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STRATEGIC MANAGEMENT

Instructors: CHARLES FIERO, RICHARD E. SMOKER***

Today we are going to be talking about this elusive, intriguing subject called "strategic management". We hope to come up with some new insights into what this means and how we might utilize it in dealing with the turbulent time that life insurance companies are going to be facing. We also want to relate this to the planning process, and where we see companies as they proceed up the scale of development in planning and strategy.

Hay Associates is a large international management consulting firm. We have approximately 1500 people operating out of 72 offices in 23 countries. One of the practice areas which has become increasingly important within Hay is that of "strategic management". This, coupled with the fact that we have a great many insurance company clients, leads us to have a particular interest in "strategic management" as it applies to insurance companies. Within this consulting practice, we help companies set up their planning process, we assist them in re-evaluating or taking a second look at the planning process they already have in place, and we are working with companies to formulate and examine alternative strategies. Once a company has a strategy decided upon, we work with them to organize or structure themselves to best implement this strategy and select the proper people to insure success for the chosen strategy.

From this consulting work has evolved a point of view that most <u>successful</u> companies don't just have planning, planners and plans, but they also take it a step further into what we call "strategic management". Certainly one characteristic of successful "strategic management" is that it has integrated planning into the very fabric of top management decision making. It is not something that is delegated by top management to a staff function, but rather something that top management views as an integral part and prime accountability of their own job.

In "strategic management" there are two separate, but inter-related management processes. "Strategic management" means setting the direction of the firm or parts of the firm. It's long term and directional in nature. Operating management, or the implementation of strategic decisions, is also part of the "strategic management" function, but with a different emphasis. Operational management is concerned with how do you go about making it happen? (Exhibit 1)

Another way of looking at it is shown in Exhibit 1. On the left hand side, "strategic management" selects from directional options. It asks questions such as "Where are we going and why?" "What do we want to be when we grow up?" . . . is another way of asking the question. Over on the right hand

*Mr. Fiero, not a member of the Society, is a General Partner with Hay Associates (Philadelphia).
**Mr. Smoker, not a member of the Society, is Director of Strategic Management with Hay Associates (Philadelphia).

side of the exhibit, operational management implements by choosing the means of getting there; of reaching this goal, or the direction we have chosen. Operational management is concerned with the "how" and the "when" aspects of implementing those strategies. Both "strategic management" and operational management deal with certain basic functions - those items listed in the center of Exhibit 1. They both deal with the planning, organizing, deciding, directing, motivating, monitoring, and controlling. So there are certain common elements in both strategic and operational management, but there is a fundamentally different focus and different skills are required. Broadly speaking, the two roles might usually be identified with the Chief Executive Officer and the Chief Operating Officer. While there are different roles, certainly effective coupling of these roles is required in order for strategy to be effectively conceived and executed.

Historically, people have tended to equate "strategic management" with planning, but this really is far from the fact, particularly in the early stages of planning. I would like to just run through the evolution of planning. Looking at Exhibit 2 . . . of the chart at about 0.5 on the left, is what we might call "budgeting". Then this evolved into Stage 1, "basic financial planning". Stage 2 might be called "forecasting". Stage 3 is what we call "bend forecast" where alternatives start to enter in and you check out various scenarios, and finally Stage 4, "re-positioning in the marketplace".

Someplace between Stages 3 and 4 is where we start talking about "strategic management". In our opinion, most insurance companies today, even those with sophisticated plans are probably someplace between 2 and 3 on this scale. Stage 1, which we call "basic financial planning", grew out of the annual budgeting process, and budgeting became "planning". If you will recall a few years ago, "planning" tended to be very much financial rather than market in orientation. It tended to have a short term horizon, and it was certainly best suited to fairly simple organizations with limited product lines, and where not much happened out in the environment (certainly not an accurate description of the world we live in today). From this came the attempt to appear into the future and talk about future assumptions and implications.

So we moved on to Stage 2 which we call the "forecasting" stage. In the early stages of this, nothing much happened different than Stage 1, except we extended the time frame. Where originally we were talking about one or two years, then we moved it out to a three to five year horizon. More powerful tools were introduced such as computer simulation models. Resource constraints forced much attention to be paid to resource allocation and some sort of a process to deal with this. But basically, in most cases, these were still financial resources we were talking about. The human resources part for example, had not really been considered to any considerable extent and we tended to focus here on short to medium range performance. One of the things that we have noticed in many companies is that planning in Stage 2 can very easily become mechanical and routine. The Chief Executive Officer, if indeed he ever had any interest in it, has lost it pretty rapidly, and "planning" is delegated someplace else in the organization - to the controller or the financial people, or in some cases the actuarial department. But the real top management involvement tends to seep away and an update may mean something as simplistic as dropping off one year, and adding another year and not talking about too many changes or implications of those changes.

In Stage 3, the company becomes more acutely aware of its marketplace, of the environmental changes, of those things in the outer-world that are happening. Now I suspect that it's pretty difficult to operate in the life insurance business today, and not be very aware of those things. But think back, not very many years ago, when we could sort of lolly-gag along and coast and the world was not changing very rapidly. It was changing for the property and casualty people much faster than it was for the life business. The governmental pressures, the consumer pressures were not on the life insurance business as early as on some of the other businesses. So in Stage 3, we become externally oriented, we look for more opportunities, and we look for threats in the marketplace. We start defining our business units, we no longer look at ourselves as only one company; we look at the component parts, the strategic business units of the company. We define the business units in ways which may be quite different than the traditional product or functional divisions.

What are the differentiating characteristics in terms of growth potential, profitability and the natural markets? We develop and evaluate strategic alternatives, set the priorities in a systematic fashion and allocate financial and human resources. It is during this stage that companies, by our definitions, evolve into "strategic management" which prepares them for Stage 4 planning, or re-positioning the enterprise.

Re-positioning the firm in its marketplace, and strategic planning becomes an integral part of the management process. It's not something that is just done by "planners" who invent time consuming forms, but it is something that is internalized by the senior management people. Each member of senior management understands the process, the assumptions, the directions, the goals of the firm. They become participants, not observers of the process. It's a process that cuts across functional boundaries. In most banks and insurance companies this is very, very important because most of these firms are organized on a functional basis. Ideally, it stimulates, it does not inhibit entrepreneurial thinking.

Stage 4 planning takes into account the long term implications of decisions upon each class of stakeholders - your policyholders, your shareholders if a stock company, the employees, the management, the community - all of these people that suddenly in the past few years we've come to recognize as important parts of our total corporate public. If Stage 4 functions properly, there is a consistency between the firm's directional plan and the company value system. This consistency with the real value system serves to reinforce management commitment to the company's goals and strategic direction and there is a realism which makes achievability of the goals a much more likely outcome.

Every senior officer of a company, in our opinion, has some "strategic management" accountability. The Chief Executive Officer is primary, but each officer needs to be involved and share in the "strategic management" of the firm. A summary description of "strategic management" might well be: <u>Strategic Management is orchestrating the firm to maximize its long term value and potential</u>.

In the course of our strategy consulting work at Hay Associates, we have found it convenient to think about different levels of strategy. There are at least three distinct levels in the Hierarchy of Strategy, namely:

Enterprise Strategy - developed in 1980's
Corporate Strategy - developed in 1970's
Business Strategy - developed in late 1960's

While probably performed by different people in a large organization, it is possible that two or even all three in fact are performed by one person. The three levels of strategy are inter-related. In descending order, the enterprise strategist sets the parameters for corporate strategy, and the corporate strategist sets the parameters for business strategy. Each level needs guidance from the level above and it limits the scope within which they operate. Changes in strategy at any one level almost always have significant implications for strategy at the other levels.

The three levels are generally related to specific positions in the company. Enterprise strategy we think of as being substantially the preserve of the Chief Executive Officer. Corporate strategy generally falls into the area of a Chief Operating Officer or perhaps the Chief Administrative Officer. Business strategy, as we define it, is usually the preserve of a division or subsidiary president. In many companies there are intermediary points, such as group people, which create another situation but for our purpose here let's just focus on these three levels of strategy, namely: Business Strategy, Corporate Strategy and Enterprise Strategy.

The concepts to support and the processes to carry out "strategic management" have only been developed over the past decade or two. This doesn't mean that it wasn't happening, but rather that the literature and the understanding that could be articulated to other people, largely came about in a time frame that is indicated above. In fact, it was the launching of the concept of a strategic business unit in the '60's, predominately at General Electric, and later at a number of consulting companies, that started this whole process going.

The Corporate Strategy area was pretty well developed in the '70's. But Enterprise Strategy, at least as we define it, is only now being developed . . . only now being understood. It does not mean that "strategic management" was not being carried out prior to those days, rather in many instances it was informal, intuitive, and often part of the mystique of successful charasmatic leaders. They did it instinctively . . . they had a model in their head that they developed through an intensive understanding of a marketplace and often was done very, very well. But often it was not communicated to others in the organization.

Managements of the future will not be content to rely upon, nor need to rely upon such informality and all of the problems that it generates. The formalization of "strategic management" processes which enables organizations to respond to change at each level of a strategic hierarchy has been the hallmark of our most successful organizations.

Lastly, we would like to share with you in summary fashion the state of the art in "strategic management", and some of the concepts that fall into each one of the categories of: planning, organizing, resourcing, controlling and motivating. Because of time constraints we have chosen to only touch different categories to give you some overall idea of what we have in mind.

The first type of strategy that I would like to talk about is at the bottom of the scale, namely "Business Strategy". As we define "Business Strategy", it's concerned with anticipating Product/Market opportunities and threats for a strategic business unit. Exhibit 3 is concerned with identifying businesses and placing them properly in this matrix - according to the relative attractiveness of the market in which the business unit operates, and its relative competitive strength. By being able to place your businesses in these grids you can better identify strategy alternatives that are available.

In the lower section of the exhibit we identify the kinds of strategy that are appropriate for each positioning. For example, if you are in a high competitive position (Invest/Grow) it pays you to put money into it. There are some very fascinating statistics to support this analytical approach. You price to buy market share. The idea is that the market is growing very actively and you move into it and you position yourself as strongly as you possibly can. You develop new products, and in order to stay ahead of the competition you develop or improve your products as you go. If it's a manufacturing company, you move to invest in capacity because everything is going towards rapid growth. You expand your sales force and your distribution system. Those are the basic, fundamental strategies that fall into an Invest/Grow.

When you are in an Earn/Protect mode, the strategies are to maintain market share. You are no longer going to accelerate growth because the market is settling down. The players have been identified, you go for optimized margins and you try to differentiate your product in this mode. You are trying to create a perceptible difference and convince the market that your particular product is different than somebody elses. It becomes appropriate to segment markets because maybe the only way you can do it is to break the market into pieces. You can differentiate if you go after a specific sector and you can communicate a perceived difference in what you are offering them.

As you get over to the Harvest/Divest stage on the right, your strategy alternatives tend to fall into the categories listed at the bottom of Exhibit 3. You start to forego market share and growth because you become concerned significantly with costs. You hold prices and margins as best you can, you prune product lines, and look very carefully at those that are not as attractive. You free up capacity and you shrink the sales force because you are in a cost reduction mode.

How do you classify a business unit? How do you determine whether it's one place or another, and how do you classify markets? We look at stages in development of the marketplace, moving from emergent to mature to declining. This could be for a product, for an industry, or a company.

In "strategic management" you are not only concerned with looking at the situation from your own point of view, but you are in a "game". The enemy is the marketplace or the competition out there and your job is to outguess the competition. "Strategic management" is a dynamic process, it's concerned with understanding the marketplace and your competition. This generally tells you what is appropriate to do, but the process also requires looking at who the other players are, and what their specific strengths are in countering your strategy.

One of the disturbing aspects of this kind of analysis is to see where "corporate America" is positioned on the grid format shown in Exhibit 3. If you take a sampling of some 500 SBU's at random from selected major companies, you will discover that we are reaching a point where the "greening of America" is no longer the right term . . . we are drifting toward the red, or lower right hand corner.

One of the problems with drifting toward the lower right on the grid is the unit should begin to develop a management structure that is consistent with moving into that mature area, and it is harder and harder to get back to a management structure that is consistent with the "developing and emergent" area. We are convinced that different positionings and strategies require different management skills and types. (Exhibit 4) If the business unit is positioned in the "Invest/Grow" section it very likely will require an entrepreneur who is venturesome and risk accepting. This is the person who feels that the company is right when it says to go out and build the business. It requires an innovative person, usually a charasmatic person because he is leading a small group of people, often hands on and deeply involved in the business. He knows everything about it - he has to because he is making intuitive decisions as he goes. He's an opportunist, he is looking for the chance and he will jump. He is effective, rather than efficient. And he is usually not very good at controlling, he runs a loose organization.

When you move out of that mode into the next, "Earn/Protect", you are looking now for a "sophisticated manager". Incidentally, in using these terms, we don't mean to imply that one is better than the other, every organization needs all types, it's just that the style which we have tried to describe. What we mean by "sophisticated manager" is that the person is much more conservative, he is concerned with the structure, putting in place the processes for the necessary activities. He is moderately venturesome, he is effective and efficient, and he is a team participant. You seldom have problems with the person in "Earn/Protect" - sophisticated manager - he knows how to work with other managers in the organization.

You get to the "Harvest/Divest" grid, or the critical administrator, and now you have somebody who is operating in a mode where cost control is quite important, he is risk averse, you are not paying him to take risks, you are paying him to hold the line on profitability. He is very conservative, often autocratic, he is pragmatic, he is efficient and he permits minimal participation.

There is also a different management compensation philosophy in dealing with units in different modes. In the "Invest/Grow" position, you tend to put more into an incentive opportunity. That is you give a higher payoff for success, but a relatively low base. Over on the other end ("Harvest/Divest"), you tend not to put in a high incentive. It creates uncertainty in a person that wants certainty. A person that resists going into an "Invest/Grow" high incentive situation is usually not risk taking in orientation. A person that insists upon incentive over on the lower right is usually not risk averse enough, and therefore becomes an interesting problem. The concept we are trying to get across is that you do motivate and compensate people differently in different SBU positions.

Moving on to the next level of strategy we are talking about "Corporate Strategy". And here the issue is balancing the demands of several SBU's with the availability of corporate resources and the direction in which the enterprise wants to go. (Exhibit 5)

Corporate Strategy must be concerned with not only the allocation of financial resources, but also human resources. This is a failing in much planning as done today, because the measures and the models tend to concentrate almost exclusively on financial issues and omit the human resource element.

Management review of Corporate Strategy must be concerned with a measure of provable achievability. Goals may be set which are not only ambitions, but virtually unreachable in view of the time frame and resources allocated. It is up to senior management to take a very pragmatic look at the likelihood of achievement for this strategy.

Taken together the business or SBU's within an enterprise comprise a portfolio - almost like an investment portfolio. The mix and balance of this portfolio must be reviewed. Along with this, overlap of units in the portfolio must be managed to avoid chaos.

A very real problem, which we are not going to deal with today, is that of the definition and classification of your strategic business units. But "Corporate Strategy" is concerned with making certain that they do have the correct classifications and definitions.

Let's turn now to the third type of strategy in our hierarchy . . . namely, "Enterprise Strategy". We define this as charting the shape and direction of the total corporate enterprise in anticipation of fundamental forces of change. These forces are multiple (Exhibit 6) and as you well know, the life insurance business is no longer isolated from the tumult of these changes. It is necessary for management to identify the forces which are important to their industry, markets and company. Each of these forces of change must be weighted in terms of importance in various time frames, and certain assumptions made.

Next, in "Enterprise Strategy" one creates or defines a unifying theme which encompasses all the diverse business units and brings them together within the boundaries of the enterprise (Exhibit 7). This may be where you really determine if you are in the individual life insurance business, or if your business is financial services. Furthermore, as you examine the values of the organization, and probable forces of change, you may want to re-define your unifying theme and divest certain businesses which would not appear to be within the boundary of the theme.

Enterprise Strategy must take an over-view because each of the individual business units is restricted in its outlook and scope. Taking the example of financial services as a unifying theme it might well include credit, travelers checks, currency exchange business, as well as property-casualty and life insurance. These are distinctly different businesses and must be managed carefully to avoid overlap. However, there can be a power in looking at them with a unified view . . . that is, via Enterprise Strategy and capturing a real concept of the business.

The Chief Executive Officer (the enterprise strategist) is always examining the definition of the mission and the concept of the business. He goes from saying "We are in the insurance business to the financial intermediary business". In view of the probable forces of change, what new opportunities exist? This may lead to a re-definition of the theme, or to Unifying Theme II (Exhibit 8).

Here, we are setting forth one approach to the problem which is what we call mapping alternative themes. The concept is that there are two elements you can look at that have generally proven to be quite successful thinking about structure. You map according to product relatedness and market relatedness. When we look at product relatedness, we look at technology and the process of producing the product sourcing around a core business that you have. We do the same thing in market relatedness by looking at customers, distribution channels and competition. We rank where the units are and we plot them. The example in Exhibit 8 says there are two alternative unifying themes. Unifying Theme I is a market theme which indicates we are going to stay close to a single marketplace. The other one (II) says that is not what we are going to do at all, but rather concentrate on developing new products or adding new products to our very strong core.

We have also discovered in "Enterprise Strategy" one of the key things is to get a structure to reinforce where you want the organization to go, and to develop the capabilities in people so that you can carry it out. It is not easy to go from a functional organization to a decentralized organization. If you decide that this is what is going to happen, you have to start creating the level of experience for management integration. Exhibit 9 deals with two important structural dimensions, namely Management Integration and Enterprise Complexity. It merely says that the best fit is low management integration in a very complex enterprise. We have just completed a study with Wharton that reinforces this concept to an extraordinary degree.

One of the interesting problems I think it raises is that of recognizing the complexity and what causes and what creates complexity. And so if you move to the next chart (Exhibit 10), we have put on some factors that are involved in complexity. It is not just the number of units that you have, or the number of countries in which you operate. As an enterprise becomes more complex, it has a number of activities, diverse customers, and has multiple core technologies. Size even of itself often creates complexity, but rate of change in addition to the relatedness of the major business units is equally important. If you have different rates of growth among your business units, you have started to generate complexity and sharp rates of growth or just uncertainty in the marketplace where you need to respond differently to this rapidly changing scene of higher interest rates, double digit inflation or whatever adds complexity.

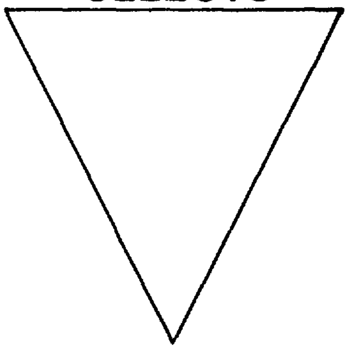
High management integration tends to be associated with the locus of power at the corporate office, and where there is significant policy setting and operating responsibility at the corporate level. They get right in on the day to day decisions of operating the business. The opposite is where you have low management integration. This is characterized by many business units each having its own locus of power. Headquarters get less involved and they operate with the overview of a portfolio manager. They are more inclined toward policy setting than operating, and so on. Management behavior is different. The statistics show, even with the small companies, you get better profit if you decentralize. It seems that it is more efficient. Contrary to what most people who have been in the industrial engineering business tell you, it's more efficient to have management structure that is responsive in the marketplace.

We think the '80's will be a period of turbulence and out of it will emerge very strong companies. But top management has to understand what is going on, and has to understand how this is affecting the organization and each of its disciplines. Unit managers can't expect to merely throw out intuitive ideas. It's great, but it really does not make the contribution because people do not know what to do with them. The ideas have to be formulated. Top management on its part should provide a structure and a process for evaluating and developing ideas and new approaches to the marketplace . . . a "strategic management" system where functional managers do get together and they think within the discipline outlined. You think not just within a structure but you think about change and what changes might be possible and you bring your disciplined approach to it. It should be an initiative oriented process rather than just reactive. The group should not just respond to suggestions coming down from on high but should develop new approaches. It should take advantage of the creativeness of individuals from different functions working and thinking together. It should be undertaken with a full understanding on the part of all participants of the "strategic management" processes outlined in Exhibit 11. The effort has to be related to the "strategic management" process. They have to tie in what they are talking about to each level and think about the consequences of it. If done by a planner sitting in a functional organization, very little will happen. It is much more likely the commitment will be there when the management group has participated in the process.

We have attempted to cover a broad spectrum of concepts and ideas which fall into the area of "strategic management". This is a rapidly developing area of management thought and science, and there are some exciting new approaches under exploration. Our own view of the hierarchy of strategy is evolving, but we see the concepts discussed today at work in client situations, and increasingly being supported by empirical evidence. We would urge you to attempt to be even more strategic in your own thinking and to apply these concepts, at least in part, to your own organization.

STRATEGIC MANAGEMENT
VS.
OPERATIONAL MANAGEMENT

STRATEGIC MANAGEMENT SELECTS



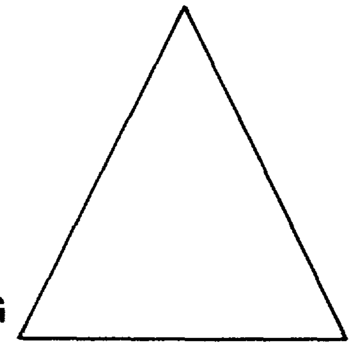
PLANNING

ORGANIZING

DECIDING/DIRECTING

MOTIVATING

MONITORING/CONTROLLING



OPERATIONAL MANAGEMENT IMPLEMENTS

EXHIBIT 1

THE PLANNING PROCESS HAS BEEN EVOLVING TOWARD "STRATEGIC MANAGEMENT". . . .

I
Basic Financial

- Financial v.s. market focus
- Near term horizon
- Simple organizations, limited product, stable environment

II
Forecasting

- Extend time frame
- Tools, e.g., simulation models
- Resource allocation process
- Tends to become mechanical

III
"BEND FORECAST" Alternatives

- Externally oriented
- Search for opportunities/threats
- Define business units
- Develop/evaluate strategic alternatives
- Structure organization to implement
- Set performance criteria/rewards

IV
Re-position In Market

- Strategic planning part of management process
- Broad management understanding of process, direction, goals
- Stimulates entrepreneurial thinking
- Direction consistent with value system in enterprise

EXHIBIT 2

BUSINESS STRATEGY

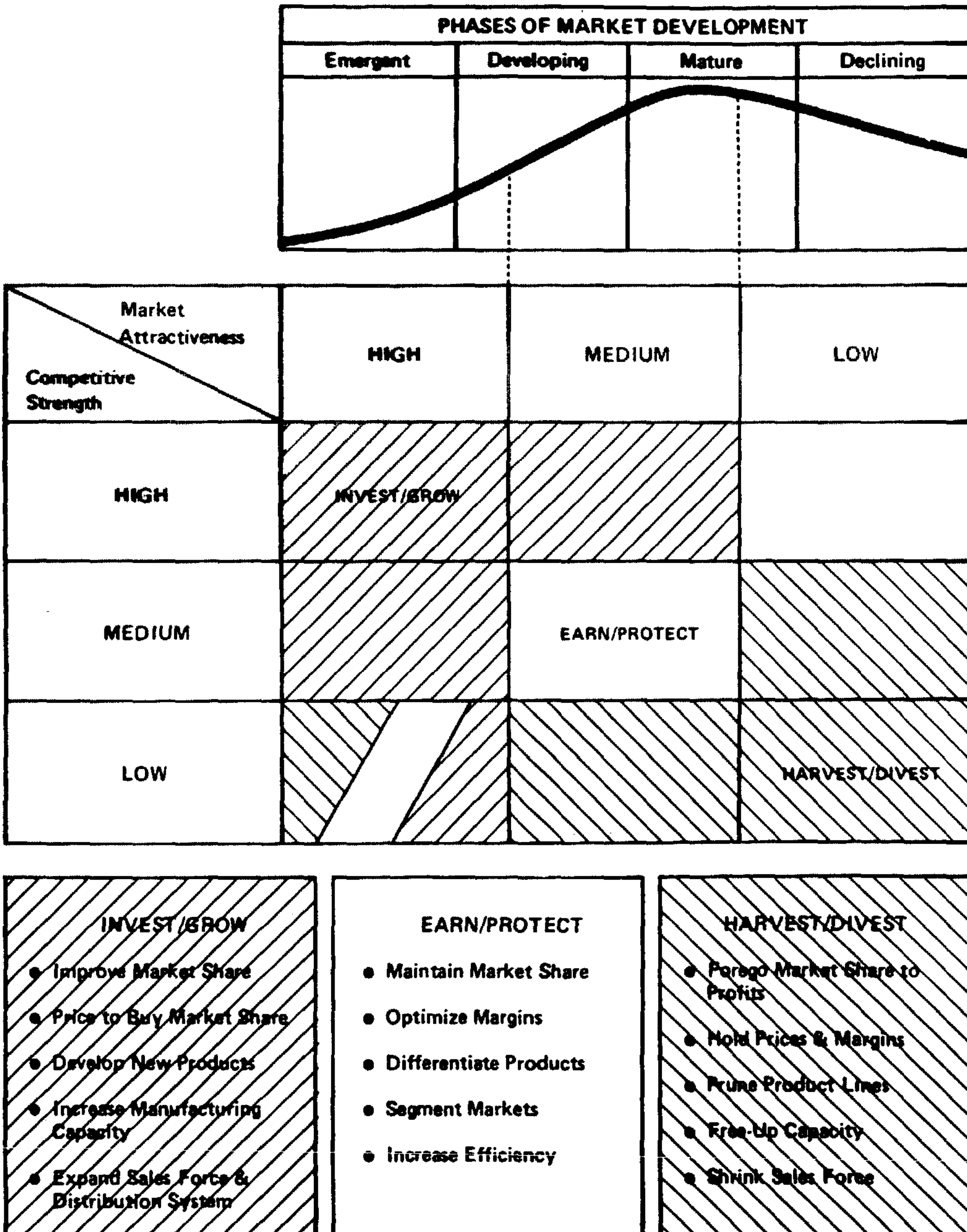
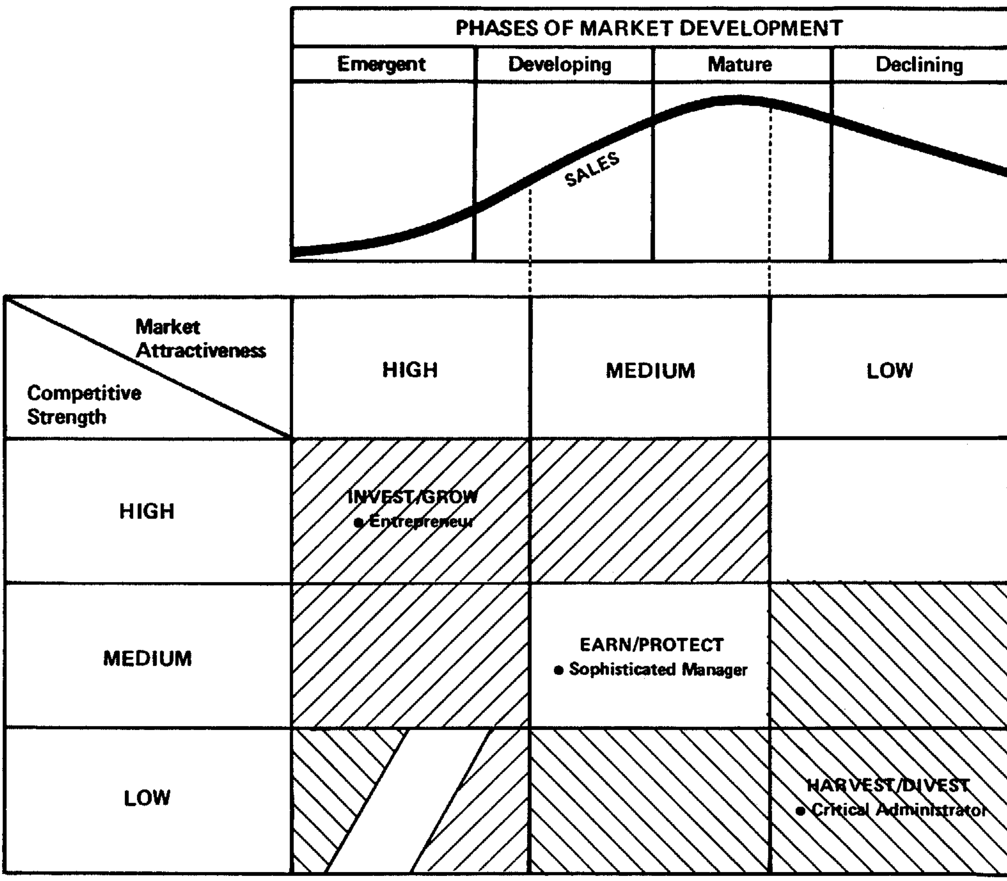


EXHIBIT 3

RESOURCING

"SBU" MANAGEMENT STYLE ASSESSMENT



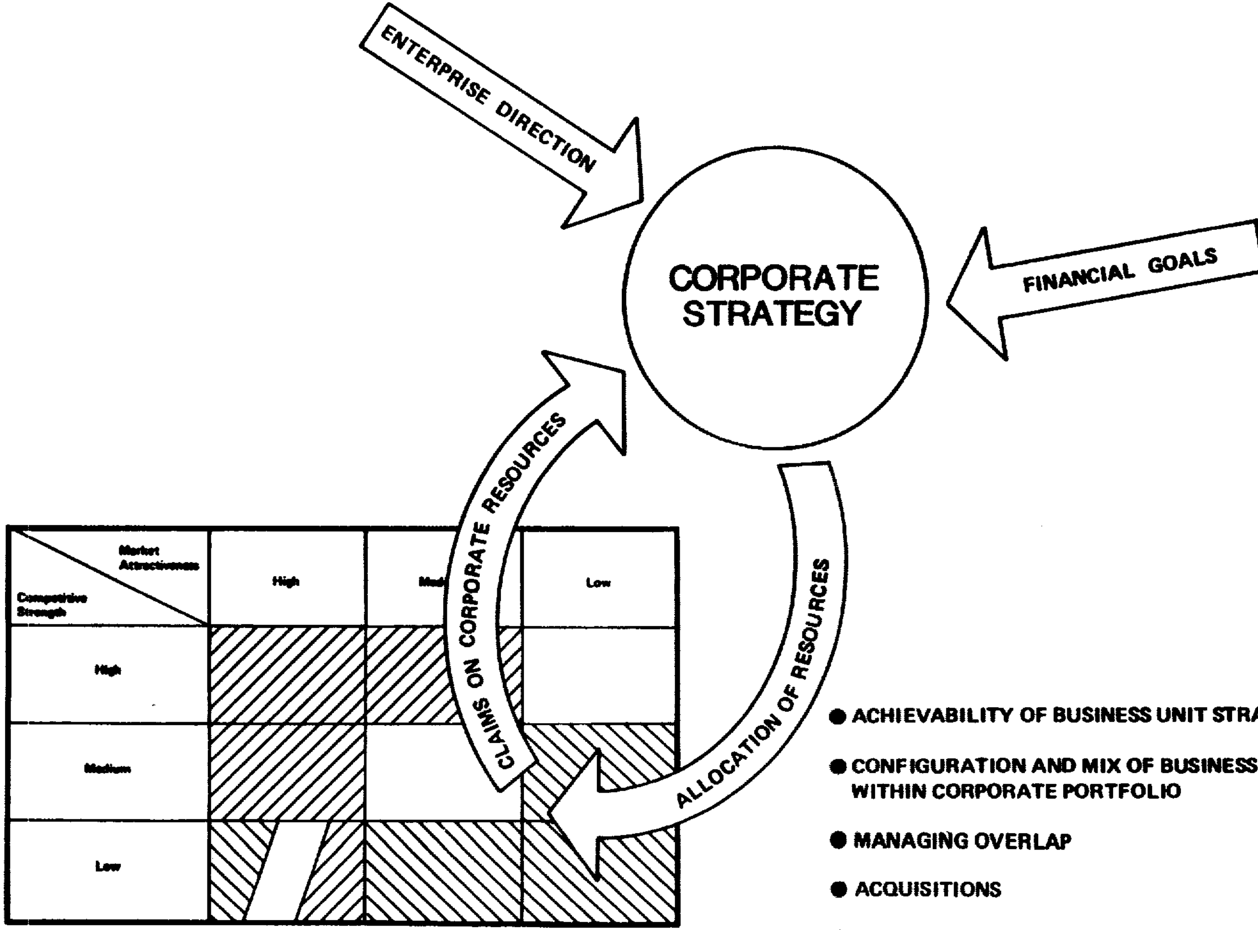
ENTREPRENEUR
- Risk Accepting
- Highly Venturesome
- Innovative
- Charismatic
- Opportunistic
- Effective vs. Efficient
- Minimally Controlling

SOPHISTICATED MANAGER
- Moderately Conservative
- Moderately Venturesome
- Effective & Efficient
- Team Participative

CRITICAL ADMINISTRATOR
- Risk Averse
- Highly Conservative
- Autocratic
- Pragmatic
- Efficient vs. Effective
- Minimally Participative

XHIBIT 4

CORPORATE STRATEGY



- ACHIEVABILITY OF BUSINESS UNIT STRATEGY
- CONFIGURATION AND MIX OF BUSINESS UNITS WITHIN CORPORATE PORTFOLIO
- MANAGING OVERLAP
- ACQUISITIONS
- DIVERSIFICATION

EXHIBIT 5

Enterprise Strategy

Forces of Change

- Economic — Business Cycles
- Financial — Market Behaviors
- Technological — Scientific Advances
- Political — Government Policies
- Legal — Regulatory Requirements
- Social — Demographic Trends
- Cultural — National Values

EXHIBIT 6

ENTERPRISE STRATEGY

• DEFINE THE ENTERPRISE'S UNIFYING THEME: THE BOUNDARY OF THE ENTERPRISE

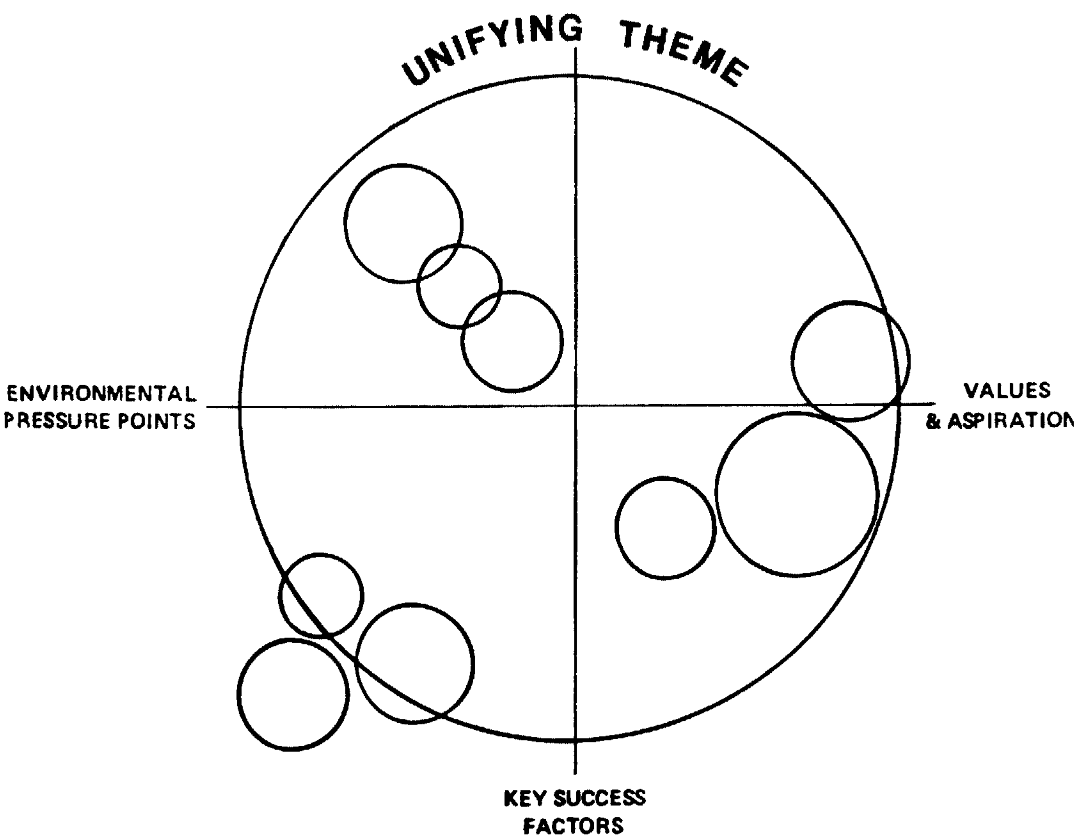


EXHIBIT 7

MAPPING ALTERNATIVE UNIFYING THEMES

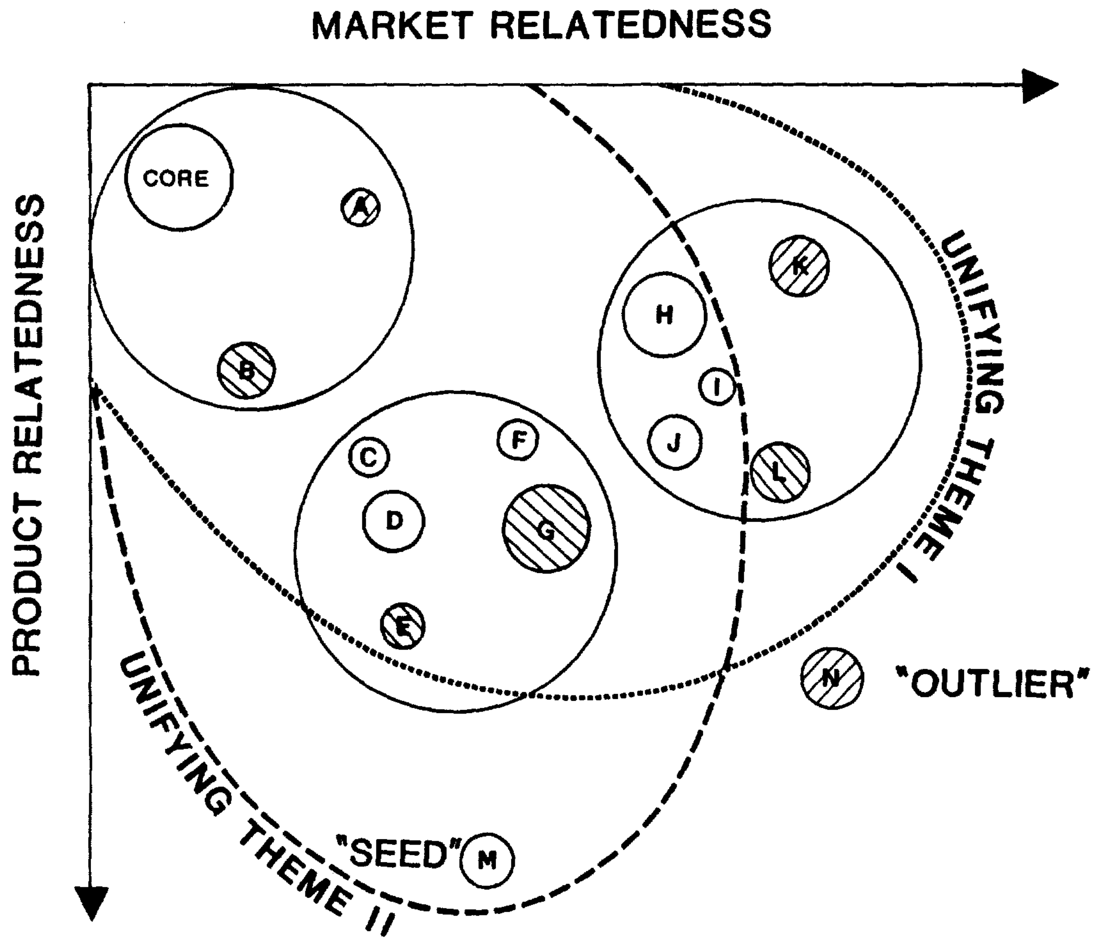
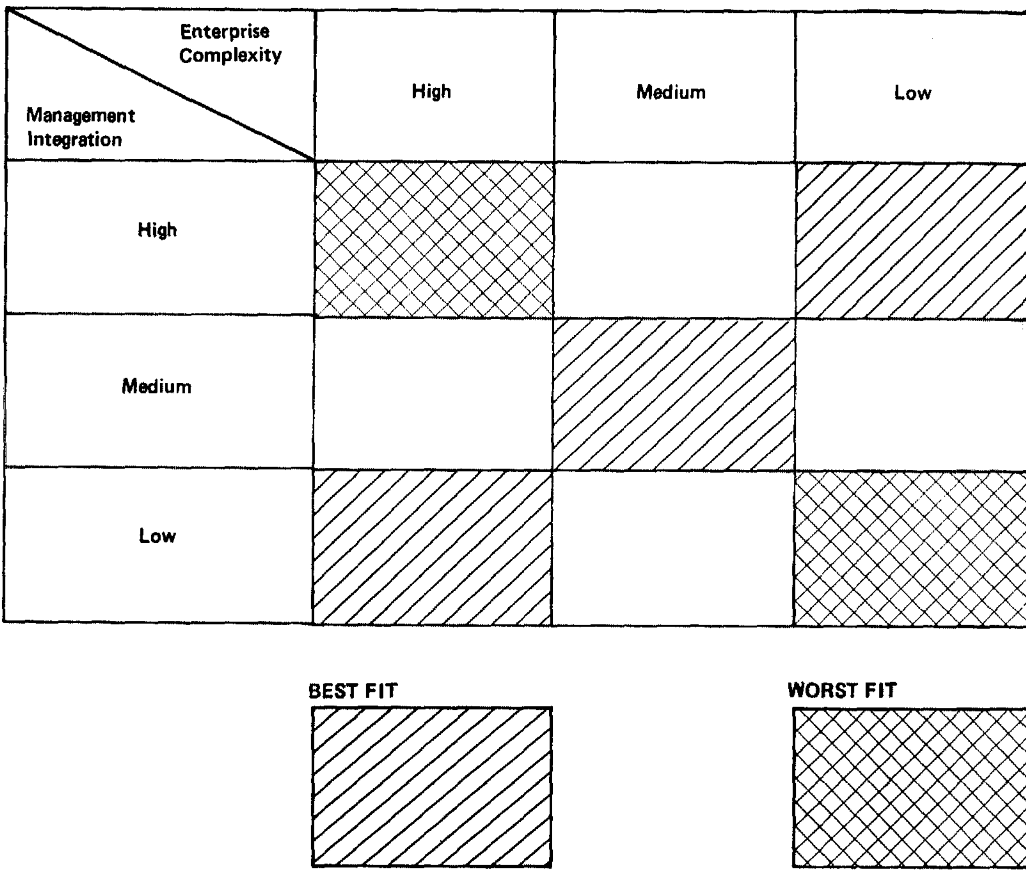


EXHIBIT 8

STRUCTURE FOR CHANGE



Enterprise Complexity: The degree of relatedness and the rates of change associated with the enterprise's products, markets, and technologies.

Management Integration: The degree of interdependency among the business units created by the enterprise's organization structure, management processes, and managerial behavior.

EXHIBIT 9

STRUCTURE FOR CHANGE

Characteristics \ Enterprise Complexity	High	Medium	Low
Relatedness of Major Businesses			
• Number of Clusters	Many	Some	Few
• Diversity of Clusters	High	Medium	Low
• Number of Business Units	Many	Some	Few
• Diversity of Business Units	High	Medium	Low
• Relatedness of Core Technologies	Low	Medium	High
• Diversity of Customers	High	Medium	Low
• Geographic Coverage	Extensive	Moderate	Limited
• Size	Large	Medium	Small
Rate of Change			
• Rates of Growth	High	Medium	Low
• Rates of Technological Change	High	Medium	Low
• Rates of New Product Introduction	High	Medium	Low
• Velocity of Product Life Cycles	High	Medium	Low
• Rates of Market Change	High	Medium	Low
• Customer Stability	Low	Medium	High
• Amount of Environmental Uncertainty	High	Medium	Low

EXHIBIT 10

THE STRATEGIC MANAGEMENT PROCESS
SETTING STRATEGIC DIRECTION