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RESEARCH NEWS

The Link Between Culture Building and Profits

Bringing an end to the decades-long debate on the bottom-line benefits of “soft” management initiatives, a new study by three McKinsey researchers demonstrates convincingly that corporate efforts to boost talent, strengthen values, and reinforce culture have a direct and positive impact on profits.

Including hundreds of global businesses in their study sample, the researchers conducted surveys with employees and managers to assess each company in nine key areas of organizational quality and then compared their findings with various aspects of financial performance. The result: Significantly, companies that ranked in the top quartile for organizational excellence were more than twice as likely as those in the bottom quartile to achieve above-average profit margins. Other metrics used by the researchers – including the ratio of net income to sales, the ratio of book value to sales, and growth in enterprise value – also helped to confirm a direct link between culture building and profits.

Executives who worry that “soft” management initiatives are difficult to justify – and hard to sell to skeptical boards and investors – can take heart from this study, say the researchers. “Companies can now pursue such efforts with the knowledge that the resulting improvements will have a positive impact on the bottom line.”

Key Areas of Excellence

Given the link between culture and profits, the researchers then set out to determine if certain areas of organizational performance deliver better returns than others. Analyzing the nine areas separately, they found that companies that ranked in the top quartile in any one area financially outperformed companies that didn't, but not all areas had the same impact on profits. Interestingly, the researchers did not find a consistent relationship between “motivation” and financial performance. “While companies that motivate their employees in truly distinctive ways appear to enjoy a financial

upside,” they explain, “there wasn't much difference between average motivators and those in the bottom quartile; both groups were equally likely to outperform other companies in the sample financially.”

Nevertheless, in five key areas of organizational performance the researchers did find a relationship with profits that's both direct and linear. The better you are in each area, in other words, the more likely you are to perform better financially. The five areas, as defined by the researchers, are:

- **Capabilities.** Internal skills and talent have been developed sufficiently to support the company's strategy and to create competitive advantage.
- **Direction:** People understand and are aligned with where the company is headed and feel they have the leadership and know-how to get there.
- **Accountability:** Reporting relationships and performance management systems ensure that people are accountable for business results.
- **Innovation:** The company focuses on generating a continuous flow of new ideas and embraces change so that it can sustain itself, survive, and grow over time.
- **Coordination and control:** Business performance and risk are routinely monitored, measured, and reported.

Among all these areas, the researchers found that initiatives to improve “coordination and control” seem to pay the highest dividends. Companies that ranked in the top quartile in this area, in fact, were almost three times more likely than those in the bottom-quartile to enjoy high profit margins.

To be sure, many factors drive financial performance, acknowledge the researchers, and evidence of correlation is not proof of scientific causation. “Still the correlations we identified are striking, as they strongly suggest that companies pay a financial penalty for weak organizational performance and that strong organizational performance reaps financial dividends.”

For more information, see The McKinsey Quarterly, No. 3, 2007, which is available to subscribers online at mckinseyquarterly.com.

LEADERSHIP FORUM

Intuition and the Senior Executive

With powerful new technologies to collect and analyze data, executives have access to more information than ever before when making business decisions. But what do you do when the numbers yield more questions than answers? Or when you're shifting your strategic course, and past data no longer apply? At times like those, say three experts in *Sloan Management Review*, you have to rely on your intuition.

The idea that executives should make decisions based on "gut feelings" is generally out of favor, and until recently there's been little research on intuitive management. But that may be largely due to prejudice, say these experts. After all, we have no problem accepting intuition as part of the thinking process of a great chess master, and we readily acknowledge the role that it plays in science. But when it comes to business, intuitive decision making is often viewed as too whimsical or irrational an approach – or simply inappropriate for modern executives.

Yet these experts cite recent studies showing that intuitive decision making is actually widespread among executives – the higher up you go, in fact, the more likely you are to use it. And far from being a magical sixth sense, new research shows that intuition is really a highly developed form of reasoning, based on years of experience and learning, that can prove invaluable when making complex business decisions.

"What we call intuitive decision making is really one's ability to recognize patterns at lightning speed – a process that often happens unconsciously," explain the experts. And because executives who've acquired deep wells of knowledge and experience can see patterns that others don't, they're able to reach good intuitive decisions much faster and more frequently.

Cultivating Intuition

Is it possible to develop more intuitive managers and to hone your own intuitive skills? While the study of management intuition is still new, say the experts, the latest research points to the following requirements for cultivating it:

- **Experience.** The more extensive your professional experience, the more likely you are to recognize patterns and to think intuitively. Studies in psychology indicate that an executive needs at least 10 years of domain-specific experience to develop the kind of healthy gut feelings that lead to good intuitive decision making.
- **Networks.** Executives need strong personal and professional networks in order to share experiences, learn from others, and hear how their intuitive decisions are received. "Senior executives should surround themselves with people who are their equals and with whom they can maintain an open climate of discussion," say the experts.
- **Emotional Intelligence.** Research shows a close link between emotion and intuition, and executives who are able to recognize and interpret their emotions tend to make better intuitive thinkers. Daniel Goleman, the psychologist who coined the

phrase "emotional intelligence," claims that 90 percent of the differences between top-performing and average-performing executives can be explained solely by this factor.

- **Tolerance.** Intuition develops best in an environment in which both positive and negative experiences are welcomed as learning opportunities. For top managers, this means a greater willingness to tolerate mistakes and the ability to create a culture that publicly and continuously supports people who take risks.

- **Curiosity.** Since intuition is based largely on experience, executives should constantly feed their curiosity by focusing more on exploiting new opportunities than on avoiding potential risks. "Thinking and acting in an opportunity-oriented way is a prerequisite for striking new paths, and striking new paths is a prerequisite for gathering experiences."

Like any good skill, intuitive thinking can be taken to extremes, so it must be practiced with discipline, say these experts. Once you make an intuitive decision, rigorously evaluate it against your facts and figures, and be sure to get plenty of feedback. "As with the chess master who spends a fair amount of time rethinking the decisions he intuitively made within seconds, executives should reflect on their intuitive decisions before they execute them."

For more information, see "Intuitive Decision Making" in MIT Sloan Management Review, Fall 2007. You can order a reprint of this article online at sloanreview.mit.edu or by calling 617-253-7170.

Winning the Global Battle for Executive Talent

Emerging markets like India and China are rapidly making the transition to top-tier global competitors. No longer just providers of inexpensive labor, they've already established a permanent presence in high-end industries like biotechnology and IT and are now magnets for executive talent, making it increasingly difficult for U.S. and Western European companies to attract the best leaders.

Reacting to this shift in the global talent landscape, many firms are working more proactively to find and deploy the best executives on a worldwide basis, says Claudio Fernández-Arãoz, a partner in the executive search firm of Egon Zehnder International. In a recent study he conducted in 50 of the world's biggest multinationals, almost all the CEOs surveyed said they plan to expand the share of executive talent outside their headquarters region, and more are becoming personally involved in global talent issues, spending up to 40 percent of their time on recruitment, development, and retention.

Despite this commitment, many companies are likely to fall behind in the global battle for executive talent, says this expert, and there are three reasons why:

- **Thinning labor pools.** Breakneck economic growth in India and China has created an acute shortage of executive talent in both countries, and compensation levels for senior positions are already approaching those in developed markets. Demographic trends indicate this shortage will only worsen: Forecasters predict a 50% drop in the global number of executive candidates aged 33 to 44 over the next five years.

- **Lower retention rates.** Regardless of past traditions of lifetime employment and worker loyalty, the “stick rate” of Asian executives hired by U.S. and European multinationals has been declining in recent years. The most common reasons these executives give for jumping ship: disappointment with leadership, frustration with the local business's relationship with headquarters, and increased job offers from non-Western companies.

- **Poor HR practices.** Even at many blue-chip companies, making people decisions is still one of the weakest of all organizational practices, says this expert, and it's typically distinguished by a lack of rigor at every step. In a recent study of 100 global executives, only half said they believed their companies are successful at identifying top performers within their ranks. “In other words, half of all executives could very well be promoting the wrong individuals into important positions.”

What to Do

Given these challenges, what can companies do to improve their ability to hire and retain the best executives globally? This expert outlines four fundamental measures:

- **Educate leaders.** Specifically, make sure that executives are fully aware of the value of good people decisions, have the training and skills to render reliable judgments about who needs to be replaced, and know how to evaluate – and where to look for – the best candidates globally. “The proper mix of training programs can enable managers to develop the right level of self-awareness in order to fight the subconscious biases that can easily sabotage their decision making.”

- **Assess the competition.** Companies need to become more knowledgeable about the hottest emerging markets and the innova-

tive talent practices that are already taking place there. A good example: Tata Consultancy Services Ltd., a leader in the IT consulting industry in India, has calculated the yield on its recruitment practices in hundreds of colleges nationwide and at some schools has begun to make blanket offers to every student in the graduating class.

- **Cut the red tape.** Almost all companies could benefit from streamlining their hiring practices, to make sure good candidates are identified sooner and signed on more quickly. Especially important is having leaders in emerging markets who are properly empowered, says this expert. “When a company has a competent executive heading a subsidiary – especially in a region where talent is scarce – that individual should have the authority to staff the operation without having to deal with reams of red tape from headquarters.”

- **Implement best practices.** A number of top multinationals have already begun to benchmark their employees against international standards, implement systematic mentoring and coaching programs at all locations, and establish new HR best practices in light of changing market conditions. After struggling in the U.S. for years, for example, the German software company SAP Aktiengesellschaft significantly retooled its hiring practices, which previously favored German expatriate executives over local talent, and has since become a major player in the U.S. and worldwide.

For more information, see “Making People Decisions in the New Global Environment” in MIT Sloan Management Review. You can order a reprint of this article online at sloanreview.mit.edu or by calling 617-253-7170.

The Future of Management

In his latest book on corporate innovation, Gary Hamel recounts the spectacular success of the Brazilian manufacturer Semco, which for 25 years has conducted one of the world's most radical experiments in employee self-management. With no business plan, organization chart, or mission statement, Semco gives its employees unprecedented control over their work lives. Even assembly-line workers get to choose their own hours, set their own salaries, and opt out of projects they don't find interesting. Using this unconventional approach, Semco has expanded its workforce from 80 to 3,000 and now operates 10 businesses globally.

The Semco story is hardly new, however, and Hamel notes that nearly 80 business schools now use it as a case study. So why don't more companies operate like Semco? And why are these types of management innovations so rare? The reason, says Hamel, is that few managers have taken the time to deconstruct the management orthodoxies they've inherited, and they remain blind to new possibilities.

Most of the tools and techniques that managers use today were invented by people born in the 19th century, says Hamel. Designed to promote control, stability, and discipline, these tools have in fact become severe handicaps for managers confronting what he says are today's three most formidable business challenges:

1. *Dramatically accelerating the pace of business renewal.* Research shows that nearly all cases of deep organizational change are stories of turnarounds, with a new CEO typically cast as the hero. But turnaround is really just transformation tragically delayed, says Hamel, a costly substitute for well-timed adaptation. "The

goal is to build organizations that are capable of continual, trauma-free renewal."

2. *Making innovation everyone's job.*

Pursuing the time-honored virtue of efficiency, many companies still work hard to wring out any slack in their operations – but they tend to wring out the innovation as well, says Hamel. "Innovation takes time – time to dream, time to reflect, time to learn, time to invent, and time to experiment." While the people in R&D and product development are given this time, most employees aren't.

3. *Creating a culture that inspires everyone to give their best.*

The most valuable capabilities that people bring to their jobs today – initiative, creativity, and passion – are gifts that employees choose to give or withhold; they can't be commanded, says Hamel. "You'll only elicit these capabilities when you start asking yourself and your colleagues: What kind of purpose would *merit* the best of everyone who works here?"

Hamel outlines a process in this book that companies can use to systematically analyze the limitations of their management models and work to find root-to-branch alternatives. To inspire them, he includes detailed accounts of new companies that have broken the management mold and pioneered new directions. Among them:

- *Whole Foods Market.* Introducing a highly decentralized management approach that combines empowerment with accountability, Whole Foods organizes each of its stores into eight teams that make all key decisions regarding pricing, ordering, and staffing in their area. Every four weeks the company calculates the profit per labor hour for each team, and teams that exceed a certain threshold get bonuses in their next paycheck.

- *W.L. Gore.* Gore has consistently avoided cost-saving measures that could

impede creativity. Instead of building new facilities in low-cost locations, for example, the company has organized its plants into clusters that maximize opportunities for personal interaction. R&D specialists, salespeople, engineers, and machinists all work in the same building, and employees are encouraged to talk face-to-face, rather than through e-mail.

- *Google.* Google has implemented a policy for software engineers that amounts to a non-revocable license to pursue their own passions. Every developer is free to devote up to 20 percent of his or her time to non-core initiatives and can earn bonuses of up to 60 percent of base salary for profit-pumping ideas. To date, half of all new product launches at Google can be traced back to a 20-percent project.

Hamel remains optimistic that more companies will meet the challenges of management innovation: "If human beings could invent the modern industrial organization, they can reinvent it." But success, he adds, will require perseverance and constant attention to those aspects of organizational performance that are often the most intangible. "As we move toward a world in which economic value is increasingly the product of inspiration, mission, and the joy that people find in their work, the sorts of management innovation that will be most essential are precisely those whose benefits will be most difficult to measure – an important fact for every management innovator, and every CEO, to keep in mind."

The Future of Management is available from Harvard Business School Press for \$26.95 and can be purchased online at www.hbspres.org

Schedule & contact information

—● AMSP Group 2008-1

Session	Location
1 April 14-17, 2008	Ashland, MA
2 July 21-24, 2008	Ojai, CA
3 October 20-23, 2008	Lafayette Hill, PA
4 January 26-29, 2009	Ponte Vedra, FL

- **Tuition:** All AMSP programs are \$16,000, payable in advance. Travel and living expenses are in addition to the tuition and are handled directly with the travel organizations and conference centers by each participant.

Applicants should visit our website, click on the admissions tab and complete an application.

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