Directional Strategy

by Stephen Bungay, Rebecca Homkes and Anthony Freeling

How to Make Good Decisions When You Cannot Make Good Predictions

In 1850, Chicago journalist Horace Greeley urged America's young men to 'Go West.' He didn't specify a destination, like San Francisco or Colorado. He didn't have to. The West was the land of opportunity and there were fortunes to be made—even though it wasn't exactly clear how the westward migration would play out. His injunction was not precise—but it was accurate. It was directionally correct.

The same is true in today's uncertain times. When conditions are volatile and the future is unclear, setting the right general direction is more important than setting a destination. Then, as conditions evolve and greater clarity emerges, companies continually adjust their heading and pace. Rather than following a masterplan, the strategic game is played out in a series of moves, each building on the last and the new situation it creates. It's a way to fight the paralysis and inaction that can come with uncertainty—or worse, the risk of making big bets on the wrong thing. This exploratory approach is not unlike that used by explorers in the age of sail. We call it *directional strategy.*

Unlike traditional strategy, which calls for a clear end-vision and specific goals, directional strategy allows companies to move forward even when facing the unknown. Most companies are quite good at planning for probable outcomes in stable environments. But few companies have a systematic process for dealing with unfamiliar unknowns such as digital disruption, artificial intelligence, or Brexit—developments with no precedent and minimal data to analyze. With so little to go on, how does a company know where to start and how does it make progress?

Directional strategy has four elements: creating an orientation by defining your beliefs; agreeing on a compass heading and pace; optimizing decisions for robustness to avoid killers and seek out kickers; and choosing a series of evolving strategic stances. Let's look at each of these steps more closely.

Orientate by Defining Your Beliefs

In familiar situations, data and experience can be reliable guides. In unfamiliar ones with little data, experience can be a trap, locking people into mindsets that no longer apply. Horace Greely urged young men to 'Go West' because of a strong belief that the West was the land of opportunity. Similarly, an important element of directional strategy is to define the beliefs and assumptions that will guide your organization forward.

This set of beliefs can become a company's true north, ensuring that everyone can make good decisions no matter how circumstances change. Fundsmith founder Terry Smith—sometimes called 'the English Warren Buffett'—has articulated a set of beliefs that guide his investment decisions: buy good companies; don't overpay; do nothing. Key characteristics of what he defines as a 'good company' include high returns on operating capital, advantages that are difficult to replicate, and resilience to change, particularly technology change. These principles govern decision-making at Fundsmith, whatever the state of the market.

Terry Smith has spent many years studying the investment management business and forming firm beliefs about what works. But if what works is unknown, beliefs must be translated into hypotheses that can be tested. The founders of what eventually became Match.com, a leading online dating site, drew on a mixture of observation, experience, and analysis to come up with the following beliefs and assumptions, which were tested and monitored continuously:

- A dating website would attract users, given that dating-focused chat rooms account for 50% of income at the largest ISP.
- Online dating ads would generate revenue, since dating ads are very lucrative for newspapers and website users would be willing to pay a subscription fee, further boosting income.
- Advertising on chat rooms would attract a critical mass of users, and the business would be viable at 20,000 profiles.
- About 5% of single people would be willing to share personal details online.

An explicit set of guiding beliefs can be tested and changed as experience and learning accrue, serving as a checkpoint when assessing and reviewing the strategy to decide on the next move.

Set a Compass Heading and Pace

Setting a compass heading allows a company to take coherent action and opens up future options by limiting decisions to only what is necessary at a particular point in time, without worrying about what the precise endpoint will be. The question for the executive team is: 'Given our beliefs about business trends and our current position, what no-regret moves can we make now to advance our interests, and how much time do we have?' The focus here should be on any actions—such as building capabilities or gaining experience in a new market—that will get the company to a better place under any set of plausible future scenarios.

Reuters is a good example of how the direction set by guiding beliefs can enable immediate action. As the financial services industry was heading into a recession in 2001, Reuters' stock price fell to historic lows, it was losing market share to Bloomberg, and it faced an uncertain future. The need for clear direction was critical. At first, the executive team discussed a long-term vision for Reuters, debating whether the company should be a generalist, a focused specialist, or a multi-segment player. Opinions varied sharply. It became clear the future was too uncertain to decide and deciding on the endpoint at that time would mean excluding the other possibilities.

Switching gears, the team stopped worrying about what Reuters should become and instead navigated by setting a compass heading, guided by a set of basic beliefs: that the future of the industry was in flux; Reuters needed to boost profitability in the near term to survive; and that it needed to strengthen and expand its customer base to ensure future growth. Driven by these guiding beliefs, Reuters developed a series of 'no-regret' moves that would make the company more competitive in any plausible future. The company cut costs, renewed its technology platform, and launched a series of new products designed to boost share in its current market segments. It made no attempt to decide what other customer groups to develop. Finally, Reuters did reach out to customers in new markets—but only after taking the other actions first. Reuters made no public statement about target margins or EPS. By 2005 the company was growing again, profits rose 28% over the previous year, and customer satisfaction was up by 2.5%.

Instead of optimizing for value, optimize choices for robustness by *avoiding killers and looking for kickers*; and instead of creating a linear plan, *choose a stance, observe the effects and reassess*.

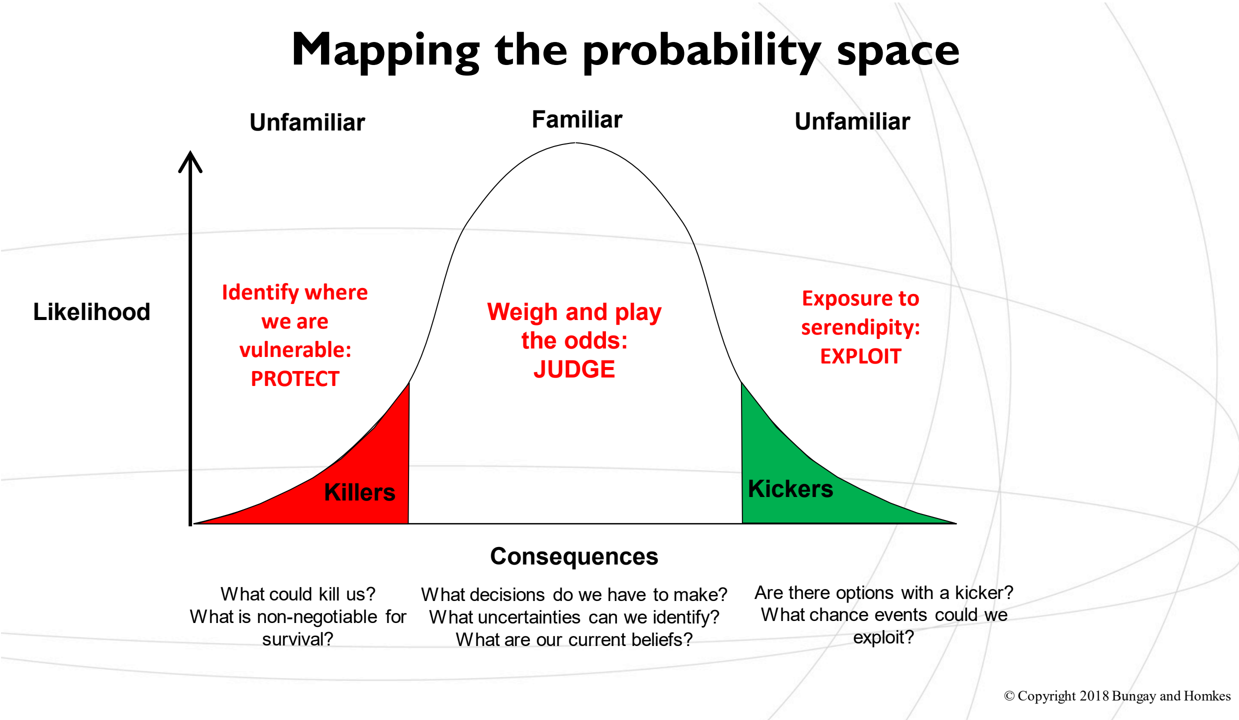
AGILE STRATEGY

Decisions for Robustness to Avoid Killers and Seek out Kickers

Threats and opportunities often depend on our perception, our expectations and our plan. If we have a plan, it is tempting to identify threats by trying to predict what problems could crop up along the way.

The problem with predicting problems is that they form an infinite set of things that may or may not occur and may or may not be relevant. But there are in fact just two critical questions: 'what could break us?' and 'what could make us?'—the *killers and kickers* that lie at the edges of the bell curve of probabilities and so form outliers that Nassim Taleb has famously christened 'Black Swans':

Exhibit 1



The way to identify the dangerous outliers that could kill us is not to ask, 'what could happen?', but 'where are we *vulnerable*?'.

Imagining what could happen is tempting but should be resisted because it could lead down the slippery path to prediction. It is far easier to think through vulnerabilities, and having identified them, one then needs to ask, 'what would have to be true for this vulnerability to become exposed?', and then, 'therefore, what do we have to do to make ourselves more robust?' [i] To do this you often need the view from the crow's nest, and the first set of lookouts is the top team.

Unfortunately, it is easy to ignore vulnerabilities until they become exposed, by which time it is too late. Contrast the attitude of Citigroup's Chuck Prince who in the summer of 2007 announced that the bank would maintain its enormous portfolio of CDOs 'until the music stops' with Goldman Sachs' Lloyd Blankfein, who has claimed to spend 98% of his time worrying about the 2% worst contingencies. In late 2007 Citigroup lost $20 billion and 30% of its market value, whereas Goldman Sachs, which had unraveled its CDO position in 2006, enjoyed its most profitable year ever, earning $17.6 billion.

What prompted Goldman Sachs to do so was not a better ability to predict the future but an awareness that the CDOs in its portfolio made it vulnerable, and that if, for whatever reason, CDOs were to go sour, that vulnerability would be exposed. Indeed, as the world soon learned, CDOs were a potential killer. Goldman Sachs acted to reduce that vulnerability before it became exposed, and by shorting CDOs, turned the potential killer into a kicker.

The way to identify the positive outliers, which could give us a 'kicker', is to ask, 'how could we win big?'.

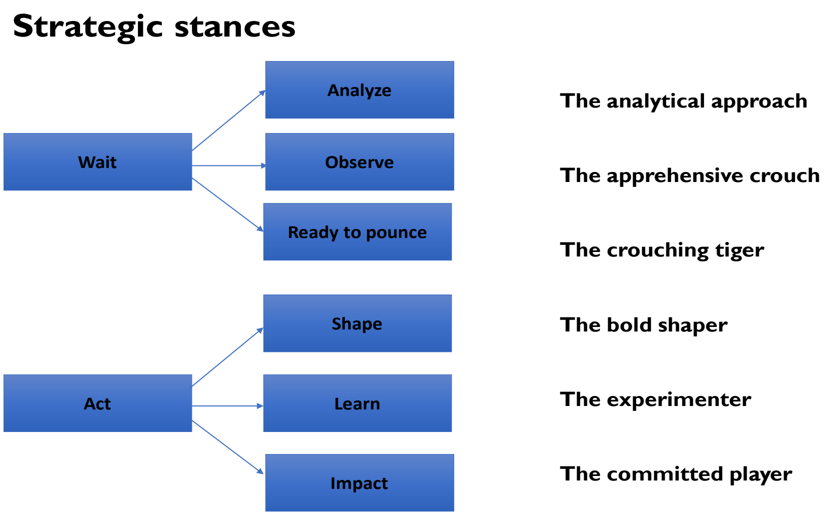
A lot of successes in business are down to luck, but it is not chance that some companies are luckier than others. Consistently lucky companies are able to exploit unforeseen opportunities through their aggression and their timing. They embrace the unknown by engaging in serendipity-rich environments in which there is a lot of change that could result in opportunities. Serendipity-rich environments are ones that usually contain threats and opportunities in equal measure. The biggest risk is not participating in them.

Pfizer's development of its biggest-selling drug Viagra was down to a decision taken in the early 1990s to explore the role of nitric oxide because it was a 'sexy' compound involved in various bio-chemical pathways about which not a lot was known. One pathway lead to a treatment for erectile dysfunction. Since then, sildenafil, the active ingredient in Viagra, has been licensed under the name Revatio to treat pulmonary hypertension, and investigations are underway to use sildenafil to treat mountain sickness, Raynaud's phenomenon and heart disease. The pathway that started with nitric oxide was a serendipity-rich environment that is still being explored and exploited.

Adopt a Series of Strategic Stances

As you move in the direction you initially set, the situation and your position within it will change and you'll need to make a continual series of decisions about your next move. A wide range of options lie within the extremes of dithering and gambling. We call these options *strategic stances*. As shown in the exhibit, three involve waiting and are decisions *not* to act, but rather to analyze, observe, or get ready to move. The other three stances involve acting, either by shaping the emerging future, experimenting in order to learn, or making a commitment in order to create an impact and get results.

Exhibit 2



A waiting stance can make sense when further research, analysis, or time is needed before acting.

UK stationary retailer WHSmith spent some years watching and analyzing the small but growing e-card business before finally acquiring a player that, while not the market leader, had the best technology. By not immediately jumping into a business it did not understand, WHSmith avoided making costly errors.

Waiting might also be a smart move when technology is changing quickly. Sometimes committing too soon is riskier than holding off. A well-known hotel chain was one of the first to install a CRM system, and was seen as very forward-looking at the time. But within a few years, digital marketing and social media had transformed how hotels interact with their guests. The hotel's CRM system had become a costly legacy.

However, we find that for most companies, most of the time, moving in the chosen direction beats waiting. This is because there is more you can learn while moving than staying still as the path unfolds in front of you. Of the action stances, shaping the environment is the boldest move and can lead to enormous market power. Apple, Amazon, and Facebook come to mind. A more common path to success is taking decisive action to win after first doing thorough preparation, as WHSmith showed. But the most important—and most underappreciated—action stance is *acting to learn* through experimentation, limited participation, or by seeing the mistakes of others and improving on their early offerings. Although large established companies tend to be less comfortable with rapid test-learn-revise cycles, this approach is the norm in high-tech and start-up companies, and an effective way to test the waters without over-committing resources. In times of high uncertainty, companies that learn the fastest relative to their peers gain a competitive advantage.

You will need to review your stance at intervals that should define the operating rhythm of the business, which should be fast or slow depending on the tempo of operations.

Traditional progress reviews tend to focus on whether an initiative is 'on track' or not. The idea that an initiative has veered off course and needs to get back on track rests on two false assumptions. First, that there is only one track. And second, that the original track is still the right one. By contrast, directional strategy keeps all options open.

Any stance your company takes will either yield new information or alter the competitive situation, so monitoring outcomes and the changing business landscape must be continuous. The timing of these reviews will vary depending on the rate of change of your industry. As clarity increases, you may need to reassess and revise your beliefs, assumptions, actions, and stance. At each progress review, the first question should be: 'Has the situation changed?' If the answer is yes, the next question to ask is if your beliefs and assumptions are still valid, and whether your stance needs to be altered.

As an example of this process in action, let's look at how a consumer research company's direction and pace evolved over time. In 2011, the company set up a small team to scan the technology horizon, looking for ideas both inside and outside the company. This mandate was far too broad to deliver meaningful results.

Then the strategy director took over the mandate, and to give it focus, simply asked himself the question 'where are we vulnerable'? The biggest element in their cost structure was the cost of collecting, transmitting, and analyzing data from consumer panels. He refocused the technology scanning efforts on finding a way to capture and transmit point-of-sale receipts to a central processing hub in order to gather better insights on buying behaviors. In 2014, the company identified a start-up that had developed such an app for mobile phones, which by then half of US consumers were carrying when they shopped. The company took a 20% stake in the start-up, changing its stance from waiting to experimenting.

One year later, faced with unexpected technical issues and a partner that seemed more likely to become a competitor, the consumer research company shifted gears again, building capability so that it was ready to pounce. It sent a team to work with the start-up and learn enough about the technology to build it in-house where, combined with their deep understanding of how to analyze and interpret the data it provided, they would not simply be less vulnerable to competitive disruption, but have a new competitive weapon in their own hands.

By the summer of 2016, with clients demanding consistent global data with larger sample sizes and richer detail, the focus of development shifted away from cost and more towards scale. Developing the in-house app accelerated. The next year, a third party acquired the start-up, and, having sold its original investment with a nice return, the research company launched its own app in the UK, finally moving as fast as possible to have an impact on the market. The app's greatest value is now seen as a way to penetrate the Chinese market.

The research company's evolution involved several different stances, from observation, analysis and learning to putting a stake in the ground to win. Its intent changed from finding a partner to developing a new capability, and the business model focus shifted from cost, to scale, to penetration of a new market. Interestingly, in this case an incumbent company—not a young upstart—played a significant role in disrupting the industry's old business model.

Taken together, the elements of directional strategy create the flexibility and dynamism that traditional strategic planning so often lacks. Along the way, companies often find that unexpected opportunities arise from the actions they take and from other chance events in the changing business environment. Directional strategy requires the humility to forsake prediction and the courage to face reality. It combines the readiness to adapt with incisiveness of decision-making at each flexion point.

Adopting this approach contains a challenge and offers a prize. The challenge is for us to assume that we know less than we think we do. The prize is that if we do so, we can learn and achieve more than we could ever imagine.

The Authors

Dr Stephen Bungay is the author of *The Art of Action*.

Dr Rebecca Homkes is a Fellow of the Department of Strategy and Entrepreneurship at LBS, a Fellow of the Centre for Economic Performance at LSE, and a partner at GrowthX corporate in Silicon Valley. She specializes in developing strategies for high growth and innovation in environments of high uncertainty.

Dr Anthony Freeling is a former director of McKinsey & Co, where he led the firm's Marketing Practice in Europe, and is currently President of Hughes Hall College, Cambridge in the UK. He is the author of *Agile Marketing—How to Innovate Faster, Cheaper and at Lower Risk*.

All three have worked together as directors of The Strategic Management Center in London.

[i] To put it in economic terms, instead of maximising utilities by asking ‘what would be the best possible outcome?’, we satisfice utility by asking ‘what would be a good enough outcome?’ and also asking ‘what options will deliver a good enough outcome under the widest range of possible futures?’. Rather than asking what is most likely, we just have to ask how wrong we would have to be for disaster to occur or for a windfall to be possible. See Barry Schwarz, Yakov Ben-Haim and Cliff Dacso, ‘What Makes a Good decision? Robust Satisficing as a Normative Standard of Rational Decision-Making’, *Journal for the Theory of Social Behaviour*, 41:2, 2011.