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The Columbia Business School professor says the era of sustainable competitive advantage is being replaced by an age of flexibility. Are you ready?

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Photograph by Matthew Septimus

Rita Gunther McGrath thinks it's time for most companies to give up their quest to attain strategy's holy grail: sustainable competitive advantage. Neither theory nor practice of strategy has kept pace with the realities of today's relatively boundaryless and barrier-free markets, says the associate professor at the Columbia University Graduate School of Business. As a result, the traditional approach of building a business around a competitive advantage and then hunkering down to defend it and milk it for profits no longer makes sense.

This is the core argument in McGrath's most recent book, *The End of Competitive Advantage: How to Keep Your Strategy Moving as Fast as Your Business* (Harvard Business Review Press, 2013), in which she steps squarely into the ring of corporate strategy for the first time. McGrath started out in government 30 years ago, after earning a B.A. in political science from Barnard College and an M.A. in public administration from Columbia's School of International and Public Affairs. "I took a job with the City of New York that eventually involved automating the City's purchasing system, which had been manual up to that point," says McGrath. "That got me interested in large-scale organizational change."

In 1989, McGrath returned to school, first pursuing her Ph.D. in the Wharton School's innovative social systems sciences department, which was founded by management iconoclast Russell Ackoff, and then joining Ian C. MacMillan at Wharton's Sol C. Snider Entrepreneurial Research Center. It was the beginning of an extended collaboration between the two that continued long after McGrath joined the faculty at Columbia's Graduate School of Business in 1993. McGrath and MacMillan wrote three books together: *The Entrepreneurial Mindset: Strategies for Continuously Creating Opportunity in an Age of Uncertainty* (Harvard Business School Press, 2000), *MarketBusters: 40 Strategic Moves That Drive Exceptional Business Growth* (Harvard Business School Press, 2005), and *Discovery-Driven Growth: A Breakthrough Process to Reduce Risk and Seize Opportunity* (Harvard Business Press, 2009).

Those books' themes—entrepreneurship, innovation, and growth in fast-moving, uncertain markets—are also woven into *The End of Competitive Advantage*. "All these pieces of research that I've done over the years came together," says McGrath. "Innovation used to be over there, and strategy was over here, but now they are inseparable. The idea of learning from failure, the notion of studying business portfolios, and the concept of building new capabilities are all linked when you consider the new competitive environment and how companies need to change in order to succeed within it."

To buttress the core argument in *The End of Competitive Advantage*, McGrath identified every publicly traded company with a market capitalization of US$1 billion or more—there were 4,793—and eliminated any company that had been unable to grow its net income by at least 5 percent annually from 2000 to 2009 (about 1 percent more than the growth of global GDP during that time). That left just 10 companies, some well known, others less familiar: Atmos Energy, Cognizant Technology Solutions, and FactSet in the U.S.; HDFC Bank and Infosys in India; ACS and Indra Sistemas in Spain; Krka in Slovenia; Tsingtao Brewery in China; and Yahoo Japan.

McGrath then compared each company to its top three competitors. The major conclusion: The growth outliers were "pursuing strategies with a long-term perspective on where they wanted to go, but also with the recognition that whatever they were doing today wasn't going to drive their future growth." They are successful, McGrath wrote, because they are "exploiting temporary competitive advantages, not sustainable ones."

> "Now the disruptions are coming closer and closer together. The competitive environment is in perpetual motion."

McGrath spoke recently with *strategy+business* and described the ramifications of transient competitive advantage on corporate strategy and organizational structure.

S+B: Has the concept of sustainable competitive advantage become completely untenable?

MCGRATH: Well, it's not untenable everywhere, but it is untenable in more and more sectors of the economy. We used to think of the competitive environment as one of punctuated equilibrium, where there were long periods of stability between disruptions. Now the disruptions are coming closer and closer together. The competitive environment is in perpetual motion.

S+B: Why is this happening?

MCGRATH: Because many of the barriers to entry that once protected companies and sectors have fallen. The most obvious reason is globalization. Your competition isn't just the company down the street any longer; it's companies from anywhere in the world. We've seen the fall of regulation in many industries. We've seen the rise of digitization, which has created instantaneous information flows and incredibly fast investment markets. There are a number of forces that have converged to make attractive opportunities more visible to more players, and the resources needed to go after them are more available, too. All these dynamics make it very hard to hang on to competitive advantage for any long period of time.

S+B: How can leaders determine if their competitive advantages are disappearing?

MCGRATH: Leaders need a process that enables them to step back from the day-to-day hustle and ask the right questions. A lot of companies don't have that level of rigor. They need to look for warning signs, such as whether they are investing in a business without getting the proper returns.

There are a number of questions that they can ask. Do they have new competitors emerging from unexpected places, or are companies from other industries starting to show an interest in what they're doing? Are there traditional barriers to entry that are coming down? Are cheaper substitutes for their products making inroads in the marketplace? Those kinds of things are pretty strong indicators that competitive advantage is starting to fade.

S+B: Is the loss of competitive advantage a new dynamic in the business world, or is it something that has always existed?

MCGRATH: There have always been industry transitions. We don't ride in horse-drawn carriages anymore,

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and telecommunications are now taken for granted. But you've also got things that are new. It used to be that if you wanted to run a railroad, you had to own all the assets required to run a railroad. Today, if you want to compete with the Fortune Global 500, you can get your computer systems from Amazon, your programmers from oDesk, etc., etc. You can assemble assets very, very quickly and then disassemble them. The ability to leverage assets that you don't own is a relatively new phenomenon.

S+B: **What are the ramifications of this for organizational structure?**
MCGRATH: If you think of competitive advantage as something that is transient, you'll organize your company in a very different way. You're going to be very careful about having your organizational system settle down too much, because too much stability can be dangerous. The leaders at Infosys, one of the outliers that I cite in the book, reorganize the company every two or three years, whether they need to or not. They don't want to get too settled into one way of working, because it gives rise to systemic resistance.

S+B: **Does that imply that the structure a company chooses doesn't matter as much as the periodic shakeup?**
MCGRATH: I don't think there's any perfect organizational structure. But we tend, unfortunately, to perceive reorganization as a negative thing. Companies use structures as a means to an end—to coordinate activity, to capture and share information, and to get the right expertise to bear on the right problem. There's nothing wrong with changing structure.

But there's a nuance to it. In a fast-moving environment, structures that require very heavy information flows or that are very hierarchical are going to slow a company down. One of the tests that [George Mason University Distinguished Professor of Information Sciences] Paul Strassmann always uses when he looks at the information efficiency of an organization is how many information exchanges are needed to respond to a demand, such as a customer order or inquiry. More exchanges mean slower response time. That's an interesting test of the fleetness of your organization.

In a world of transient advantage, you're going to be making different trade-offs. You will choose flexibility over optimization, even if you have to give up a bit of margin to do that. (The classic example is Amazon. For years now, it has valued growth and flexibility over margins, and that makes Amazon very, very hard to compete against.) You will choose people who are educable rather than people who are deeply specialized. You will think of your competitive position in terms of arenas rather than industries.

S+B: **What's the difference between an arena and an industry?**
MCGRATH: Industry is a very traditional concept in corporate strategy. Industrial organization economics says that the structure of the industry determines the profitability of the firms within it, and those firms with favorable positions within an industry will outperform those with less favorable positions.

I would argue that is a dangerous idea because in many sectors, the most significant competition you're going to face will come from other industries, not your own. Look at broadcast television, print journalism, and my business, education. The most significant competition for Columbia probably isn't going to be Stanford: It's going to be somebody with a great idea for how to turn education into a game.

It's still important to look at your industry, but you also should be thinking about what I call arenas—pots of resources that are going to be contested by various players that want a piece of them. A report in the *Wall Street Journal* noted that from 2007, when the iPhone was first introduced, to 2012, household spending in the U.S. on communications increased by 11 percent while spending on cars declined. So if you're a carmaker and you're comparing yourself to other carmakers, you're missing this completely. You need to look at the arena of addressable household spending and ask how to make cars that are very relevant to American households. You need to ask if your company should stay in the car business or maybe diversify into another line of business with better prospects. I think you'd start asking different questions, and you'd start reframing where your company adds value and where it doesn't.

S+B: Is an arena defined by customers?

MCGRATH: If you start to put those kinds of frames on it, you limit what you see. Consumer spending is a customer arena. There are arenas in the factor markets [markets used to trade the services of a factor of production, such as labor or capital] for labor and raw materials and other resources as well. Skilled computer programmers are highly sought after not only by the Googles of the world, but also by the likes of Macy's. It becomes a very interesting contest: If I'm Macy's, how I am going to attract programmers when they all want to work for Google? I didn't get much into factor markets in this book, but it's something I'm going to be looking at down the road.

One of the intriguing things about strategy going forward is that you're going to have to take into account both your customer markets and the factor markets required to serve them, because you're going to see competition playing out in both kinds of arenas. It requires a quite different kind of strategic thinking.

S+B: You characterize this as a "strategy of continuous reconfiguration." Is it a form of diversification?

MCGRATH: Traditional diversification strategies seek businesses that follow different rhythms. When one's down, the other's up, and you can still show your shareholders steady quarterly performance. What I'm talking about is the assumption that all of your businesses are coming and going and, therefore, your diversification moves are aimed at creating platforms for tapping new opportunities as they present themselves.

For example, I recently heard about a food manufacturer in India with a lot of free cash flow that bought a tobacco plant. The idea was that in learning to make tobacco products, they would gain access to lots of different kinds of opportunities that might then be relevant to the food business.

In an environment of temporary advantage, you need to be able to reconfigure assets, people, and capabilities to move from one opportunity to the next as the advantage shifts. That requires continuous morphing as opposed to extreme downsizing or restructuring.

S+B: Doesn't continuous reconfiguration pose a major change management challenge?

MCGRATH: If you Google "change management," you get something like 21 million citations. To me, that symbolizes the fact that human beings are very bad at chaos.

Companies need to provide some stability in the midst of change. There has to be a mix. People need to be able to count on their leaders and the values of the firm. They need to have a common understanding of what's within the strategy and what's excluded from the strategy. There needs to be clarity about the relationships and the development of people. These things provide stability. On the other hand, they need to be pushed to avoid complacency, to try new things, and to stretch a bit. Part of the skill of leadership is being able to provide both. It's provoking change and giving people something they can count on at the same time.

Atmos Energy, another of the outliers, has done this quite well. Its CEO, who took over when the company was in bad shape, purposefully created a culture of high performance and change. The company is now running a regulated energy business and an unregulated energy business—two very different business models with very different drivers, and yet they are able to work together in a coherent way.

S+B: Another challenge posed by transient competitive advantage is the need to disengage from businesses. How should companies approach this?

MCGRATH: When it's time to disengage, you need to choose the right way. If you've built a capability for doing something, perhaps it would be really valuable to someone else—like Verizon selling its phone book business to a hedge fund that was perfectly happy to have the steady cash flows coming from a mature, stable business. If the business is dying—like dial-up Internet or landline telephony—you need to figure out how to depreciate its assets and get out.

That's the sad part of the Kodak story: Its leaders had plenty of time to disengage from the film business, and lest we overlook this, they really tried to disengage. They tried to get into digital, pharmaceuticals, and other businesses. But the weight of the core film business hamstrung them. They couldn't stop clinging to the core.

S+B: Why couldn't Kodak disengage from the film business?

MCGRATH: With failures like this, there's usually a complicated parentage. For one thing, the film business was so long-lived and profitable that most of the people in power were connected to it in some very deep way and couldn't turn their backs on it, even when they knew that they should. Also, Kodak had been so good at the film business for so long that it didn't know how to be good at anything else. Another thing that is unique to Kodak is its location in Rochester, N.Y. I think it becomes very difficult to see what's going on in the rest of the world when you're physically apart from it. The environmental cues in a place like Rochester are that everything is fine.

In contrast, there is Fuji Photo Film. While Kodak was sinking, Fuji was hungrily searching out developing opportunities and, at the same time, pulling resources out of exhausted opportunities. There's a dynamism in this that is missing in conventional strategy. The traditional company invests a huge amount of resources in its strategy and then tries to defend it. Fuji is less about defense and more about opportunities.

S+B: Why could Fuji make that transition when Kodak couldn't?

MCGRATH: The major driver was really the CEO and executive team. When Sony introduced the first digital camera, Fuji's leaders were already convinced that it was the wave of the future and they didn't want to be left behind. In 1999, one of their senior executives told *Businessweek*, "Digital is like a religion with us."

Fuji's leaders cut the budgets of the divisions associated with classical photography development and invested in digital and other new businesses where their capabilities were more relevant.

S+B: You call out resource allocation as a prime culprit in clinging to the core. How should it be managed?

MCGRATH: The resource allocation process is a powerful lever for shifting the center of gravity in a company and shifting people's attention, too. Often, resources get trapped in the core businesses, and innovative new businesses have no hope in heaven of getting anywhere. There are many examples: Research in Motion, Microsoft, Nokia. All of these companies have had trouble getting resources out of their core businesses and into anything new and different.

The trouble with innovation is that it's unpredictable. New businesses tend to be small and failure rates are high. They don't operate with the same rhythm as core businesses, and their size and scope are insignificant relative to core businesses. That's problematic if you're running a P&L, and that's why resource allocation should not be wedded to a particular line of business. It should be centralized or at least managed separately from the day-to-day businesses.

The pace and rhythm of allocation decisions need to be speeded up, too. Infosys allocates resources quarter by quarter. They say, "OK, what's happening next quarter? What happened last quarter? Where do we need to move people and resources this quarter?"

If you have really good IT, you can do that. If you're competing in arenas, as I've suggested, you need information systems that give you a line of sight into what's going on in those arenas, and you need to be able to move resources quickly.

S+B: Do companies need different management systems for core businesses and new opportunities?

MCGRATH: Yes. Take UPM, a 100-plus-year-old wood products company in Finland. It sells lumber and paper—businesses it has been in forever.

Its CEO realized two things:

first, that print magazines and newspapers were declining; and, second, that lumber was heavily dependent on the health of the unpredictable construction industry. So he started moving resources out of those businesses and into new businesses, such as biochemicals, bioresearch, and biodiesel, that would benefit from the company's capability at managing biomass.

What's interesting about the way he did it is that he's given his business unit leaders different challenges depending on the businesses they're running. Leaders running mature businesses need to run them with absolute efficiency and really sweat the assets, while being aware that their businesses may be shrinking. They don't feel like second-class citizens at all: They're the heroes defending the castle and giving the newer businesses running room.

The leaders of the new businesses are charged with finding the best opportunities, getting the kinks out of the technology, and figuring out how to differentiate UPM in their markets. If they can come up with a proposition that works, the company is going to invest like crazy in that business. Thus, the company is building a first-of-its-kind €150 million [US$202 million] biodiesel plant in Finland right now.

So, I think it's a question of defining the kinds of opportunities in a company's business portfolio and making a distinction between where you should be playing a defensive game and seeking efficiency, and where you should be playing for growth and seeking opportunity.

S+B: Do companies need to change their approach to innovation in a time of transient competitive advantage?

MCGRATH: If you buy the idea of sustainable advantage, you don't need innovation that often, right? You innovate once in a while and then maximize the benefit of whatever it was you innovated. Innovation is fragile and episodic.

When companies say they spend a lot on innovation, typically they're talking about guys in white suits mixing stuff up in test tubes. But when you think of all that's required to bring an innovation to market, there's so much more to it than that. In fact, I would argue that having too much money is actually really dangerous to innovation because it causes people to latch on to a given route to market too early. When I studied big corporate flops, in almost every case I found that having too much money up front caused people to fix on certain assumptions that later proved untenable.

"Having too much money is actually dangerous to innovation because it causes people to latch on to a given route to market too early."

Innovation needs to be considered a continuous capability in a company that's built for transient advantage. It has to be embedded in the organization. It's an ongoing thing: It has ongoing rhythm, governance, and funding. It's as routine as your quality process or your supply chain process or any other essential process.

Take India's HDFC Bank. It is constantly experimenting with new opportunities, and its CEO is constantly pushing it into new spaces. In one market, it partnered with Vodafone to serve the unbanked. In another market, it partnered with the Cirrus network to deliver ATM capabilities in places where branch offices don't make sense. In another market, it tried microlending.

S+B: How does the leadership mind-set have to change if competitive advantage is no longer sustainable?

MCGRATH: Leaders need to get out of defensive mode and be honest. There are two things I hear senior leaders say that make the little hairs on the back of my neck stand up.

The first is, "Don't bring me surprises," which is supposed to mean hit your numbers. But when the surprises are unanticipated developments, like a new competitor coming from out of left field, leaders need to hear about them or it could be fatal.

The second one is, "Don't bring me a problem without a solution." That makes perfect sense in a world where we always know what we're supposed to be doing. But in a world where the unexpected happens, if I can't bring you a problem that I don't have an answer for, guess what: You're not going to hear about it until too late.

Leaders have to be much more open to information and welcoming to news, even if it's bad news. They should be candid and probing, and a little less focused on operational excellence.

S+B: If businesses are continually coming and going, what happens to the people who work in them?

MCGRATH: This is a good news/bad news story. The good news is that the outliers I studied are terrific employers. They make enormous investments in training and in making sure people have the tools they need. Infosys has an education complex in Mysore, India, in which it can train 14,000 people per day.

The bad news is that in some industries, such as retail and restaurants, companies tend to react to transient advantage by taking it out on their people. They bring people in when the opportunity is good and lay them off when the opportunity goes bad. That's a problem we have to fix, because it's not good for society to have individuals bearing the brunt of this, nor is it good for the companies in the long run.

It's ironic that many companies aren't investing in people, but are then prepared to pay through the nose for people who have critical abilities. A farsighted company realizes that human talent is one of the few things that enable it to surf from wave to wave of advantage. A company that treats people like disposable resources is going to get rewarded for it in the near term and punished in the long term.

I don't see this as a doom-and-gloom message for employees. The upsides could be pretty significant: In a transient-advantage world, you can step out of your career for a while—climb a mountain or raise kids—and step back in. It's more like making movies or running the Olympics: You can miss one and come back and work on the next one. Continuous reconfiguration also creates the opportunity to reconfigure your career, and to acquire new skills.

S+B: Wouldn't career continuity be even more important in a transient-advantage world?

MCGRATH: There are conditions to being able to step in and out of a career. You have to keep your experience relevant. You can't let your network ties get stale. You've got to be very diligent about keeping your skills up to date.

One of the pieces of bad news is that we have very few traditional mechanisms (and the few we have are fading every day) for making sure people get the right skills and keep them up to date. I really worry that our institutions of higher education are not teaching people what they need to know to succeed in a context like this.

On the upside, we're starting to see the emergence of lots of new institutions that are up to that challenge. Massive open online courses are an example. If we are smart, we will start making those kinds of technologies accessible to more and more people.

S+B: If the nature of competitive advantage is changing, do business schools need to change the strategy curriculum?

MCGRATH: I think about that a lot. If you helicopter over the typical MBA strategy classroom, you see "five forces" analysis and industry focus and first-mover advantage being taught. As educators and as people who are dedicated to thinking about strategy in a holistic way, we need more tools. I'm hoping my book makes the case that we do some innovating ourselves.

I think we need to place more emphasis on identifying opportunities and disengaging from declining businesses. In addition to industry analysis, we should be teaching arena analysis. And we need to create a place in the mix for IT. To me, the next wave of work in strategy is to rigorously develop the tool kit that companies are going to need for this brave new world of transient advantage. +

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