

Strategy as “Inferior” Choice

A Re-interpretation of Porter’s “What is Strategy?”

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Abstract

The article develops on the seminal work of Porter (1996) and in its five sections looks at the meaning of strategy as divorced from operational efficiency. It dwells on the extension of Lionel Robbins work (1932) on the concept of trade-offs and choice. Subsequent sections look at the managerial obsession with growth, strategy as positioning and how wrong choices emerge when the focus is on OE rather than the risks associated with strategy. The article also discusses the approach of strategy as Nash Equilibrium and the understanding of strategy as inferior choice.

Keywords: Strategy, nash equilibrium, inferior choice, operational efficiency, sustainable fit

It had been a long standing lament of the late Mr. Hendrix (1968), voiced through a possibly imaginary conversation between the Joker and the Thief¹, that “*There’s too much confusion, I can’t get no relief*”. This is not a dissimilar emotion that prevails in most of the people who are concerned with the exact meaning of strategy, be it in the academia, bureaucracy or the corporate world.

Porter (1996) in a seminal article “What is Strategy?” did try to dispel some of the popular notions regarding Strategy. But like all much of Porter’s work, here also the academic robustness stood in the way of popular reading. Moreover, this interpretation of strategy has not found much favor from the non-Industrial Organization proponents of strategy (the non-economists). And so the confusion persists.

The following brief attempts to reiterate² some of the observations made by Porter updated in the current context with an aim to rest the confusion that shrouds the subject. Let us review some of the

propositions that Porter makes in his interpretation of Strategy.

OPERATIONAL EFFECTIVENESS IS NOT STRATEGY

One of the bigger mistakes that corporates and academics make is their inability to distinguish between the two. The understanding of this difference between strategy and OE is crucial for organizations for the simple reason that there may be a feeling of complacency in wrongly defining something as strategy when it is actually doing nothing but OE. OE decisions are what a company should be doing (anyway); Strategy decisions are what the company would like to do.

Porter (1996) brings out the difference very succinctly, explaining it as a matter of “Choice”. In the realm of operational efficiency we do not have a choice. In the realm of Strategy, we do have choices. The concept of choice in managerial decision making is not new: Lionel Robbins, had talked about this as long back as 1932. Porter’s main contribution is in the establishment of the “trade-off”. In war, a general can deliberately lose a battle; in the corporate world a manager can deliberately make financial losses. Both actions depend on the nature of the end objective. In the

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former example, it may be to create a sense of complacency in the enemy and force him to mis-allocate resources. In the latter case the objective may be market penetration through predatory pricing.

In each of the three examples given in Table 1, we see that while OE would demand one course of action, the CEO may like to deliberately take an “inferior” position so as to reap additional benefits beyond the immediate time horizon.

It is important to understand that the difference between Strategy and OE is largely tautological. Because OE represents the best that one can do, it cannot be strategy; and as strategy is about short-run inferior decisions, it must imply moving away from what can be achieved merely by sticking to OE. OE thus is required (it is necessary) but just by sticking to OE we may not achieve sustained competitive advantage: Operational efficiency, alone does not guarantee competitive advantage of a sustained nature. Porter puts it very nicely in one

key sentence in his article where he asserts that “*Operational Efficiency is a necessary but not a sufficient condition for Sustained Competitive Advantage*”

HLL deliberately chooses to make losses on one product group, so that it is able to protect its other revenue generating groups³. This is a case where one does something deliberately wrong; so as to maximize our long-term benefits in the future. Strategy is thus about the art of making suboptimal choices. Sometimes it is better for us to lose a few battles so that we can win the war.

The difference between OE and strategy can be amplified further into the difference between what you *must* do, (which will give rise to operational efficiency: you have no choice) and what you *should* do (where you do have a choice: and this is your strategy). By failing to distinguish between what we *must* do and what we *should*, we are also confusing between what operational efficiency is and what strategy is. For example: Cost reduction is not a strategy; cost leadership is. Globalization

Table 1: Strategy Vs Operational Efficiency

Company	Question	OE Demands	Strategy Results
1 Hindustan Levers	Should we continue with the loss making product “Wheel”?	Close it down; divert capacity created to other profit contributing products.	By continuing with Wheel, HLL ensures that the prime products like Surf and Lux do not face competition by Nirma.
2 South Africa Cricket Team	Should we deliberately lose to a weaker team Zimbabwe?	Let us win all the matches we will play.	If by losing to Zimbabwe, we can ensure that Zimbabwe will get into the finals, (and thus keep India out) we will have maximized the likelihood of winning the series.
3 Maruti Udyog Limited	Shall we close down the low profit M800 line?	Yes, and divert the resources to the smaller but growing market share of the Esteem and Zen	By continuing with M800 you have assured the existence of the thousands of service stations networks that provide invaluable service to your “profit making” products.

in today's increasingly integrated world is similarly not a strategy. Quality is not a strategy; although price/performance ratio may be a strategy; similarly customer satisfaction is not a strategy. These are things that any manager must do. What can be in the realm of strategy is where there exist certain choices. For example, Price is a strategy: it is up to you to choose to make a profit or make a loss on account of strategic reasons and cross subsidize. Technology can also be considered a strategy. The Gucci case of positioning low technology [hand made shoes] as a premium product.

Table 2: Operational Efficiency Vs Strategy

Operational Efficiency	Strategy
1. Cost Reduction	Cost Leadership
2. Cost	Price
3. Quality	Value Proposition
4. Globalization	Regional Trade
5. Customer Satisfaction	Customer Torment ¹

¹ See also Brown, (2001).

The danger of confusing between strategy and OE is that it can result in organizational complacency: something that is never good for the strategy process.

STRATEGY RESTS ON UNIQUE ACTIVITIES

The literature on Strategy is fairly well established in its need to recognize that the singular purpose of strategy is to seek a unique positioning for a firm vis-à-vis its competition. The unique positioning must result in competitive advantage, which in turn must be translated in a cardinal measure of the ability of the firm to make profits over and above the industry average.

The concept of unique positioning is explained best with the use of the Strategy Clock (Johnson, Scholes and Whittington, 2010). Consider the airline industry in India. Recent times have seen the polarization of two strategic groups, low cost-low

value, and high cost-high value.

At the upper end of the market there exists a polarization of players like Jet and Air India and at the lower end of the market we have the no-frills operators like SpiceJet, Indigo and GoAir.

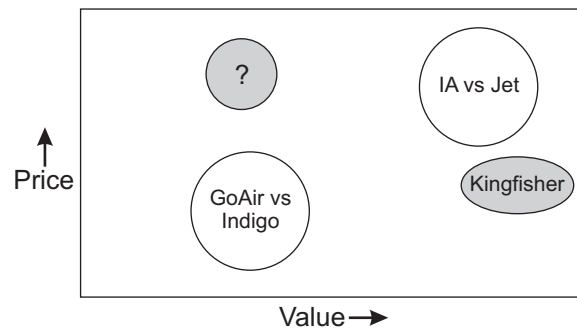


Figure 1: The Strategy Clock

Source: Johnson, Scholes and Whittington (2010)

One new entrant, Kingfisher has chosen not to enter into the competitive arena, and in the process of taking inferior choice is seeking its own positioning in terms of “low price- high value”.

Some caveats emerge from this. First, most firms would prefer not to enter a competitive market⁴. Second, the strategic group dynamics will demand the existence of a dominant strategy that will define the strategic group. Within the strategic group, the competitive positioning will be determined by a subdominant strategy. Third, every group will try to erect entry barriers so as to not only prevent the market from getting crowded, but also to prevent the customers from migrating.

The positioning is critical for the firm as this will determine how attractive the industry is. In the standard five forces model exposition, Porter would argue that from the producer's point of view the ideal market would be one in which the level of forces are uniformly low. These will allow the firm to make profits over and above the industry average.

The corollary to this is interesting. Wherever the forces are not low, the firm will try to migrate to a positioning which does satisfy this criterion. For an

airline like Sahara (now Jet Lite), which is now feeling the heat of competition, there are two options that it may consider: first it may delve into the Kingfisher segment or possibly more attractive, develop a “blue ocean strategy” and enter the corporate charter jet segment (low value-high price).

The “blue ocean” strategy is well illustrated by the example of Titan and HMT in the 1990s. The latter was a dominant and near-monopoly player in the Indian watch market. Titan, a two time failure, was able to take on this mighty goliath by attacking the fundamental value proposition that HMT was offering. Instead of offering the similar value proposition, they offered a totally disparate value proposition (see Figure 2). Not only that they ventured successfully into the “blue ocean” by offering a new parameter in the value chain:

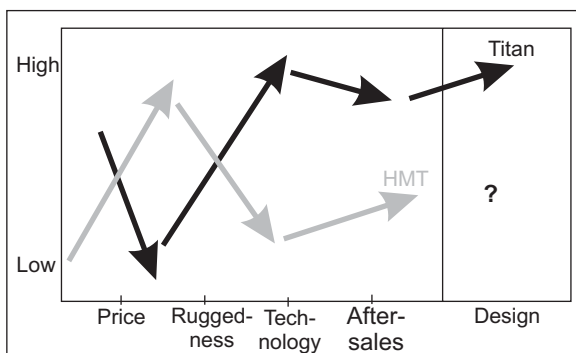


Figure 2: HMT Vs Titan

“design”, something that HMT had neglected totally. Today, for a variety of reasons, strategic and non-strategic, Titan is the dominant player in the Indian market. This is again a clear example of a inferior position involving substantial risk, resulting in ultimately a dominant position.

A SUSTAINABLE STRATEGIC POSITION REQUIRES TRADE-OFFS

As mentioned earlier the concept of Choice as the distinguishing factor between Strategy and OE is not a new concept; Lionel Robins as early as 1932, had looked upon the study of economics as a study

in the logic of choices. It is only when choices⁵ exist, that we must think in terms of managerial decision-making and strategy. If there are no trade-offs, then obviously there is no need for a decision. A good strategist is able to extract the payoff in his favor. The elements of trade-off also give the strategist a chance to maximize the uncertainty that exists.

Consider the standard probability continuum as detailed in Figure 3. At one end we have the probability of success as zero, at the other end we have it as one. The area in between is one in which there is a risk (and naturally, a return). But one does not consider the entire continuum: the first section is known as the Gamblers Risk, the payoff is more in terms of chance, while the latter is referred to as the Strategic risk, the payoff being more in terms of skill.

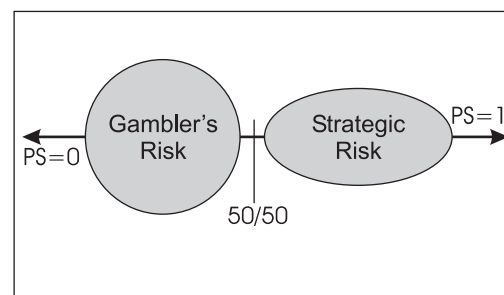


Figure 3: The Probability Continuum

The trade off for the strategist is in terms of a dual function, (1) how to avoid falling into the trap of trying to reduce uncertainty, and (2) within that uncertainty, how to maximize the payoff (or minimize the loss).

The payoff becomes important especially in the light of our earlier discussion on inferior choices. No strategist will accept inferior choices ad-infinitum. He will accept inferior choices only in the short run, as long as he is allowed to maximize his probability of achieving a higher return in the long run (time value of money notwithstanding). In our discussion on positioning, Kingfisher has taken a big risk with its market entry and positioning. Nevertheless, this risk will be

translated into reward if because of the positioning; Kingfisher is able to cater to a segment conscious customer and build up brand loyalty.

The concept of trade off is critical to the determination of sustainability. Because the payoff matrix will have a fine number of cells, and the cells will necessarily have to be evaluated in a cardinal manner, defining strategy on the basis of payoffs will limit the activities that the firm may plan. This will also have the advantage of limiting the manager's temptation to spread resources thinly across many activities.

FIT DRIVES BOTH COMPETITIVE ADVANTAGE AND SUSTAINABILITY

This is perhaps the most contentious of Porter's assertion: that sustainability of strategy will be driven by the organization's drive to achieve both internal and external "fits". These fits will lead to the absence of trauma, and it is possibly only in the absence of organizational trauma that strategy implementation particularly can be successful.

Consider the opposite view. In a competing article, Gary Hamel (1996) asserted that it is the very element of "stretch" that will drive both strategy formulation and strategy implementation. The

stretch is at the very basis of driving organizational growth, be it in the nature of gathering resources, introducing emotional fervor through the process of Strategic Intent (Hamel, 1989) or even in terms of "aiming for the stars but at least hitting the moon".

Though not formally crystallized, these two divergent approaches represent the two schools of thought that are emerging in the study of strategy. The following table brings out some of the major differences.

It may be noted that the approach of the 7-S framework⁶ fits in nicely with the Porter premise. To recap, for strategy to be successful, there must be consonance between the 7-S's: Strategy, Structure, Staff, Style, Skills, Shared Values, and Super-Ordinate Goals.

It may be asserted that the conflict between the two schools of thought is inevitable. Perhaps a compromise can be reached using the PLC wherein the different schools of thought become relevant at different phases of the PLC.

REDISCOVERING STRATEGY (THE GROWTH TRAP)

Understanding Porter's assertion that the

Table 3: The Consistency Vs The Stretch School of Thought

	The Consistency School	The Stretch School
1. Proponents	Porter, Drucker, McKinsey	Hamel, Prahalad, Mintzberg
2. Thesis	Growth is possible only when there is a "fit" between ambition and resources, trauma is bad for the organization	Growth is facilitated when there is a deliberate mismatch between ambition and resources; trauma is good for organizational stretch
3. Strategy Proposition	Defining Unique value chain, do activities differently	Exploit discontinuities in the value chain, do different activities
4. Motivation	Deliberate, cerebral, planned	Revolutionary, exploratory, open
5. Role of Leadership	As a "doer"	As a "facilitator"
6. Life Cycle Position	"Best" in the maturity phase	"Best" in growth and/or decline phase
7. Who is responsible?	Top Management	John Doe (every one)

managerial obsession with growth stands in the way of successful strategy requires intellectual flexibility. According to him the purpose of strategy is to drive competitive positioning, growth may or may not be a concomitant of it. However, if there is an organizational obsession for growth, then the competitive positioning may be undermined.

The logic is very simple. If a firm is obsessed with growth, it is not likely to take any risks (inferior choices). In the absence of risk it is unlikely that there will be any return. The absence of long term return will then undermine the basis of competitive advantage⁷.

Nevertheless, growth is required as firms need to expand (if for no other reason but that if they don't expand, someone else will). In the expansion path two things stand out very significantly, one the need for market control, and two, the need for diversification. The first need is expressed on the initial phase of the growth theory. Firms need to grow more than the market rate of growth, because if they don't they are losing market share. Moreover, growth is likely to be readily coming in the areas of forward integration [FI] than backward integration [BI], simply because the ICOR [the incremental capital output ratio] is likely to be more in forward integration: there is more value added. Unit capital invested in FI is likely to generate more surpluses than a unit capital in BI.⁸

The process of defining a path for growth becomes more complicated, and this implies that in the long run the firm has to be prepared to move out of the industry. Ansoff's brilliant exposition⁹, often forgotten by modern day students, lays emphasis on this. The sequencing of the four quadrants, while industry specific, does lay down that in terms of pecking order concentric diversification will be followed by conglomerate diversification.

The last option for growth is the traditional residual option, where having exploited possibilities of conglomerate diversification, companies now enter into the "rent seeking

behavior [RSB]"¹⁰ Here firms simply license out their "names" to seek rent. This is perhaps the point of no return, as the existence of RSB implies the death of the entrepreneurial spirit.

The growth opportunities of firms needs to be evaluated against their existing resources and capabilities, as also what their end objectives are. Thus, if L&T, an engineering major decides to enter the shoe manufacturing and export business, it needs to ask itself: is this really where my capabilities should be developed, or is it simply a market gap that exists and the organization seeks rent on that basis.

Porter's assertion is that the short term approach to exploiting market gaps can result in a tactical rather than a strategic approach to growth. And the whole problem with tactical approaches is that they do not lend themselves to sequential summation.

Prahalad's (1991) approach to identifying the growth path of a firm provides interesting insights in the strategy process. By asserting that the second test of the Core Competence is that "it must provide potential access to multiple markets and multiple products" Prahalad reflects the view that in the corporate growth process, conglomerate diversification is inevitable.

In an indirect way this also supplements Porters assertion on the limitation of organizational growth. If the growth option of conglomerate diversification is imminent, the firm needs resources. Obsession with growth may result in a misallocation of resources from diversification to a futile penetration or market development strategy.

However it also must be remembered that Prahalad's assertion that "core competencies need to be developed in-house" has not found much favor with the modern day practitioners, who find the M&A route a faster way for growth. The M&A route, wedded in the basic principles of Increasing Returns to Scale provides us with the root of the desire of firms to venture into areas outside their existing business. It is this desire of business to look for new investment opportunities that provide increasing returns to scale, that drives the

diversification options that a firm has. Related to this concept is also the understanding of decreasing marginal efficiency of capital. This concept underlines the theory that as you invest more and more in a particular business sector; the return from capital is likely to fall. Thus after some time, it is not profitable at all to invest in that business, but to move capital into other areas¹¹.

Porter's assertion now starts to make a little more sense. If the firm's obsession is with growth in existing areas of business through either penetration or market development, this is likely to hit decreasing returns to scale after a period of time- something that will work against the strategic positioning of the firm. Strategy is supported best by industries (and markets) that will support increasing returns. The two concepts of IRS¹² and MEC form the basis of growth strategies of firms: and the eternal quest for sustainable competitive advantage.

In addition I would like to press one additional proposition, over and above Porter.

STRATEGY AS NASH EQUILIBRIUM

In 1950, a young mathematician at Princeton broke new ground with a small 17 page thesis. The article on game theory challenged the conventional mould of economics based on luxurious assumptions of decreasing returns to scale and pure competition. Not unlike Emile Durkhiem's thesis, it challenged the fundamental Adam Smith "classical" view that allowing individuals to chose the best for themselves necessarily results in the best choice for society. This concept of the Nash Equilibrium (NE) lies at the foundations of the new economics and the yet evolving Strategic Management thought. Where Durkhiem stressed on the need for social contracts for social stability (optimality), for Nash convergence was not necessarily guaranteed and would depend on a variety of other factors, especially so far as noncooperative games are concerned.

The concept of Nash Equilibrium is best understood in the often quoted example of the

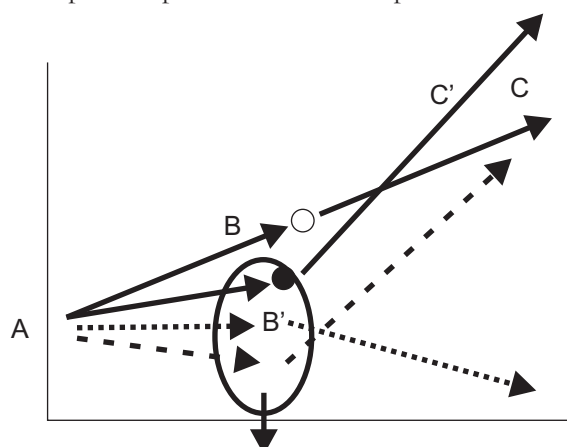
Prisoners dilemma. Two prisoners, Bonnie and Clyde are apprehended by the police, who do not have enough evidence to put them away. The rules of the game are explained to them in separate cells. If neither confesses, both will go scot-free. If both confess, then both will get 10 years in prison. If one confesses, then the other goes to jail, while the "informer" will walk scot-free. Using the Kakutani's fixed point theorem, Nash proved that although the best for the collective will be for neither of them to confess, in actuality, both will end up confessing. This is referred to as the Nash Equilibrium.

The implications of this suboptimal decision process were phenomenal. For one, it questioned the very basis of an individual's ability to take the best decision for either himself or his family or even society. Nash's work went on then to prove that in an "n" person noncooperative game, many Nash equilibrium points will exist. The impact of this inferior choice on the study of economics was obvious. The traditional Marshallian school of thought had already been challenged by moderates like Lionel Robbins on one hand and the Austrian school representatives like Bohm Bawerk. Walrus and his supporters were developing their own version of market equilibrium that went beyond the simple comparative static's of Marshall. John Hicks too was feeling uncomfortable with the growing threat from increasing returns to scale which completely threw out the traditional supply side economics out of gear. Trying to adapt to the onslaught of the Increasing Returns to Scale phenomena, economics went into the defensive tangent of the General Equilibrium Models.

Strategy in a way emerged from this defense mechanism. Where economics was desperately trying to focus on introducing stability and convergence to markets (both factor and commodity), strategy was to go one step further and premise that competitive markets are not necessarily the best for the producer. The role of the strategist thus gets defined in his ability to deliberately introduce imperfections in markets so as to gain competitive advantage.

Taking off from Robins' definition of Economics as the "choice that society has to make between unlimited wants and limited resources", a concept that Michael Porter modified marginally in 1996 in his assertion of choice as the delineating factor between decisions of operational efficiency and decisions of strategy; the concept of strategy thus evolves from the prisoners dilemma as the off-diagonal elements in the 2x2 decision matrix. At the top is the traditional Adam Smith approach to Pareto Optimality, which if neither confesses then both will go scot-free? At the bottom is the Nash Equilibrium point where both will confess and be collectively incarcerated. The two off diagonal elements also represent the Nash Equilibrium points and these give a lead to the strategy: how can I convince the other guy not to confess, while I confess (and thus go free)!

The Nash Equilibrium approach to strategy gives rise to the concept of "inferior" choice, which can effectively be correlated to Porter's distinction between OE and Strategy. Consider the diagram alongside. Let points A B and C represents points on the efficiency frontier. Porter's assertion is that a movement from points A to B and then to C is nothing but operational efficiency as there is no concept of choice here. However, a movement from point A to an inferior position B' may be construed as a strategy. There obviously can be many such points B'. This is the existence of multiple NE points. All would represent "inferior"



Nash Equilibrium points
Only one may lead to PS
Figure 4: Strategy and Inferior Choices

choices: the caveat being that not all inferior choices will result in a superior position that would not have been gained by following OE alone.

It is possible that the movement to a B' position may actually result in a C'', or a C''' position. It is also possible that a C' position which catapults the organization beyond OE may not even exist. In this case it would be best not to go in for a B' position at all but stick to the A-B-C OE transition. This is where the job of the strategist lies. From the innumerable B' positions, the strategist has to isolate that one B' [if it at all exists] position that will lead the organization to a situation that is superior to that which would have been achieved by following only OE. And if such a B' position does not exist, then the strategist must ensure that the path defined by OE is strictly adhered to.

The concept of "inferior" choice is normally difficult to swallow: but it must be remembered that this is defined only in the short run. In the long run two things will happen that will ensure the irrelevance of strategy:

1. The capacity to support short-run inferior choices will eventually depend on how "deep" the firms' pockets are, and
2. all strategies will necessarily collapse into operational efficiency over a period of time,

CONCLUSIONS

Where do we go from here? Are we slightly clearer on the issues that confused Mr. Hendrix, or have we clouded the muddy water even more. In a subject that demands a great degree of academic discipline, we would like to conclude by a recap of the following issues:

1. Strategic decisions must be delineated from operating efficiency decisions. The Nash Equilibrium framework gives us one way of looking at strategy as inferior choice.
2. The inferior choice is obviously in the short run. In the long run, future value of benefits must equal the present value of costs, capital

and revenue expenditures

3. The payback can be related to (a) lower costs of operations, or (b) higher realization in terms of revenue, operating and salvage prices
4. The investment decision concerned is probably going to be greater than the gestation lag for the industry. This makes formal financial ratios like payback periods etc difficult to define and to justify. Nevertheless, this should not result in rationalization of inefficiency parameters.
5. Strategic decisions can be identified in terms

of “trade-offs”: although in this spatial case, the trade-off would essentially be relating to short term gains today as opposed to more than substantial gains tomorrow.

At the end of the day, one may well remember Maurice Dobb (1955) in his classic Chapter IIIc musing on the Kantian distinction between the moral and pragmatic imperatives that will drive the firm to define its optimum level of profits. Sometimes, this distinction will lead to inferior choices and it is in this context that companies must evaluate their strategic approach to growth (if at all) and competitive positioning.

NOTES

1. It may be of interest to recall one interpretation of the Joker and the Thief representing Jesus Christ and the common criminal that He was crucified with.
2. The broad section headings followed in this article are similar to the ones that Porter has used.
3. Industry watcher would recall the negotiation between HLL and Mr. K B Patel in the reported selling of the Nirma brand. If this had happened and Nirma had become part of the HLL stable, it should be clear that Wheel would certainly be closed down. It would then cease to give any strategic benefit to the company.
4. It is interesting to recall that despite having a portfolio of a huge number of models; Toyota's entry into the Indian market was through the SUV route: there was hardly any competition in this segment. In 2002, having established itself with the Quails, Toyota has entered in the upper end of the passenger car market.
5. It may be recalled that Robbins original choice decision was between limited resources and unlimited wants.
6. McKinsey, 7 s framework in Peters, T. and Waterman, R.H., (1982), page 10.
7. Please recall that competitive advantage can be defined as the ability of the firm to make profits over and above the industry average. The risk-return equation thus becomes important.
8. There are however exceptions to this rule. The Reliance group of Industries in India is one, which has successfully demonstrated a growth strategy that has been based on backward integration for the past three decades.
9. Igor Ansoff, Corporate Strategy, Penguin, also discussed in Ghemawat's, Strategy and the Business Landscape, Pearson, 1998.
10. see also Rawls (1971).
11. This is perhaps at the crux of the distortions that have plagued the Indian Economy since independence. The Industrial Policy Resolution 1956 curtailed the growth of business into the sectors of existing competencies by an elaborate system of licenses. Per force thus, industry had to move to areas in which they had little competency. Thus TISCO, a steel major went in for shrimp farming. This also led to a flourishing secondary market in Industrial Licenses: and the emergence of the classic “rent seeking” behavior of organizations.
12. See also W. Brian-Arthur (1996).

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