Forget Formulas:
How Managers are Fooled in their Search for Success

By Phil Rosenzweig

What should be changed in business? Managers should stop trying to find the formula for success, but should adopt a more realistic view, one based on probabilities.

What do I mean by a "formula for success"?

» I mean the promise of a "master blueprint for building organizations that will prosper long into the future" found in *Built to Last*, the 1994 best-seller by Jim Collins and Jerry Porras. They claimed to have identified "underlying timeless, fundamental principles" that, if followed with precision, could predictably bring about long term success—a claim made credible by what seemed like extensive and careful research.

» I'm talking about the claim of "immutable principles of organizational performance" in *Good to Great*, Jim Collins's 2001 blockbuster. Collins told readers that there exist eternal principles that lead to high performance with the predictability of physics. And once again, the claim seemed credible as it was supported by seemingly rigorous research.

» I refer to the "formula for sustained business success" set forth in the 2002 book, *What Really Works*, by Bill Joyce, Nitin Nohria, and Bruce Roberson—respectively a professor at Dartmouth's Tuck School, a professor at Harvard Business School, and a former McKinsey partner. Companies that followed a specific formula, they argued, were "virtually guaranteed" of high success—and their claims, backed up by five years of research, had all the looks of serious research.

These books, and many others like them, claim to have isolated a set of principles that lead to the promised land of outstanding performance. Such books naturally appeal to managers who are constantly on the lookout for a way to deliver great results. Yet for all their appeal, for all their attractive words and their inspiring promises, they are deeply mistaken. Wise managers should see these blueprints and formulas for what they are: At best, they provide comfort and inspiration by repeating commonsense bromides. At worst they can be dangerous, diverting managers' attention from the real nature of competition, which invariably involves probabilities under uncertainty.

DATA VALIDITY AND THE HALO EFFECT

Why are so many studies deeply flawed when they appear to be based on extensive data?

The problem that undermines so many studies of business performance is one of data validity. The researchers may have gathered vast amounts of data, but the quality of much of the data is questionable. Indeed, the data are biased.

The key weakness is the halo effect, a concept that was first identified by psychologist Edward Thorndike in 1920. It refers to the basic human tendency to make specific inferences on the basis of an overall impression. People tend to have an overall evaluation about someone or something, and let that evaluation shape specific features. The halo effect is found in many walks of life, including the way we evaluate job candidates—the graduate from a well-respected school tends to look good across the boards, while a graduate from an unheralded local school tends to look less attractive. Brand building, too, is based on the halo effect—companies know that consumers will attribute favorable qualities to a product from a respected company, and therefore go to great lengths to create positive associations with their brand.

Here's how the halo effect works when it comes to company performance. Imagine a company that is doing well, with rising sales, high profits, and a rapidly increasing stock price. Most people naturally infer that it has a brilliant strategy, an inspiring leader, a capable workforce, superb execution skills, solid values, and more. But when that same company suffers a decline in performance—when sales fall and profits shrink—people quickly make the opposite attributions: They infer that the strategy went wrong, the leader became arrogant, the people were complacent, the company forgot how to execute, and so forth. In fact, these things probably did not change much. Rather, a company's financial performance creates an overall impression—a halo—that shapes how we perceive its strategy, leaders, employees, culture, and other elements. Many of the things we commonly believe drive company performance are instead attributions based on performance.

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ABB provides a good example. In the 1990s, following the merger of Sweden's Asea and Switzerland's Brown Boveri, the newly-combined company posted several years of strong results. During those years, it was widely praised by journalists and business professors for its brilliant strategy, its charismatic CEO Percy Barnevik, its nimble matrix organization, and its vibrant corporate culture. It was ranked as Europe's most respected company for six consecutive years. Authors described ABB's employees as a new breed of super-managers. But in the years after 2000, as ABB's performance fell sharply, the story changed completely. Now ABB was criticized for a misguided strategy. It was maligned for an overly complex organization structure and a chaotic culture. Percy Barnevik, once revered as a brilliant CEO, was now derided for his arrogance and narcissism. Curiously, no one claimed that ABB had changed much—the difference was in the eye of the beholder, shaped by a decline in performance. Once the financial halo was removed from ABB, observers saw it in a different light—this time one of low performance.

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The fact is, many everyday concepts in business—including leadership, corporate culture, core competencies, customer orientation, and more—are rather ambiguous and difficult to define objectively. As a result, we often infer perceptions of them from other things that appear to be more concrete and tangible, namely financial performance.

The halo effect of company performance is widespread. It shapes many articles that we read in the business press, it is present in business school case studies, and it affects company histories. The halo effect also turns up in interviews with managers, as they tend to describe past events through the lens of subsequent performance. Other common sources of data, including surveys and questionnaires, are also frequently biased by the halo effect. Whenever people know that a company has performed well or not, and are asked to explain performance, there is a tendency for attributions based on performance.

And that, in a nutshell, is the problem that plagues so many studies of business performance, including some of the best sellers of recent years. These studies may indeed have gathered large amounts of data, but much of it comes from sources that are routinely contaminated by the halo effect. The authors pride themselves on the vast quantities of data they gathered, but overlook the fact that it's the quality of data that matters, not the quantity. If the data are biased by the halo effect, the results will be misleading. Whereas these studies appear to show a predictable relation between a specific set of actions and high performance, when in fact they do nothing of the kind. The direction of causality is backwards. Rather than explaining what led to high performance, these studies merely show how successful companies tend to be described. Far from providing a credible explanation of what drives success, they offer little more than comforting stories. These books may seem to be credible, but as they are based on flawed data, they are not what they claim to be: they do not explain the drivers of high performance.

COMPANY PERFORMANCE IS RELATIVE, NOT ABSOLUTE

If the data are biased by the halo effect, the results will be misleading. In fact, a given formula can never ensure high performance, and for a simple reason: in a competitive market economy, performance is fundamentally relative, not absolute. Revenues and profits depend not only on a company's actions, but also on those of its rivals. A company can improve its operations in many ways—better quality, lower cost, faster throughput time, superior asset management, and more—but if rivals improve at a faster rate, its performance may still suffer.

Take the case of Kmart. Once the leading discount retailer in the United States, Kmart faltered during the 1990s, and by 2002, it was bankrupt. Business school professors, journalists, and industry analysts have heaped criticism and scorn on Kmart, blaming it for a poor strategy, incompetent management, an inefficient organization, and more. But a closer look suggests a

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very different story. On many measures of performance—measures that are objective, and not shaped by the halo effect—Kmart actually got better during the 1990s. Inventory turns improved by 60%. Better use of central purchasing helped to lower costs. Point of sale information technology led to faster reordering. Supply chain management became more efficient. Yet by the end of the 1990s, Kmart's market share had declined and profits suffered, eventually landing it in bankruptcy court. Did Kmart improve its performance in the 1990s? Yes, if we look at absolute measures, but certainly not if we think in relative terms—which, after all, is what competition is all about. What can explain this apparent paradox? It's simple: while Kmart was improving in many ways, two of its major rivals—Wal*Mart and Target—were getting even better on those very same measures. Kmart's demise is due to a relative failure, not an absolute failure.

Formulas for business success can therefore never ensure high performance because they are based on a fundamental misunderstanding—they treat performance as if it were absolute rather than relative. Furthermore, by relying on data that are compromised by the halo effect, they lead to a further misconception: that the drivers of high performance are all internal to the firm. Very often, they stress such things as having a clear focus, strong values, humble leadership, persistence, deep concern about customers, and so forth. These things may be generally useful, but they can never, by themselves, ensure success, because they ignore the vital dimension of competition. They create the misconception that companies can achieve high performance regardless of the actions of competitors—potentially a very dangerous delusion. In fact, a company can never achieve success simply by following certain steps, no matter how good its intentions—as Kmart discovered. High performance comes from doing things better than rivals, which means that managers have to take risks.

In order to achieve high performance, companies cannot content themselves with following a formula, no matter how comforting that may seem. Rather, they have to make strategic choices that will enable them do things differently—and better—than rivals. Being different, in turn, demands that they take risks. After all, if there were a formula for success, and all companies followed it, they wouldn't excel at all—they would merely be average. This uncomfortable truth recognizes that some elements of business performance are beyond our control, yet it is an essential concept that managers at all levels must grasp.

FROM THE PROMISE OF CERTAINTY TO A RECOGNITION OF PROBABILITIES

If managers should change from a misplaced belief in formulas, what should they change to? If thinking in terms of formulas is not only misguided but often dangerous, how should they think instead?

Rather than search for simplistic formulas that promise success, managers would do better to adjust their thinking. First, they must recognize the fundamental uncertainty of the business world. Decisions become a matter of probabilities, ways to improve the odds of success, while never imagining that high performance can be engineered. Thinking this way does not come naturally. People want the world to make sense, to be predictable, and to act according to clear rules of cause and effect. Managers want to believe their business world is similarly predictable, that specific actions will lead to certain outcomes. Yet strategic choice is inevitably an exercise in decision making under uncertainty.

In fact, managers contend with several sources of uncertainty. One source of uncertainty has to do with customers: will they embrace or reject a new product or service? Even if a company accurately anticipates what customers will do, it has to contend with a second source of uncertainty, namely the unpredictable actions of existing rivals and new entrants. Each of these competitors is, concurrently, assessing our potential actions—adding even more complexity to the equation. A third source of uncertainty comes from technological change. While some industries are relatively stable, with products that don't change much and customer demand that remains fairly steady, others change rapidly and in unpredictable ways. A fourth source of uncertainty concerns a company's internal capabilities. Managers can't tell exactly how the company—with its particular people, skills, and experiences—will respond to a new course of action. Their best efforts to isolate and understand the inner workings of organizations will be moderately successful at best.

Combine these factors and it becomes clear why strategy involves decisions made under uncertainty. The goal of strategic analysis should therefore be one of gathering accurate information and subjecting it to careful scrutiny, not in the false hope of guaranteeing success, but in order to improve the odds of success. Wise managers know that business is about finding ways to improve the odds of success—but never imagine that it is a certainty.

EVALUATING ACTIONS SEPARATELY FROM OUTCOMES

These insights lead to a next point: Rather than think in terms of predictable cause and effect relationships, it would be better if managers understood that actions and outcomes are imperfectly linked. While it is natural to infer that good outcomes must have stemmed from brilliant decisions, and that bad outcomes must mean that someone blundered, the truth is more complex. Good choices do not always lead to favorable outcomes, and successful outcomes are not always the product of brilliant judgment.

This point is not obvious. In many companies, a favorable result is naturally treated as a reason for celebration. A poor outcome often leads to the conclusion that someone erred and must pay the consequences. Yet if we recognize that actions and outcomes are imperfectly linked, we also need to change the way we quickly bestow praise or lay blame. Rather than jump to the obvious and satisfying—but often-times wrong—conclusion, it is important to examine the decision process itself. We should make a practice of asking: Were the full range of options identified, or were some overlooked? Did we gather the right information or had some important data been overlooked? Did we make our calculations accurately, or were some in error? Did we properly anticipate obstacles and remedies, or did we not think about ensuing challenges?

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This sort of rigorous analysis, with outcomes separated from inputs, is more demanding. It calls for a judgment of actions on their merits, rather than making convenient attributions, whether favorable or not. But such thinking is essential. Wise managers resist the natural tendency to make attributions based solely on outcomes, to avoid the halo bestowed by performance and insist on independent evidence.

CHANGING THE WAY WE THINK ABOUT BUSINESS

So far, I've urged managers to change how they think about company performance—replacing the search for formulas with an understanding of performance as based on decisions made under conditions of uncertainty. Rather than assume there are ways to ensure predictable outcomes, we should think instead about ways to improve the probabilities of success, while never imagining success to be guaranteed.

That's a good start, but there's no reason to stop there. The focus of this article is but one example of a larger problem—the difficulty that many people have in evaluating the validity of data and the quality of resulting conclusions. Ideally, managers should not need a manifesto such as this one to recognize flawed data and to detect dubious claims about performance. They should become more discerning, more appropriately skeptical, so that they may be able to spot errors on their own and insist on sound reasoning. Raising the general level of business thinking—and making managers less vulnerable to simplistic stories that present themselves as rigorous research—is a change well worth pursuing. ■

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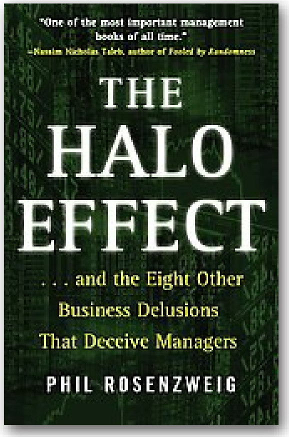

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Phil Rosenzweig helps business leaders think more critically and wisely about what really affects company performance. He is the author of *The Halo Effect…and the Eight Other Business Delusions That Deceive Managers*. Phil has a Ph.D. from the Wharton School and was on the faculty of Harvard Business School. He has taught extensively in executive programs around the world, including the United States, Europe, Asia, the Middle East and South America. Phil is a Professor at IMD, the International Institute for Management Development, in Lausanne, Switzerland.

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