

Stress-Test Your Strategy

The 7 Questions to Ask

By Robert Simons¹

An economic downturn can quickly expose the shortcomings of your business strategy. But you can identify its weak points in good times as well? And can you focus on those weak points that really matter?

A stress-test – an assessment of how a system functions under severe or unexpected pressure – can help you home in on the most important issues to address, whatever the economic climate. By asking tough questions about your business, you can identify confusion, inefficiency, and its implementation. weaknesses in your strategy

As Peter Drucker once mistakes are not being answers. The truly wrong questions.” For the the drivers of successful of companies and have identified seven should ask – and be able to

Who is a “Customer”?

Don't use the word “customer” to refer to anyone inside the organisation. Internal people are never a company's primary customers, and treating them as such may cause you to lose sight of your true focus.

warned, “The most serious made as a result of wrong dangerous thing is asking the past 25 years I have researched strategy execution in a variety industries. Through this work I questions that all executives answer. Master this list, and

you will keep the fundamentals of your strategy execution on track. The questions may seem obvious, but the choices they represent can be tough, and their full implications are not always immediately clear. The first two questions compel you to set strict priorities. The next two assess you ability to focus on those proprieties by designating critical performance variables and constraints. Questions five and six investigate whether you are using techniques that will enhance creative tensions and commitment. The final question deals with your ability to adapt your strategy over time.

Let's take a look at each question, so that you can see how you – and your strategy – measure up.

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The Seven Questions

1. Who is your primary customer?
2. How do your core values prioritise shareholders, employees, and customers?
3. What critical performance variables are you tracking?
4. What strategic boundaries have you set?
5. How are you generating creative tension?
6. How committed are your employees to helping each other?
7. What strategic uncertainties keep you awake at night?

Ask the Whole Team

The seven questions are intended to be tools for stimulating engagement. Everyone in your business, from the CEO to the front line, must be actively involved in discussions about the key factors that will enable the successful execution of your strategy. Therefore, *how* you ask the questions is crucial. These commonsense principles will help you involve your whole team.

You must pose the questions face-to-face

“Look me in the eye” interaction is essential. You cannot get real engagement remotely or by e-mail. You must be able to see the subtle body language that can tell you when to challenge, probe, and push and when to offer encouragement and support.

Discussions must cascade down the organisation, not stay stuck at the top

The tone you set will echo throughout the business.

1. Who is Your Primary Customer?

Choosing a primary customer is a make-or-break decision. Why? Because it should determine how you allocate resources. The idea is simple: Allocate all possible resources to meet and exceed your primary customer's needs.

Consider McDonalds, whose 32,000 restaurants feed more than 58 million customers each day. The company's growth over its 50 years history has been described as the greatest retail expansion in the history of the world.

What was the fast-food chain's key to success? A clear choice of a primary customer and an understanding of when that choice needed to change. In the 1980s and 1990s, McDonald's considered its primary customers to be not the people who ate in its restaurants but multisite real estate developers and franchise owners. By focusing most of its resources on those customers through centralised real estate development, franchising, and procurement functions, it opened as many as 1,700 new stores a year.

But by 2003 same-store sales were declining Worldwide markets were saturated, and people were tiring of the chain's standardised fare. This crisis prompted the new CEO at the time, Him Cantalupo, to make a tough-decision: "the new boss at McDonald's is the consumer," he announced.

The company's subsequent changes in resource allocation reveal the profound implications of this decision. Consumers' tastes differ widely by region and throughout the many countries in which McDonald's operates. To satisfy these varying tastes, McDonald's reallocated resources from centralised corporate functions to regional managers, who were encouraged to customise local menus and store amenities. In the United Kingdom, McDonald's now serves porridge for breakfast; in Portugal, it offers soup; in France, it sells burgers topped with French cheese. The Paris design centre designs franchisees with nine different design options, allowing them to customise the décor for their clientele.

As of last January, McDonald's had delivered 81 consecutive months of increasing same-store sales around the world. Its customer satisfaction scores rose each year from 2005 to 2009 (they faltered slightly in early 2010, as more upscale customers began to choose McDonald's over pricier alternatives). It's no accident that McDonald's was one of only two companies in the Dow Jones Industrial Average to end 2008 with a gain in stock price.

Unlike McDonald's, many companies resist choosing just one customer. Executives often attempt to avoid the adjective "primary" by announcing, "We have multiple customers." This is sure recipe for underperformance. Allocating resources to more than one customer results in confusion and less-than-optimal service.

Trying to accommodate multiple kinds of customers led to trouble at Home Depot. After taking over as CEO in 2000, Bob Nardelli concluded that the consumer home improvement business was saturated, and shifted significant resources away from consumers in order to cater to professional contractors. Consumers would no longer be the primary customers – but it wasn't clear that professional contractors were filling that role, either. Home Depot laid off customer service employees – the ones walking the aisles in orange aprons at its 1,900 stores – and spent the savings on an \$8 billion acquisition spree, snapping up 30 wholesale housing-supply companies.

The acquisitions nearly doubled company revenue, but even so there weren't enough resources to meet the needs of two such different types of customers (there never are), and neither group was well served. During Nardelli's tenure Home Depot's consumer satisfaction scores suffered the biggest drop of any U.S. retailer ever. At the same time, the wholesale supply operation was not getting the support required to obtain the efficiencies needed for a low-margin business.

It took a new CEO, Frank Blake, to refocus the business. In 2007 he announced that home owners would again be the primary customers. Home Depot sold its wholesale businesses, increased the number of orange aprons on the floor, and rehired master trade specialists to offer consumers how-to-advice. Consumer satisfaction scores and same-store sales and profits have begun to rebound.

Of course, your choice of primary customer may change over time – recall what happened at McDonald's. But you need to recognise that such a change will probably require restructuring your business.

The flip side of maximising resources for your primary customer is that you should minimise the resources devoted to everything else – including all external stakeholders and all internal units that do not create value for your primary customer. They should receive enough to meet the needs of their constituents, but no more.

2. How Do Your Core Values Prioritise Shareholders, Employees, and Customers?

Companies that execute strategy well define their values to reflect the relative importance of shareholders, employees, and customers. Value statements that list aspirational behaviours aren't enough. *Core* values must indicate whose interests come first when difficult trade-offs must be made.

At some companies, customers come first. At others, it may be shareholders. At yet others, it may be employees. There is no right or wrong choice. Each choice is based on a different theory of value creation. But making one and communicating it effectively are essential.

A case in point in Merck's costly decision to withdraw Vioxx, its blockbuster Cox-2 pain suppressant, from the market. On September 24, 2004, then CEO Ray Gilmartin got a call from the head of Merck's research labs, informing him that the preliminary results of an ongoing clinical study indicated that Vioxx caused unexpectedly high numbers of heart attacks and strokes after 18 months of continuous use. Gilmartin had three options: Merck could carry the study through to its planned conclusion to gather more data. It could ask the FDA to approve a "black box" label warning doctors and patients about the newly discovered risks. Or it could take the drug off the market, foregoing \$2.5 billion in annual revenue.

On September 30 – six days after the phone call – Gilmartin convened a press conference to announce the worldwide withdrawal of Vioxx. He explained his decision by citing the company's core value : "Merck puts patients first."

In contrast, Pfizer executives put shareholders first when faced with a similar situation. After discovering that Celebrex – the Cox-2 inhibitor Pfizer acquired when it brought Pharmacia – sometimes caused cardiovascular problems, they decided to keep manufacturing the drug. But they did so responsibly, adding a black box warning that allowed patients and doctors to make fully informed decisions. Shareholders thus avoided losing billions of dollars in profits.

A third option is to put employees first – a choice that can actually keep customers and shareholders content as well. As the former Southwest CEO Herb Kelleher has argued, "If employees are treated well, they'll treat the customers well. If the customers are treated well, they'll come back, and the shareholders will be happy." To drive his point home, Kelleher regularly appeared in national newspaper ads under the caption "Employees first.

Customers second, Shareholders third.” Other companies have made and communicated a similar choice.

Each of these rankings worked because the company put a clear decision and implemented it consistently. This is not always the case. Confusion about core values was at the root of the recent Fannie Mae debacle. Company executives, acting at politicians’ behest, dedicated \$1 trillion to democratizing home ownership by offering mortgages to disadvantaged customers. However, they were also trying to maximise shareholder value. To boost short-term profits, they built up and sold increasingly risky loan portfolios – until the housing market collapse, leaving taxpayers with a \$100 billion bailout bill.

3. What Critical Performance Variables Are You Tracking?

Many managers complain that they’re overwhelmed by how many things they’re asked to keep track of in all-inclusive lists of performance measures. It’s not uncommon for companies to create scorecards with 30, 40, or more variables, in the mistaken belief that adding measures results in a more complete – and therefore better – scorecard. Information technology enables us to gather more and more data at lower and lower cost. But we cannot keep tracking so many variables. Effectively managers monitor only a small number – those that could cause their strategy to fail.

The problems generated by trying to track too much data became evident at Citibank in the late 1990s, after executives introduced a new scorecard in their consumer bank. In addition to traditional financial measures, the card included new metrics for such things as strategy implementation and customer satisfaction.

As one district manager was pondering the award level for her top branch manager, conflicting signals from the new scorecard stopped her short. Although the branch manager had delivered outstanding financials, his customer satisfaction scores were sub-par. The system would not permit a full bonus unless every measure was rated at par or above. Making an exception for one person could destroy the integrity of the system. But the branch manager might leave for a competitor if the scorecard undervalued his contribution. In the end his manager fudged the scorecard to ensure that he received an acceptable bonus. Because of similar problems involving other employees, the bank soon dropped the new scorecard.

Apart from avoiding this sort of dilemma, there is a simple but often overlooked reason to measure just a few variables: Management attention is your scarcest resource. As you add metrics to your scorecards, you incur an opportunity cost, in that people have less time to focus on what really matters. Think of Amazon, where inconvenience for buyers tops the

list of factors that could cause strategy to fail. Executives there focus relentlessly on making purchasing as easy as possible: They concentrate on revenue per click and revenue per page turn, not on long lists of measures that have little to do with the customer's purchasing experience. At Nordstrom customer loyalty is key, so executives keep their attention on sales per hour and revenue per square foot. At Marriott the crucial metrics are associate satisfaction, guest satisfaction, revenue, and RevPAR (revenue per available room).

There's another reason to limit your focus: If you add too many measures to your scorecards, you will drive out innovation. In the old McDonald's – the one that prioritized franchise growth and standardised food – field consultants visited each store to measure its compliance with prescribed operating standards. They analysed 500 metrics, producing a 25 page report on each store. With all the constraints imposed by these measures, store managers had no opportunity to innovate or respond to consumer preferences. Standardised mediocrity was the result.

4. What Strategic Boundaries Have You Set?

Every strategy carries the risk that an individual's actions will push the business off course. The risk intensifies when managers feel pressure to hit growth and profit targets.

There are two ways to control such risk: You can tell people what to do, or you can tell them what *not* to do. Telling people what to do helps assure that they won't make mistakes by engaging in unauthorised activities. This is the prudent approach if safety and quality are paramount concerns – if, say, you're running a nuclear power plant and overseeing a space launch. In such cases you want employees to follow standard operating procedures to the letter.

However, if innovation and entrepreneurial thinking are important, you should follow a different course: You should hire creative people and tell them what not to do. In other words, you should give them freedom to exercise their creativity – within defined limits.

Steve Jobs followed this principle when he declared that Apple would not develop a PDA. He later argued that without such discipline, the company wouldn't have had the resources to develop the iPod. "People think focus means saying yes to the thing you've got to focus on," he later said. "But that's not what it means at all. It means saying no to the hundred other good ideas."

Setting clear boundaries also lets organisations avoid the waste and risk that inevitably accompany undisciplined growth. To take one dramatic example, Wells Fargo weathered

the 2008-2009 financial crisis because it strictly forbade its employees to venture into structured investment products and low-documentation mortgage loans. Unlike most of its competitors, Wells Fargo also refused to court future business from Warren Buffet by lending money to Berkshire Hathaway at below-market rates. This decision actually won Buffett's respect. "I got a big kick out of that, because that was exactly how they should think," he told *Fortune*. "The real insight you get about a banker is ... what they don't do. And what Wells didn't do is what defines its greatness."

But remember: Boundaries are powered by punishment, not rewards. You must be willing to discipline – and fire, if necessary – anyone caught stepping over the line. If you follow up forcefully and consistently, word will travel throughout your organisation, reinforcing the importance of your prohibitions.

5. How Are You Generating Creative Tension

As a business leader, one of your primary jobs is to make outside market pressures felt inside your business. This can motivate employees to think and act like winning competitors, rousing them from comfortable ruts. The bigger your business, the more insulated people are from market pressures, and the more imperative this becomes.

Here is a menu of techniques that can generate creative tension and spur innovation. In this instance unlike when defining a primary customer or ranking your responsibilities, you needn't choose just one; choose whichever and however many are right for your company. In fact, the more innovation you desire, the more techniques you should consider.

Assigning stretch goals. The most common way of motivating people to innovate is to set stretch goals – sometimes called challenge goals or big hairy audacious goals. Conducting business as usual or making incremental improvements is not enough. The only way to meet aggressive targets is to do something completely different.

Ranking according to performance. Many high-innovation organisations rank employees on the basis of demonstrated performance. The ranking affect who is promoted, who is placed on probation, and who is asked to leave. The challenge, of course is to prevent the competition from becoming negative and destructive.

GE's Jack Welch is unapologetic when he argues the merits of this approach. The ranking system at GE was "very controversial," he has said. "Weed out the weakest.... It's been portrayed as a cruel system. It isn't. The cruel system is the one that doesn't tell anyone where they stand."

You can take this approach a step further by ranking the performance of teams and business units. This will unquestionably produce adrenaline to compete – and to innovate. Nike's CEO, Mark Parker, likes to fire up friendly rivalries by posting each footwear division's performance scores after every season. "People see each other's scores, and they huddle and really look at how they can make it better next season," he has explained.

Setting spans of accountability that are greater than spans of control. If you want people to innovate, try holding them accountable for measures that are broader than the resources they control. This is the well-worn path followed by every successful entrepreneur, and you can use it to foster entrepreneurial behaviour within your business.

Tom Siebel, of Siebel Systems, understood this principle well when he based his managers' bonuses on customer satisfaction measures, even though no one manager controlled all the resources needed to make a customer happy. His action forced the managers to innovate their way to success. As one business unit head put it, "To do my day-to-day job, I depend on sales, sales consulting, competency groups, alliances, technical support, corporate marketing, field marketing, and integrated marketing communications. None of these functions report to me..... Coordination happens because we all have customer satisfaction as our first priority."

Allocating costs. The way in which you charge corporate overhead costs can also stimulate creative tension. Jamie Dimon, the CEO OF JPMorgan Chase, insists on full allocation of overhead – everything from legal to marketing expenses – to the parts of the business that use them.

The purpose here is twofold. The most obvious goal is to generate accurate cost data. But often the more important one is to motivate managers to become actively involved in discussions about the value of corporate services provided. When operating managers have skin in the game, they will generate ideas about how units can work together to do things better, faster, or cheaper.

Creating cross-unit teams and matrix accountability. Another way of forcing employees to think outside the box is to assign them to a second box. New perspectives emerge when people are forced out of their routines. When they attend cross-unit team meetings, employees not only serve as emissaries for their home units but also return with ideas and innovations from their new colleagues.

You can push this approach to an extreme by adopting a matrix design, in which every manager has two bosses. One may be a regional head, the other a product market head. Everyone in the matrix is then accountable for conflicting priorities. Many global

companies, including ABB, Novartis, and P&G, have at one time or another used this approach.

As with each of these techniques, you must be careful to balance the benefits and costs. On one hand, you will generate creative tension as people present and negotiate multiple points of view. On the other hand, you risk having the added bureaucracy slow down decision making. When P&G adopted a matrix structure, global product leaders had to get approval from the relevant regional head whenever they wanted to introduce a new product. Too many people had veto power. So in 2005 P&G abandoned the matrix in favour of global business units.

6. How Committed Are Your Employees To Helping Each Other?

Although you want your employees to achieve their personal best, they must also work together toward shared goals. To create the high levels of commitment that requires, leaders must build an organisation that has the following four attributes:

Pride in purpose. If people are proud of their organisation's mission, they will assume shared responsibility for its success. The sort of pride embodied in the Marine Corps slogan "Semper fidelis" ("Always faithful") is echoed in Merck's "Putting patients first" and Amazon's "Earth's most customer-centric company." In each case the tagline inspires and motivates members of the organisation.

Group identification. Belonging to an elite organisation is itself a source of pride, one that carries with it a sense of responsibility toward others in the group. In the Marines ("The few. The proud"), the first loyalty of every member is to the unit – to helping those in it no matter what.

The same principle can apply to businesses. Employees of Southwest Airlines, for example, take pride in a rigorous selection process that admits fewer than 2% of the 100,000 annual applicants. To reinforce their identification with the company, employees from different departments are encouraged to interview job candidates and veto those they feel would not be a good fit. Applicants who are hired know they are part of an elite team whose members go above and beyond to help one another.

Trust. When you trust your colleagues, you're willing to make yourself vulnerable – to put your reputation on the line to support them. Trust is vital if you want people to work collaboratively. At Nucor, the industry-leading steel company, employees are encouraged to propose innovations to improve efficiency. Nucor shares the resulting savings with its

employees, rather than increasing production targets. This policy has built trust among the workers, who are confident that they and the executives are working together toward the same goals.

Fairness. The final requirements for collaboration is fairness. Disparities in compensation among peers post the most obvious challenge: Nothing is more certain to kill the desire to help a colleague. In themselves, inequities in pay are easy to fix; far more insidious are perks signalling that those at the top are more deserving than everyone else. To guard against this danger, Southwest's highest executives work out of small interior offices that have been described as only slightly nicer than janitors' closets.

Vertical pay inequity is also an issue; if you want people to commit to helping one another, you must share rewards fairly up and down the organisation. Southwest has operated with a rule that executive pay increases cannot be larger, proportionately, than other employees' raises. And in bad times executives take pay reductions along with everyone else. An industry analyst once calculated that as a result of these practices, Southwest generated 10 times more revenue for every dollar of executive compensation than some of its big U.S. competitors.

If you want your employees to embrace your vision of shared success, you must be perceived as putting fairness and equity above self-interest. When Sam Palmisano took over as IBM's CEO, he asked the board to reallocate half of his bonus to the executives who would be leading his new, team-based strategy. And early last year, when he announced that 250,000 IBM employees would be getting raises, he added, "The Executives won't – but that's fine. We make enough money!"

7. What strategic Uncertainties Keep You Awake At Night?

At the root of very failed strategy is a set of assumptions about the future that eventually proved false. We assumed housing prices would never fall simultaneously across the country. We assumed asset diversification would eliminate risk. We assumed the migration to digital media would be slow and orderly. We assumed customers wouldn't accept fewer features in exchange for a lower price.

Only three things in life are certain: death, taxes, and the fact that today's strategy won't work tomorrow. At some point your products will become obsolete, your customer's tastes will change, or technology will render your business model uncompetitive. Today's successes will be tomorrow's old news. The question is not if, but when.

To adapt successfully, you must constantly monitor the uncertainties that could invalidate the assumptions underpinning your current strategy. Your entire organisation must continually scan the competitive environment for changes and send intelligence up the line. And because everyone watches what the boss watches, if you want your employees to focus on specific issues, focus on those issues yourself.

The most powerful way to signal what's important to you is to use your business control systems as interactive tools. Pay close – and visible – attention to the data they produce, and use them to generate questions that will activate the search for information throughout your business.

By using its P&L system interactively, Goldman Sachs avoided the mortgage-backed securities debacle that brought most of its competitors to their knees. A Goldman executive has described the process this way: “We look at the P&L of our business every day. We have lots of models that are important, but none are more important than the P&L, and we check every day to make sure our P&L is consistent with where our risk models say it should be. In December [of 2006] our mortgage business lost money for 10 days in a row. It wasn't a lot of money, but by the 10th day we thought that we should sit down and talk about it.” The talk quickly turned into action: Goldman issued an order to reduce exposure to mortgage-backed securities and hedge remaining positions against future losses. This early move allowed the firm to prosper as competitors were forced to liquidate.

Depending on your business, the system you choose to use interactively could be a profit plan, a new-business booking system, or a project management system. Any performance measurement system will do as long as it contains easy-to-understand information, requires face-to-face interaction among operating managers, focuses dialogues on strategic uncertainties, and generates new action plans.

Once you've chosen a system, you must not only ask your employees to challenge deeply held assumptions, including your own, but also regard those who have the courage to tell you bad news. When Alan Mulally arrived at Ford as the CEO he discovered that executives were afraid of admitting failure. Their presentations at Thursday morning meetings highlighted only successes (colour-coded green), never problems (colour-coded yellow and red). Mulally asked how everything could be so rosy when the company was losing billions. Mark Fields, the head of the Americas division, finally gave a presentation noting technical problems with the new Ford Edge. Everyone waited to see how the new boss would react. “The whole place was deathly silent,” Mulally recalled in an interview with *Fortune*. “Then I clapped, and I said, ‘Mark, I really appreciate that clearly visibility.’ And the next week the entire set of charges were all rainbows.”

A Checklist for Executing Strategy

Executing strategy successfully requires making tough, often uncomfortable choices based on simple logic and clear principles. But we frequently avoid making choices, in the mistaken belief that we can have it all. Instead of focusing on one primary customer, we have many kinds of customers. Instead of instilling core values, we develop lists of desired behaviours. Instead of focusing on a few critical measures, we build overloaded scorecards.

There is no magic bullet that can zero in on the pitfalls of your business strategy. There is only one route to success: You must engage in ongoing, face-to-face debate with the people around you about emerging data, unspoken assumptions, difficult choices, and, ultimately, action plans. You and they should be able to give clear, consistent answers to the seven questions posed above. Only then can you be confident that your strategy is on track.