I don’t think one can generalize about whether it is more appropriate to move up or down. Different companies will make the tradeoff in different directions partly based on their own internal circumstances and partly based on where the array of competitors is positioned.

One of the things that I suggest a company do is to examine product line and customer line profitability. If overhead and effort are allocated properly, companies usually find that they are more profitable in certain product lines and with certain customers. Through this empirical approach, it is often possible to learn where a company is really unique and get clues about which direction to move in getting away from straddling. If a company finds that it is not making money in the lower price products, this reveals weaknesses that help to resolve the issue. In moving to a clear strategy, companies often get caught up in scale—the desire to be big—which defers strategic choices. But one of the keys to American competitiveness in the world economy is that we are one of the few countries where companies can shrink with honor. This allows companies to exit areas they should not be in or shrink product lines that are blurring overall position.

HODGETTS: You have written that strategic positions emerge from three distinct sources. Could you tell us more about them? What do managers need to know so that they can more clearly understand and apply this idea?

PORTER: The essence of a strategy is setting limits. A company must set limits on what it is trying to accomplish in the marketplace; what value it is trying to deliver to whom. The three sources of strategic position you referred to, which I refer to as origins, are three generic types of limits.

HODGETTS: I see. What are these three generic types of limits?

PORTER: One is to limit the product or service set that a company offers. I call this variety positioning. A second is to limit the customers served based on their need. Third, a company can limit the customers served based on their accessibility.

To devise positioning, managers must examine their industry along each of these three dimensions and see if there is a meaningful segmentation. Let’s take variety positioning. The starting point is to list all of the existing and potential product or service varieties that exist in the industry. Then the task is to group them into categories based on the economics of the value chain for providing them. A robust positioning grows out of the advantages of a tailored value chain in serving the targeted varieties. The brass ring often goes to the company that can devise the new way of grouping varieties or customers—not old ones. Dell is a good example. Many companies thought in terms of the high end and the low end, but Dell found that if it addressed the mid-range where customers were reasonably knowledgeable and the service component was modest, then the whole direct sale model became feasible.

HODGETTS: A second approach is called needs-based positioning, yes?

PORTER: Right. We have long known from the marketing literature that you can segment groups of customers with different needs. If one does this creatively, one can often find a new grouping that reveals a new positioning. My theory, however,
stresses that a customer segment alone is not enough to support positioning. The value chain that best serves the segment must also be different.

HODGETTS: How does the third type, access-based positioning, work?

PORTER: Access-based positioning focuses on delineating customer groups that are accessible in different ways. For example, Carmike Cinemas operates movie theaters in cities and towns with populations under 200,000. Operating efficiently in these locations requires a different configuration of activities than in urban areas, and Carmike has honed these by specialization.

HODGETTS: What are the implications for managers in effectively using these positioning approaches?

PORTER: The challenge is to find a creative way of setting limits in one of these three ways to allow for uniqueness. Strategies often involve a combination of more than one of them. The trick, of course, is to find a set of customers or products that is not already the strategic focus of a competitor, and to ensure there are tradeoffs—serving the set well is incompatible with serving others.

HODGETTS: In some of your recent writings you have been discussing first, second, and third order fit. What do you think practicing managers need to understand about this topic of fit?

PORTER: First order fit is simple consistency. A low cost producer has low cost marketing as well as low cost production. This notion of fit has long roots in the literature and the way managers have tended to think about the idea.

HODGETTS: What do you mean by second and third order fit?

PORTER: With second order fit, all activities are reinforcing—what an economist calls complementarity. For example, the merchandising approach in a retail chain is reinforced by the logistical model. The two activities work hand in hand. Third order fit occurs when there is optimization of effort throughout the entire value chain—this involves substituting effort in one activity for effort in others. A retailer might store inventory in the store (as in The Home Depot) instead of relying on frequent replenishment from a regional distribution center (as in Lowe’s).

HODGETTS: Let me turn to another idea that you have been incorporating into some of your latest writing—the use of activity systems to create value and develop unique strategies. What do managers need to know if they want to learn how to effectively map activity systems? It seems to me that it is not something that is intuitive. It takes quite a bit of thought.

PORTER: It does. There are two directions in which I would take your question. One is how can a company, such as Southwest Airlines, ever develop its activity system? We’ve done some research on the historical evolution of activity systems and found that companies rarely get it all in the beginning. They start with a core of activities but over time see more opportunities to extend the system and new types of fit. Linkages are made explicit that previously were only intuitive. Good
companies also continue to extend their activity system based on new opportunities offered by changes in technology or other external conditions. For example, ten years ago high convenience in banking meant ATM machines. Today high convenience means internet banking and mini-branches in other retailers.

A second way to address your question is to return to cognitive limits. There are very few people who can start off with a clean sheet of paper and invent an entire activity system around a new positioning. The actual process is to start, refine, improve, and extend. Managers struggling with the concept of mapping activity systems must see it this way, not as a 10-dimensional system that can be solved from the beginning. The starting point is to lay out the activities at a given point in time, and then investigate how individual activities relate to others. This leads to an understanding of the types of fit that might exist.

There has been a tendency in some of the strategy literature to portray it as the fixed outcome of a single planning process. Actually, strategy is not static. Companies strive for a robust first approximation that clarifies their direction. As they learn and understand, new tradeoffs and nuances can be identified. It’s a never-ending process.

HODGETTS: In a recent article, you made an interesting comment about Japanese firms not being able to compete effectively in recent years, and you linked this to the absence of strategy. Can they change, or do you think that they are culturally constrained?

PORTER: I have recently been working with some colleagues on a book on Japanese competition. Japanese firms, for many historical and cultural reasons, became incredibly good at improving operational effectiveness, but face very high barriers to developing clear strategic positions. They quickly copy new products, new services, and new approaches used by the competition. The West has caught up in operational effectiveness on traditional dimensions, but Japanese companies are behind in new areas such as IT.

If organizational issues are stacked against strategy in the United States, they are doubly or triply stacked against strategy in Japan. Japan is a country where consensus is a way of life. It is a very egalitarian society where there are few individual incentives, and managers tend to be risk averse—they imitate and copy. The real challenge facing Japanese firms is that developing real strategies will require a cultural and organizational change of a high order. Right now the companies in Japan that have clear strategies are few and far between, and are viewed as mavericks. That’s the bad news. The good news is that things are very bad in Japan right now. The country is beginning to question many things about itself, and there may be growing openness to modifying some of these long-standing cultural practices.

HODGETTS: Is it easier for Japanese firms that have operations in the US to make adjustments that they can’t or won’t make in their home market?

PORTER: Yes, it is. One of the big hang-ups to strategy in Japanese firms is the permanent employment model, which has forced them to do almost anything to generate enough revenue to keep people employed. Yet any company that starts out to preserve employment is almost guaranteed to destroy employment. Japanese firms are caught in this trap, keeping people working even though they are not
competitive. Additionally, this can result in firms making decisions to go into fields where they have no expertise. Japanese firms feel less of these pressures when operating in overseas countries. So in some respects, their foreign subsidiaries should be the places where Japanese firms learn strategy. Having said this, I should point out that I have found that Japanese MNCs operating in overseas locations almost always see other Japanese firms as their primary competition.

HODGETTS: Is this behavior also culturally driven? They want to look good vis-à-vis other firms from their home country?

PORTER: Yes. The Japanese press, as you probably know, provides extensive coverage of Japanese firms. Individuals' personal status and prestige is very much tied up with their companies. This tends to compound imitation.

HODGETTS: Let me close by asking you one final question: What are three things that managers will have to do better if they want to compete effectively in the 21st century?

PORTER: One is that they are going to have to get better at making strategic choices. After an era of operational improvement, we have to get back to strategy. Second, there is a need to restore the role of the general manager. In the last few decades we have seen the role of the general manager blur. Too many general managers see their jobs as doing deals and delegating. The role of the general manager in strategy is the primary role. Third, we will need to move beyond the era of cost and price and understand differentiation both as competitors and as customers. Imitation is undercutting real customer choice and prices. This is a byproduct of operational effectiveness competition. Companies, in turn, have gone too far in paring down and beating up on their suppliers. There is a need to move to the next level of understanding that creating superior customer value, and justifying different price levels for different products, is an integral part of competing.

ABOUT THE INTERVIEWER

Richard M. Hodgetts is a professor of management at Florida International University. He is the author or co-author of 22 hardcover texts, including International Management (McGraw-Hill, 1991), which he co-authored with Fred Luthans. He has earned degrees from New York University, Indiana University, and the University of Oklahoma.