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STRATEGIC PLANNING

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Recorder: DAVID L. BAXTER

- o Strategic planning process in insurance organizations
- o Differences in process among small, medium and large companies
- o Effectiveness of process
- o How to monitor and follow-up the implementation of these plans

MR. DAVID L. BAXTER: In addressing the topic of strategic planning, I'll start out with a brief overview of some broad global trends and influences in the insurance industry today. Then Don Welsch will discuss strategic planning, both process and content, from the external viewpoint; that is, the external environmental factors -- market, competition, industry dynamics, etc. -- which have a major impact on strategic planning decisions, and how a company evaluates these factors. I will address the internal factors which are important in making quality strategic decisions.

A 1987 Ernst & Whinney survey of life insurance company executives found that only 27% of those executives were very satisfied with the profitability of their companies, 15% were very satisfied with their productivity, and 10% were very satisfied with their expense levels. Only 38% were very satisfied with their distribution systems. This study also showed three major areas rated as especially high priority by these executives. These three priorities were increased growth, increased profitability, and improved distribution systems.

Moody's 1987 industry outlook showed a decline in industry profits from 3.5% in 1982 to 2.7% in 1986. Further, Moody's expects this decline to continue due to industry competitive pressure. Executives predict the average Moody's rating for life insurance companies will decline.

A somewhat dated study, The Twenty-Year Strategic Outlook for the U.S. Life and Health Insurance Industry, produced by the Center for Futures Research at USC, developed a few divergent scenario situations the insurance industry could find itself in. I'd like to talk about some of these potential industry scenarios.

Society experiences significant technological change, leaving insurance industry technology behind in a cloud of dust. The elderly dominate both the market and political scene, life insurance demand is down 30%, and banks beat out the insurance companies at marketing to the older population.

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The insurance industry successfully reacts and responds to a continuing high interest rate environment and alternate distribution systems.

Third world debt causes banks to fail. As the government focuses attention on the banking industry, the Social Security system collapses. National health insurance severely hurts insurance industry margins, forcing companies to turn technology toward developing slow improvements in their own productivity. By the turn of the century, the majority of the industry is not yet bankrupt. But this lean expense position leaves the industry vulnerable as competition erupts, the stock market crashes, and major pension funds fail.

There is strong economic recovery. The federal deficit is erased by 1993. Due to low interest rates, there is a strong demand for traditional insurance products. But by the year 2000, full-service financial institutions own 50% of the insurance business in addition to their host of other products.

These four scenarios are clearly very divergent, but each has aspects of forces in the industry you can see today.

How does a company effectively cope with this changing environment? How does a chief executive achieve increases in product, profitability, and growth in this environment? I think the answer is by effectively evaluating this environment and subsequently evaluating its impact, relative to a company's own particular strengths and weaknesses and relative to its particular strategies in the marketplace.

MR. DONALD WELSCH: We'd like to take a specific view of some of the problems of strategic planning. You may want to call this a "how to" session. We're going to stay away from abstract concepts if we can.

I will begin by saying that a good strategic plan is really built on two or three basic components. The first is an assessment of the external environment. Dave has shown you that we as insurance producers and insurance companies are facing a volatile economy -- a volatile financial market which is not likely to change in the near future. An assessment of this environment is essential to a good plan. Second, as you may know, many insurance companies are slow to make changes and slow to adapt their organizations to new times. Therefore, a candid, in-depth assessment of the current position of your company is an important part of a good strategic plan. And finally, for us as actuaries, foretelling the future is clearly an important component in the planning process. Since none of us can do this, we need to prepare for possible alternative outcomes and let our companies know how they can deal with alternative futures.

As Dave mentioned, we have divided this session in half. I'll be dealing with issues of strategic planning for market, product and distribution, and Dave will be back later to discuss the strategic aspects of what this means to the internal operation of your company.

First, I'd like to give you my assessment of the environment. I will suggest that you take a close look at the panel discussion, "The Future Economy" elsewhere in this *Proceedings Record*. There are some excellent discussions and some good ideas about the future the insurance industry will face. I do not intend to do that kind of in-depth presentation. Second, I'd like to spend some time helping you to understand how you can define what strategic options are available to your company. And finally I'd like to spend some time showing you

how to choose from among the options which appear appropriate to your company.

THE EXTERNAL VIEWPOINT

First of all, the U.S. economy and the world economy are not going to help the insurance industry much in the next three to five years. The business cycle is going to show its true colors once again and most economists believe there will be a recession within the next three to five years. The business cycle is now entering its sixth year of expansion, a relatively unprecedented period of time between recessions. Regardless of whether the budget, trade deficit, trade balance, and various other deficit measures are brought into alignment between now and 1992, we can expect budget crunches, deficits, and taxation to continue to have an impact on the life insurance industry. Tax increases can be expected, and normally when tax increases are instituted, the life insurance industry is looked upon as a source of new tax revenue. We also believe the trend towards closing the tax loopholes open to life insurance companies will continue for the next few years. Inflation is going to have a negative impact on the insurance industry, primarily through its impact on interest rates. I do not anticipate the double digit inflation we saw in 1979-1981, but we can expect to see inflation in the higher single digits between now and 1993. We believe this will result in some disintermediation, and companies who are not prepared for it and who did not deal with it effectively during the last difficult period should prepare to do so now.

The bright spot in the economic outlook is in demographics. The baby boomers continue to play an important role in the insurance industry. They are more sophisticated, more educated, more affluent, and they will live longer, all very strong impacts on our business as insurance providers. In the long term, the baby boomers are going to come of age. As they come of age, we can expect to see greater productivity, improvements in the U.S. economy, a better employment picture, and higher levels of savings. In the long term, the insurance industry will prosper. But we've got to get by in the short term.

What about the financial market? As you might expect, the financial market will offer a continuing challenge to us in insurance. Interest rates will probably rise and lock step with inflation. Foreign capital flow into the United States will start to heat up again, as the spread between our interest rates and foreign rates increase and more foreign investment will seek a home in the United States. We suspect one of the prime targets will be the accumulation of American assets through the acquisition of insurance companies.

What about the industry itself? At best we can say these are trying times, both for the insurance industry and financial services as a whole. The major forces we see in the industry are what we call the 3 1/2 Cs: competition, consolidation, capital shortage, and crimp in margins.

Interest rate increases are going to renew the intense competition between banks, brokers, and insurance companies for the marginal investment dollar of the baby boom generation.

We continue to see a growth in the number of acquisitions resulting in consolidation. The government tells us that the number of companies that will produce 80% of premium income by 1992 is going to shrink by 15% to 20%. You can expect to see middle-sized companies under a great deal of pressure either to merge or to consolidate their operations, and we expect to see small companies

with a particular market niche or geographic niche being looked at carefully by their large brothers.

Clearly, most companies, and in particular, mutuals, are in need of additional surplus. This comes at a time when cheap sources of surplus are not as abundant as they were. We expect to find many insurance companies with a capital shortage in the next few years.

Insurance will continue to compete in a broader financial services market. Both insurers and noninsurers will make the market for interest-sensitive products extremely competitive.

So this is our brief, if not terribly optimistic view, of what we see for the future of the insurance industry. In this kind of environment, there really are only two options (or 2.5 options) open to us as life insurers. The first is growth. We can expand our product lines, we can open new markets, we can learn to compete for market share more effectively in our existing markets. Or we can go for cost control, improving our cash flow, and somehow prepare ourselves for a leaner, consolidated or reallocated future. These basically are the options open to us in this environment.

Consolidation, I believe, is primarily an issue dealing with the allocation of the internal resources. I'm going to ask Dave to deal with this issue when he discusses it.

STRATEGIC OPTIONS AND GROWTH

Growth can be achieved through three essential sources.

Expand Your Internal Capacity

When doing this, you must understand that this requires the ability to grow and improve on the resources you have within your company.

Acquisition

This however, requires the capacity to raise capital to fund the acquisition and also to manage new organizations with perhaps different cultures. So while it is an alternative to the internal capacity growth, it offers different kinds of challenges.

Strategic Alliance

This requires a different sort of effort. In order to participate in strategic alliances, we believe companies have to take a close look at their competitive strengths and weaknesses. It is that candid assessment of strengths and weaknesses that provides the possibility and the probability of success in strategic alliances.

INTERNAL CAPACITY FACTORS

If you are going to focus on the internal growth of your company, I suggest you take a hard look and answer a few questions.

How good is your market intelligence? Do you really know what's going on in the market for your product? And if you're planning to add new product lines, do you really understand what the market's looking for in those new products? If you're planning to open a new distribution channel, how knowledgeable are you about what drives and motivates and works as an incentive for that distribution channel?

How good is your research and development capability? Do you really have the kind of creative product development people you need to be able to innovate in a marketplace with a high degree of uncertainty?

Do you really know what your market image is? Do you understand how the consumer or final purchaser of your products really looks at your company? Are you considered to be aggressive, are you considered to be modern or are you considered to be somewhat more conservative?

Do you have in place an advertising program, both for your agents or other distribution channels, and for your consumers, which portrays to them the kind of image or picture you would like them to see of you as a company?

How well positioned is your distribution network relative to the competitive forces we think will emerge, or have already emerged in many cases, in the next few years?

These are the kinds of questions we would like you to take a hard look at if you are looking at internal capacity as a means of growth. Just as a side point, I should mention that the Ernst & Whinney survey Dave mentioned earlier indicated that 59% of the respondents would be entertaining noninternal growth strategies as a means to achieve larger market share, and 54% said they would seek some sort of a joint venture or strategic alliance to establish or introduce new products. So, in many cases, our fellow executives are turning to noninternal growth strategies as a way to achieve growth potential.

ACQUISITION

According to *Mergers & Acquisitions* magazine, there were 119 exchanges or acquisitions of domestic life companies in 1987. Those companies had a purchase value, not an asset value, of close to $3 billion. Of the 199 acquisitions, 109 changed hands domestically. This means that a relatively small percentage of the life insurance companies that changed hands in 1987 were sold to foreign investors. We don't believe this percentage will remain this low.

The number of acquisitions in itself is fairly interesting, and the value of those acquisitions is also worthy of note. But there are a couple of underlying issues which do not come out in the numbers that I want to call to your attention. A number of these acquisitions were done to avoid unpleasant alternatives. I am an alumni of the Beneficial Finance Corporation, who, in 1987, disposed of close to $3 billion in insurance assets, mostly to stave off a takeover by another company.

We also found a number of companies changing hands in 1987 that had changed hands as recently as three years before. In many cases, companies essentially said, "Look, I never should have done this deal. It was a bad merger to begin with. I'm going to cut my losses and dispose of something I acquired only a few years ago." As painful as it may sound, we'll see it again in 1988.

Many companies were forced to dispose of units within their own companies or within their own group of companies to consolidate their position, and focus more sharply on their original or core business. And these acquisitions were clearly not made as a means of integrating growth.

Although mergers are a traditional route for growth, we believe that for the remainder of the 1980s the merger and acquisition must be looked at carefully in

terms of whether it meets the strategic goals and the corporate objectives of your company.

Another thing we want to call your attention to is that the marketplace does not necessarily value all mergers as being good. Of the acquisitions made in 1987, *Mergers & Acquisitions* magazine noted that Moody's downgraded 176 of the companies involved in mergers and acquisitions and upgraded 100. This may have been because of the debt of the acquiring or the acquired company, and these were not just life insurance companies, but other companies, too. Standard & Poor's, on the other hand, downgraded 284 issues of companies that were merged, and upgraded only 188. So it is not a foregone conclusion in the eyes of the capital market that an acquisition necessarily benefits the stockholder and the policyholder.

STRATEGIC ALLIANCE

Mystic Insurance Intermediaries feels the strategic alliance is an important trend in the 1980s. In its essential form, it is not new to the insurance industry. But we think it should be looked at as a method to achieve more strategic objectives than were formerly considered. We define a strategic alliance as a business venture involving the participation of two or more entities to achieve a specific corporate goal.

A new wave of strategic alliances is occurring in a number of unlikely areas. For instance, in the areas of research and development, we have found companies as large as Digital Equipment Corporation (DEC) and Apple jointly developing new technologies rather than taking the financial or technological risk in developing these new technologies alone. In marketing and distribution, we have seen large pension mutual funds develop shared marketing support programs for their basic pension products to reduce costs. In operations, we have seen a number of health care insurers, in an attempt to reduce their costs, set up their own captive mutually-owned third-party administrators. And finally, there have been a number of moves where financial capacity has been shared among insurers. Once again, I must remind you that the Ernst & Whinney study of corporate executives found 58% who would seriously consider employing a strategic alliance as a means of achieving a corporate objective in the next few years.

Why may these strategic alliances be beneficial? First of all, a strategic alliance allows you, as a company, to remain flexible. If the business cycle should turn adverse to your company, if its economic or financial position should put you in the position where this strategic alliance is no longer advisable, there is no large commitment of capital, management or the basic resources of your company, and the pain and cost of withdrawing from this joint venture would probably be less than if you were fully committed to an acquisition or a complete internal growth program.

Second, it reduces the capital risk to you in entering a new venture. In a time when financial market volatility is clearly always just below the surface for many investors, any way to reduce capital risk in an industry which is looking to build up its capital is probably something that should be considered. If you don't want to be acquired, you want to stay away from the merger game, especially if you are the acquired rather than the acquirer. One of the best ways is to keep your head down. Strategic alliances, because they tend to get less press and be more blurred, keep you less visible in the capital markets than if you were out to acquire or to be acquired.

Finally, because of shared resources, the commitments to strategic alliances reduce the need for staff and resources. There are some distinct advantages to this approach to strategic management.

It tends to minimize business risk. When you choose to enter something and you choose to do it with the "I'll put my toe in the water and see how it looks" approach, your commitment of resources is less than it would normally be, and in many cases minimizes the business risk. More importantly, it allows you to come to the table with your competitive strengths and allows your strategic partners to shore up your weaknesses by focusing on their strengths. Alliances based on two companies that are meshed from the point of view of their own strengths are usually quite successful.

In many cases, the establishment of a legal entity in the regulatory environment we face is not advisable. Strategic alliances minimize the need for new entities and regulatory approval.

A strategic alliance allows for the adaptation of different management styles. You do not enmesh the entire company in a new venture but rather single out a group of talented managers within your company. You mesh them in a task force with skilled managers from your joint partner, and the issue of management style does not arise. Many mergers have failed because management could not satisfactorily be meshed in time to make the acquisition profitable.

If your strategic options therefore are to grow through internal expansion, to acquire, or to enter into somewhat of an informal alliance, how do you decide which option is right for you? Actually, it's quite simple. Determine your strengths and weaknesses and match these against the opportunities and threats offered by the marketplace. You can, in fact, come up with a good solid selection of the right strategic options.

STRENGTHS AND WEAKNESSES

Michael Porter has published a number of books, the latest being *Competitive Advantage*. In it, he says a company should revisit what it does in terms of its value chain. The value chain is what each function or group within your company contributes to the overall value of the product or services you provide. If you were to begin with research and development and end at operations and services, and if the total were to equal 100%, how would you allocate the 100% of value to the various functions in your company? If you were Texas Instruments, you would probably put 50% to 60% of your value added in the first category of research and development. If, on the other hand, you were Sony or Casio or a company like that, you might want to focus on marketing and sales as a big contributor to your overall value. The important thing is to look at your own company and see where your value to your policyholder really exists. Is it in your ability to design your product? Is it in your ability to get a product through the regulatory morass and into the market? Is it in your ability to motivate your distribution, your field force, your agents? Is it your financial strength to be able to enter and exit markets at will because of the management of your financial resources? Is it in your policyowner service, your underwriting, that makes your company special?

Overlay on the things that are a little bit harder to get a handle on. How are your relations with your parent company (if you are a subsidiary of a company)? What is your corporate infrastructure really like? What is management's capacity to deal with change? What is management's capacity to anticipate things that will

happen with your company? How good is your back shop? Are your computers and software up to date? Are you using the latest technology available that is appropriate to your marketplace?

If you do this assessment in a candid way and understand your environment, the rest is relatively easy. If you rethink what your company does in terms of a value chain and be honest with the results of this assessment, you'll find it useful in choosing a strategic option.

Once you have completed an internal assessment of your strength and weaknesses and have evaluated what you think the opportunities and threats are in your market, there are only four options remaining to you. The opportunities you have at any given point in time are unlimited. Yet the resources you have in achieving those objectives are quite limited. The question is -- can you select priorities?

First, I don't want to tell you what to do, but if I saw significant opportunity in the marketplace and felt it honestly was a strength of mine, I think I would want this opportunity to be my first priority. If you're good at it, and the market wants you to do it, it shouldn't be hard to do.

Some people may challenge me on this next one. I believe if you're good at something, and you perceive that the marketplace or the environment is going to create a threat to you as a company or to your segment of the industry, you should focus your strengths on threats. Deal with those things you can see coming. It may be something like modifying your product in anticipation of a change in the tax law.

The third priority would be to look at those areas where you are the weakest and where you believe the environment is going to come down hard on you in the next few years. The shoring up of your weaknesses against a perceived threat from the environment is an extremely important third priority because if you neglect it, you may not be around to deal with it when it comes.

The fourth priority would be to take advantage of opportunities created for your weaknesses, which is sort of like pushing a boulder up a hill. It's a tough way to do it.

Let's examine each one of these alternative strategies and see how they might work. I have in mind a company which is extremely good at product development. Their research and development and actuarial capability is the best. However, the company is not awash in premium surplus. If anything, the company is in a position where it may be either currently or in the future experiencing some financial capacity strain. Let's see how a company like this would react to the four strategic options I've suggested.

MATCH STRENGTHS TO OPPORTUNITIES

Profitable Products to New Distribution

If you were good at research and development, one of the first things you'd want to do is take your high-profit, high-margin products and modify or enhance them to be sold through a new distribution channel. This is a cost-effective way to take advantage of an opportunity. If the savings and loans are saying, "What I really need is a policy that looks like a certificate of deposit," and you're already good at those kinds of annuities, it seems to me a logical first step to address those opportunities.

New Related Products to Current Customers
If your product development efforts have created a good reputation for you among your policyholders, why not take advantage of that strength and develop products closely related to your most popular products, and sell them to your existing clients as an add-on. Now, everyone says, "That seems rather obvious; I've got my agency force out there, and unless you beat them over the head with a stick they're not going to make a cold call anyway, so why bother?" If you address the quality of your existing product base and identify what kind of customers you are attracting, you may get a different perspective on what is essentially an old cliche.

Wholesale Product Development to Noncompetitors
If your strength is product development but your capacity to write new business is limited, why not wholesale your product development services to noncompetitive companies? In other words, use your strength as a source of developing new sources of income, even though it is fee income. It is low risk and has a lower cost because the people are already in place. But of course the profits are lower because you are not getting the return on your resources you would get if you were writing your own business.

Now, these three are only suggestions. But it is the type of thinking I think companies ought to go through when they say, "Here's my list of strengths and here's how I think the marketplace looks in the next few years. And when I match those two, these are the kinds of things I come up with."

Focus Strengths on Threats
Improve existing products before your competition. Again, we have a good research and development company with maybe a potential for strain surplus capacity. How can you improve your products before your competition? First, you can look at your margin and say, "I'm successful there, but if I could segment that market into smaller pieces and tailor my products more specifically, since this is a strength of mine, I might be able to avoid a competitive threat to my marketplace by beginning to differentiate my product even before my competitor thought about approaching that marketplace in a generic sense." Also, you may want to look closely at your distribution channels and maybe tweak existing products a little so they respond to the sort of low-grade complaints and low-grade needs your distribution channels are starting to produce. And finally, you must be sensitive to the changes in those markets, and be ready to introduce new products.

Develop New Service Value for Neglected Distributors
If systems, policyholder service, and management information are a strength of yours, and has remained within your company, you may want to consider a strategy to push this information closer to the distributor, the brokers, and your network as a way of saying to your people, "Look, here's a strong company. We're adding value to the product we ask you to sell." This also creates good visibility in the marketplace. Don't neglect the fact that an important component of what the insurance company has to sell is information. And the more aggressively you sell, market or distribute the information related to policies, the more you may be perceived as a major competitor in your marketplace.

Anticipate Legislative Product Impacts
If your strength is product development, you should be keeping your ear to the ground on Pennsylvania Avenue, on Capitol Hill, and on every one of the state regulators. Because your ability to anticipate legislative and regulatory change

and implement them into products quickly and effectively may very well be the future source of your competitive advantage.

IMPROVE WEAKNESSES THAT ARE THREATENED

Withdraw from Markets with Unprofitable Products and Competitive Activities

This may be hard to do, but if you perceive that you do not have a profitable competitive position in a marketplace and believe competition will heat up in that marketplace, you may have to bite the bullet and withdraw from the market. If this room were filled with health care providers, which it's clearly not, I think one of the things they would say is, "We should be thinking about getting out while we still are intact." Especially when you are looking at limited financial resources, you should consider when to cut your losses.

Invest in Functions That Affect Threatened Markets

You may want to invest marginal dollars of your own in a market you believe is threatened. I would suggest that, given the risk of this kind of strategy and the limited availability of resources for this kind of approach, you may want to consider the strategic alliance and its low-risk, low-capital involvement characteristics as an appropriate way to bolster a weakness in a threatened market. If I had to pick a spot where I wanted to avoid an acquisition or massive investment of my own internal management or line resources, this would be one of the areas in which I'd want to do it.

WORK ON WEAKNESSES THAT PREVENT FUTURE OPPORTUNITIES

This is a long-term, painful kind of thing and really not something I think we need to get into.

Let me close with a few conclusions, which I hope will help you make sense out of this. It's nothing new that the old rules don't apply any more. But I just thought I'd say it. Frankly, the markets will continue to change and if the economic pundits we heard yesterday are correct, the environment is likely to change the rules again. We strongly believe that, as we go forward in a competitive consolidating crimped margin industry, flexibility and the ability to innovate is going to be the premium strategic objective. Dodging and weaving is going to be a skill we're all going to have to learn. It's just a question of when and how.

Last but not least, I would counsel, for lack of a better word, that a long-term strategy will never get done, unless it's attacked one piece at a time and every year a little bit of that strategy gets accomplished. It's like mowing the back forty. If it grows another inch for another six months, it's no big deal. I'll get to it one of these days. I believe that in the environment we face, putting off dealing with long-term strategic goals is probably not good business.

MR. BAXTER: Once you have a solid understanding of the environmental factors operating in the industry, what the possible strategies are, and which of the strategies can be competitively effective, it's important for you to realistically evaluate your own particular strengths and weaknesses relative to a specific strategy. Not only do different industries have different viable strategies, but there can be many different viable strategies even within the same industry.

We can look at a competitive strategy as the mobilization of corporate resources to effectively reap the industry opportunities and combat the threats, given all aspects of the external environment which Don has talked about and a company's own strengths and weaknesses and corporate culture, which I'll be talking

about. In assessing your own internal situation, it's important to get a good handle on every one of these items, and it's important relative to the anticipated strategy. (See Exhibit 1.)

INTERNAL ASSESSMENT

Brand reputation -- is consumer brand awareness necessary for this strategy? Do you have it? If not, you're not going to get it overnight. Is brand awareness among distributors important? Do you have the distribution capacity to fully and effectively implement the strategy? Are your technology and systems up to the task required by that particular strategy? There are strategies which are system intensive and strategies which are not. Do you have the expertise in underwriting, benefits, and the systems required by that strategy? Do you have competent management? Do they understand the strategy?

Is your company's cost structure appropriate? Do you have competitors with significantly lower cost structures?

Is the strategy consistent with other corporate financial objectives? If a strategy requires a significant capital outlay or drain on surplus in early years, is this an acceptable situation, given your overall corporate financial objectives?

Is the strategy consistent with your own culture, the motivations, desires and values of the key executives expected to implement that strategy? A strategy which does not fit well with your executives' culture and motivation will probably not be effective.

Given this assessment, I tend to break strategies down into three major generic types. A lot of people have called them a lot of different things, and some people may say there are two or four of them. But the three we will focus on are:

1. Overall cost leadership assumes a company is somehow able to reduce its own cost structure, either through high volume, unit cost reduction, or technology. This allows them higher productivity, and they are able to compete in the marketplace on the basis of low price relative to competition.

2. The second strategy says the company is going to effectively compete by differentiation of its product in some way and offer that product at a higher price because it is differentiated.

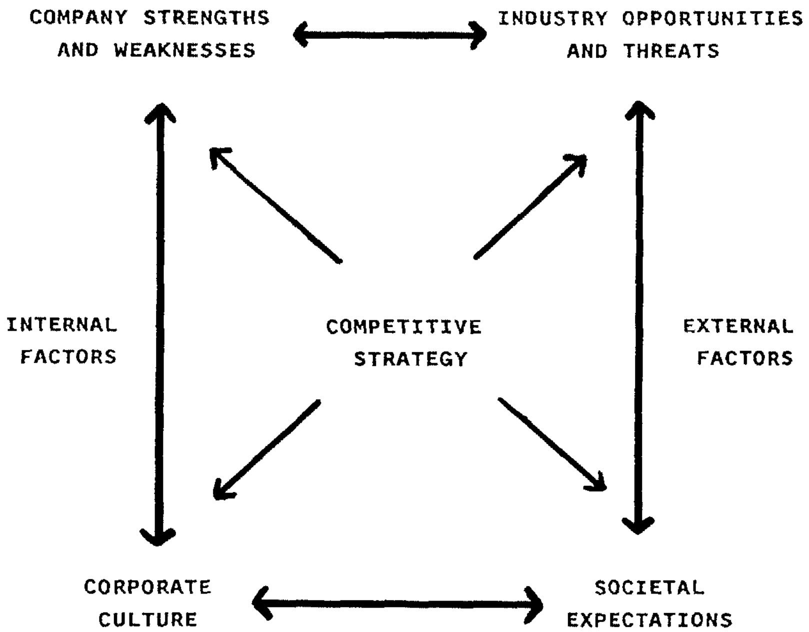
3. The final strategy is one of market focus, where a company segments an overall industry and identifies a subsegment of that market. It identifies the needs of that market so well that they can meet the unique needs of that particular segment better than any other company in the industry.

Companies who do not focus the majority of their resources in at least one of these directions tend to get stuck between two or three of these various strategies. They divert resources away from the most effective strategy and do not compete as effectively as they could on either basis.

RESOURCE NEEDS OF THE VARIOUS STRATEGIC OPTIONS

The overall cost leadership strategy requires the following resources: typically, but not always, high capital investment primarily aimed at productivity advancement; effective administration; effective systems; simple products, as it will be hard to avoid adding bells and whistles to compete against differentiated

EXHIBIT 1



companies; but once you start on that road, your cost structure is going to increase; efficient and low-cost distribution; and resources must be devoted to not just cost control but to cost accounting and cost analysis, and not only for keeping costs low but also for identifying segments of the business which have lower costs for pricing strategies.

Differentiation requires strong marketing skills; strong product design and internal creativity skills; a strong product research and development department; the good reputation of the company to add credibility to the differentiated feature -- credibility and value must be attached to it, since the consumer does not necessarily view being different as being better and the product requires added credibility to add to the value; and solid distribution.

The market focus strategy requires the same resources as the other mentioned above, but requires in addition a thorough understanding of the market, brought about by solid market research; flexibility, particularly to be responsive to the changing needs of your particular subseqment; and a service orientation -- a solid market focus strategy must address the true service needs of that market.

Once a tentative strategy has been selected, you must thoroughly assess that strategy relative to every aspect of your company's operations, and revisit the external environment to test the fit. There's a need to test for internal consistency environmental fit, available resource fit and effective communication and implementation of the strategy throughout the company.

Are the goals of this strategy consistent with the other goals of this organization and other goals within the strategy, or do they oppose? The key operating policies should support the goals, and should support and reinforce each other. There should be a synergistic effect with the key operating policies.

Does this strategy exploit industry opportunities? Does it deal with the threats? Is the timing of your strategy correct relative to the timing of the environment? For instance, if your product depends on certain legislation, will the legislation be enacted in time for you to implement your strategy effectively? Does your strategy respond to societal concerns? Is it acceptable to society at large?

Does the company have the necessary resources to implement all goals and policies of that strategy? You can't effectively implement half, or two thirds or three quarters or even 90% of a strategy. All resources have to be available. Can your organization absorb the changes required to effectively implement that strategy? Do you have recruiting or training needs, and can these be accomplished within a time frame so that your strategy will still be effective?

Do the key implementers understand the overall strategy? Are the strategies in line with the personal values and goals of the key implementers? Do you have sufficient managerial capabilities to effectively implement that strategy?

I want to emphasize the importance of implementation here. An article in the December *Harvard Business Review* discussed strategy and tactics. It was written by Arthur Rock, a venture capitalist who financed such ventures as Fairchild, Scientific Data Systems, Intel, Apple Computer, and Teledyne. He states that when he's evaluating a venture, the first place he looks is not at the financial plan, or how well the business plan is written, or how good the market research is. The first things he looks at are the resumes of the implementers.

According to Arthur Rock, strategy is easy, but tactics are hard. And his experience has apparently shown that successful implementation is not due to good strategy as much as to effective implementation. That's why I want to emphasize that it's important to have the appropriate fit between your strategic planning and the actual implementation and support of that plan.

Another *Harvard Business Review* article discussed a study of 16 successful British companies which evaluated the control these companies exert on the basis of a grid of strategic control; that is, control at the strategic planning process level versus control at the implementation, financial or operational level. (See Exhibit 2.) The study found that companies are successful if they operate along the arrow; that is, either high on strategic control and low on operational control, or high on operational control but low on strategic central control. There was also a successful group of companies in the middle of the arrow. Those companies exercising low central control over both the strategic and operational were not successful, and there were no companies in existence who were high on both scales. The environment created by this combination is too stifling to even be feasible. Again, this shows the importance of the proper match between strategic planning and operational implementation.

Looking at the insurance industry quickly, a couple of additional features apply. It is a fragmented industry, with thousands of companies. No one or two companies can exert any significant control over the marketplace. It's also a maturing market. These two additional features give unique characteristics to effective strategies.

I'd like to talk about some basic strategic errors which happen in the planning process, particularly in fragmented, maturing industries.

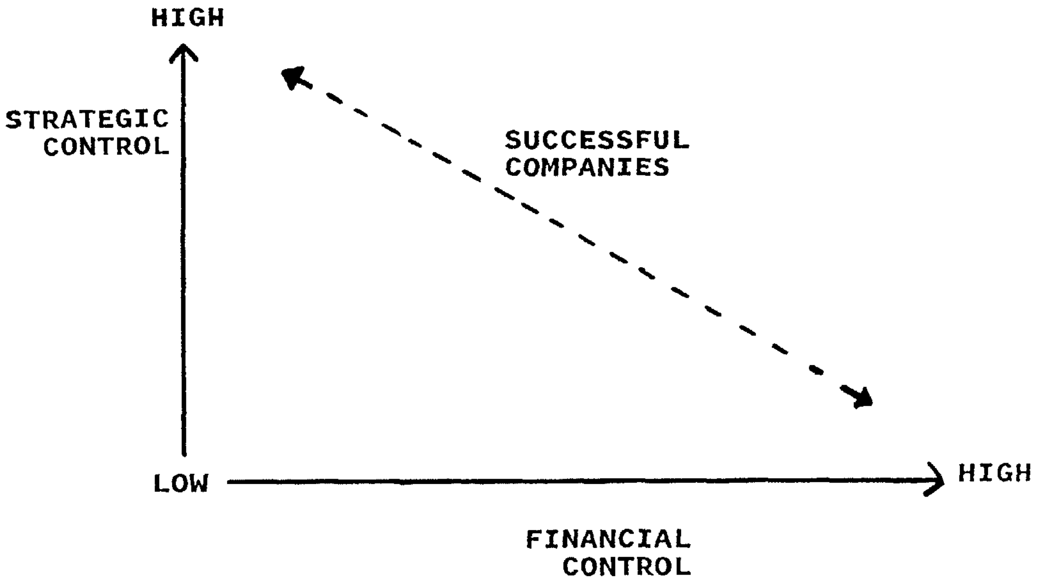
Self-image, particularly in the marketplace, may also be an unrealistic assessment of one's strengths and weaknesses; for example, feeling a company has an exceptionally strong computer system when in reality they do not. In a maturing market, you'll find companies with an unrealistic perception of their marketplace image. They are not on target relative to their own self-image.

Companies tend to make erroneous assumptions about their competitors. They make erroneous assumptions about the goals and financial objectives of competitors, about what they want to accomplish, and their particular strengths and weaknesses.

As the market tends to mature, companies often find they have not been well focused in one of the three generic strategies of cost differentiation or market focus. This becomes more apparent as the market matures and growth slows. What you find is a company trying to operate more than one strategy, perhaps trying to be in the middle of the low-cost and differentiation strategies. They are going to be chewed up at both ends by the companies who are effectively focused in the various strategies.

It's often a mistake to over invest to obtain additional market share in a maturing industry. On the other hand, once a company is holding share, it can often be a mistake to sacrifice current market share for short-term profits. As the market continues to mature, size and economies of scale may become more important down the road. The advantages gained down the road from size may be more than the profit you can squeeze out of that today.

EXHIBIT 2



Often there is an irrational reaction to price competition. I've been there myself. "We're a quality company; we don't compete on price." We'd all love to say that. But as the market matures, price becomes a factor in competition. A company has to be able to respond. Often an irrational reaction to industry changes, and we see new entrants to the market and new distribution methods. They are there, they have to be accepted, and we cannot readily dismiss new methodologies as being ineffective or nonthreatening.

There's a tendency to overreact and to readily accept new products rather than focus on existing products and enhancements to existing products.

A company may have an unrealistic viewpoint of themselves as a high-quality company and what this really means. IBM is being hurt badly in the personal computer market because they place too much of a premium on what they view as quality to the consumer.

Excess capacity is a double-edged sword. More than just increasing the cost to a company, it exerts subtle pressures on a company to utilize this excess capacity. And the methods of utilizing excess capacity can come in ways to take them outside of what would have been a viable strategy.

In a fragmented, maturing market, it's rare that the cost of seeking additional market share can be justified by the benefits to be reaped down the road. It can often be a mistake in an industry like this.

How do you avoid this? How do you put it all together? We see it as a cyclical process (see Exhibit 3), which starts out with a situation analysis, evaluating the environment and your strengths. From there, a company makes its strategic decisions, implements those strategic decisions, and monitors the financial and operating results, and constantly reevaluates the key assumptions which went into the original strategic decision. The company reassesses that decision, cycling back to the situation analysis, and if necessary revises their strategic decisions.

With a process that constantly cycles through this evaluation, with a determined effort to know a company's own self, and with a little luck, a company should be successful at steering a clear course through this turbulent and uncertain environment.

EXHIBIT 3

STRATEGIC PLANNING CYCLE