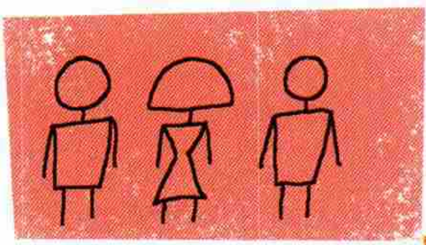
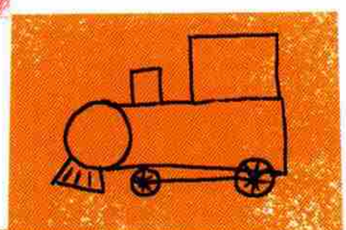
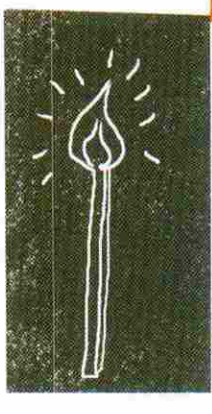
What Really Works

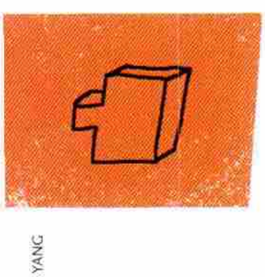
by Nitin Nohria, William Joyce, and Bruce Roberson

Separate the facts from the fads: A groundbreaking, five-year study reveals the must-have management practices that truly produce superior results.









JAMES YANG

THE DOT-COM BOOM OF THE 1990s had changed the rules of business forever, it seemed; all you needed was a sexy IPO, cold nerve, and the magic carpet of momentum trading. But even as entrepreneurs and venture capitalists were dismissing traditional business models as antiquated and conventional business wisdom as old school, we found ourselves wondering if they were right. For years we had watched new management ideas come and go, passionately embraced one year, abruptly abandoned the next. "What really works?" we wondered. Our curiosity prompted us to undertake a major, multiyear research effort in which we carefully examined more than 200 well-established management practices as they were employed over a ten-year period by 160 companies.

Our findings took us quite by surprise. Most of the management tools and techniques we studied had no direct causal relationship to superior business performance. What does matter, it turns out, is having a strong grasp of the business basics. Without exception, companies that outperformed their industry peers excelled at what we call the four primary management practices – strategy, execution, culture, and structure. And they supplemented their great skill in those areas with a mastery of any two out of four secondary management practices – talent, innovation, leadership, and mergers and partnerships.

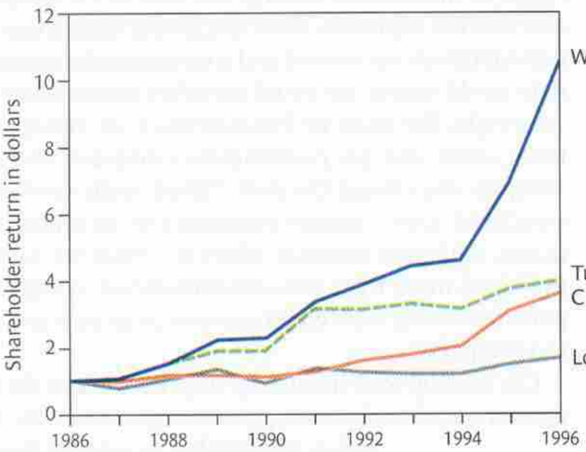
We learned, for example, that it doesn't really matter if you implement ERP software or a CRM system; it matters very much, though, that whatever technology you choose to implement you execute it flawlessly. Similarly, it matters little whether you centralize or decentralize your business as long as you pay attention to simplifying the way your organization is structured. We call the winning combination the 4+2 formula for business success.

A company that consistently follows this formula has better than a 90% chance of sustaining superior business performance.

The 160 companies in our study – which we call the Evergreen Project – were divided into 40 quads, each comprising four companies in a narrowly defined industry. The companies in each quad began the study period (1986 to 1996) in approximately the same fiscal condition. Yet their fortunes differed dramatically over the decade.

How They Fared

Adherence to the 4+2 formula for business success can have a significant impact on a company's fortunes. As the chart shows, the winners in our study generated the highest total returns to shareholders throughout the decade represented in our research (1986 to 1996). If an individual invested $1 in a portfolio of winning companies, he or she would have received approximately $11 by the end of the ten years. If that person invested $1 in the losing companies, he or she would have received only $1.50.



Source: Compustat, Evergreen team analysis

One company in each foursome emerged as a *winner* – it consistently outperformed its peers in the industry throughout our study period; one a *loser* – it consistently underperformed against its competitors; one a *climber* – it started off poorly but dramatically improved its performance once it applied the 4+2 formula; and one a *tumbler* – it began the decade in good shape then fell far behind. Over the ten-year period, investors in the winning companies saw their money multiply nearly tenfold, with total returns to shareholders of 945%. By contrast, the average loser produced only 62% in total returns to shareholders over the decade. (For more on our methodology, see the sidebar "The Evergreen Project: Our Research.")

Winners, losers, climbers, and tumblers – with startling consistency, their fortunes marched in lockstep with how well they performed on the 4+2 practices. Consider how Tennessee-based retailer Dollar General, a winner in our study, fared during our research period compared to Kmart. (The other companies in their quad were Target and the Limited.) Both companies were in roughly the same financial shape in 1986, but Dollar General grew steadily, showing healthy profits year after year. Meanwhile, Kmart floundered, its market share plummeting from 30% to 17% between 1990 and 2000. (We confirmed our findings in the five years following the study period.)

Both companies' performance was directly linked to whether or not they adhered to the 4+2 formula. In the strategy practice, for example, Dollar General never wavered from its focus, which was to provide quality products at a low price to low- and fixed-income consumers. Kmart, by contrast, couldn't seem to decide whether it was focusing on low- or middle-income consumers. What's more, it got distracted by a major foray into specialty retailing, moving even further from its core customers. At the same time, Kmart was trying to compete with Wal-Mart on price – a losing battle and in direct conflict with the organization's effort to go upmarket. (For an overview of how much value the companies in our study returned to their shareholders over the ten-year period, see the exhibit "How They Fared.")

The eight essential management practices we cite are not new, nor is their importance particularly surprising or counterintuitive. But implementing our formula for success is not as simple as it sounds. Companies can all too easily forget or ignore the basics, as we saw in the waning years of the last century. And succeeding at the eight business practices can be hard work. Maintaining a laserlike focus on strategy alone, year in and year out, can be grueling. Yet the winning companies in our study were running full tilt on six tracks at once – impressive when you consider that a single misstep on any of the six can be fatal. Indeed, some of the companies that were deemed winners during our ten-year research period have since stumbled in one dimension or another – for instance, Dollar General lost its focus on the values in its culture and, as a result, recently had to restate its earnings. It's much easier to be a tumbler than it is to remain a winner. Our

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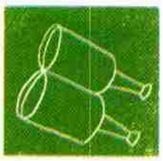
research found that less than 5% of all publicly traded companies maintain a total return to shareholders greater than their industry peers for more than ten years. And so, it seems, there is value in being reminded from time to time what really works.

Excel at Four Primary Practices

The primary management practices – strategy, execution, culture, and structure – represent the fundamentals of business. But what does it mean to excel in these areas? There are myriad tools and techniques available to help executives master these practices. To improve execution, for example, leaders can employ TQM, Kaizen, or Six Sigma, among others. The conventional wisdom about what works best shifts with the times. Our research shows that while such tools and techniques are helpful and even necessary in streamlining execution, for instance, or developing strategy, there is no single, obvious choice that will bring a company success. There are, however, hallmarks of effective strategy, execution, culture, and structure – which virtually all of our 40 winners demonstrated for ten solid years. That's no small accomplishment, especially given the limited resources companies have and the unpredictable pressures they face.



Strategy

Devise and maintain a clearly stated, focused strategy.

You can succeed by competing on low prices, top quality, or great service. And it doesn't matter whether your strategic direction comes from the CEO, a consultant, or a collaborative executive team. The key to achieving excellence in strategy, whatever you do and however you approach it, is to be clear about what your strategy is and consistently communicate it to customers, employees, and shareholders. It begins with a simple, focused value proposition that is rooted in deep, certain knowledge about your company's target customers and a realistic appraisal of your own capacities.

Dollar General, for instance, consistently sold quality products at low prices to the low end of the market. It located its stores in small towns and low-income urban areas, priced items at rock bottom, and carefully selected its merchandise with its core customers in mind.

Target, a climber in our study, has risen to become the nation's second-largest discounter behind Wal-Mart. The company's climb is best understood in terms of its leaders' ability to clearly define and establish a highly focused strategy: Provide good value within a traditional department store experience. Its value proposition, "psychic comforts at value prices," is manifest to customers in the form of stores that are bright and clean, easy to navigate, and well stocked with quality products and unique, higher-end merchandise from designers like Michael Graves and Todd Oldham. Target chose a clear, viable strategy and stuck with it.

Now compare Target's consistency with the Limited empire, a retail winner-turned-tumbler that lost its focus on lifestyle-based fashion concepts. The company's branded stores originally sold very different merchandise, and shoppers knew what to expect from each. Express was designed for hip singles, the Limited targeted suburban mothers, and Lerner (which was part of the Limited's stable of brands until 2002) served budget-minded career women. But by the early 1990s, the different stores were selling many of the same items, putting them in direct competition with one another and confusing customers.

And then there's Kmart. It struggled miserably throughout the years of our study. Successive CEOs tried to devise strategies that would make the company more competitive, but all of them lacked clarity and consistency. Kmart had always targeted low- and middle-income consumers, but when Wal-Mart and Dollar General began to eat away at this clientele, Kmart decided to pursue a more affluent, fashion-conscious consumer. That led to deals with Martha Stewart and Kathy Ireland – but it also prompted Kmart's disastrous detour into specialty retailing. At the same time, Kmart fudged its focus because it couldn't resist the urge to go head-to-head with Wal-Mart, cutting prices on thousands of items. Wal-Mart, as usual, refused to be undersold, so Kmart's price cuts failed to deliver new customers and simply reduced the company's earnings.

Staying clear on strategy means companies need to be careful how they pursue growth. Executives are often tempted to seize any opportunity to expand, sometimes pushing their companies into unfamiliar territory as a result. But moving into areas unrelated to the core business inevitably creates strategic drift. Confusion reigns, performance falters, profits evaporate. Our evergreen winners set aggressive growth goals – indeed, they grew twice as fast as the average company in their industries. But their primary aim was to grow the core business while at the same time expanding only into related markets.

Over time, ancillary businesses can become part of the core, allowing companies to gradually shift focus as market demands change. After all, while you need to stay clear on strategy – and the essence of what you do will change little over time – you still need to be able to fine-tune your focus in response to new technologies, social trends, or government regulations. Wal-Mart, for instance, stayed focused on providing everyday value to consumers and has continued to grow its core business. Meanwhile, it has also expanded into new and related businesses, like Sam's Clubs, and into new geographies, like the United Kingdom.

Execution

Develop and maintain flawless operational execution.

As with strategy, it's not what you execute that matters but how. We found no relationship between the degree to which a company embraced outsourcing, for instance, and its financial performance. Nor did success hinge on the extent to which a company invested in specific ERP, CRM, or supply chain management technologies and systems. That's not to say these tools and techniques aren't useful or productive; it's just that embracing them won't necessarily catapult your company to the head of your industry. Disciplined attention to operations is what really counts.

To be a steady winner, a company must increase its productivity by about twice the industry's average. During our research period, the mean productivity growth across all industries was about 3% per year; the winners in our study increased their productivity by 6% to 7% every year. New technologies play a role in productivity improvements, but such investments must always be judged by whether or not they significantly lower costs or boost output. Indeed, a hot new technology will not automatically enhance a business's performance any more than steroids can instantly turn ordinary athletes into gold medalists.

Kmart suffered from an inability to execute from the very start of the decade covered by our research. Wal-Mart and Target had raised the bar on store design, product availability, and customer service, and Kmart CEO Joseph Antonini knew his company needed to catch up. And yet the retailer was never able to fulfill Antonini's vision of clean, attractive stores and a revamped distribution system. The people closest to the customers – the store managers and employees – received inconsistent messages from the top team and poor support in trying to implement operational and technological changes. Vendors and customers continued to complain about shabby store displays and the fact that Kmart rarely discontinued items that didn't sell; unpopular merchandise would languish on the shelves while hot items were frequently out of stock.

By contrast, Dollar General regularly and ruthlessly reviewed every stockkeeping unit. On average, it replaced 150 to 200 items yearly. The company used sophisticated information technology at all its stores to accelerate the checkout process and to manage inventory scrupulously. And it continually tweaked its operations. For instance, former CEO Cal Turner, Jr., doubled the amount of space in the company's distribution centers, thereby reducing the number of runs the retailer's drivers would have to make, and called for a redesign of Dollar General's stores. They now boast better merchandise-display systems, wider aisles, and a brighter, cleaner look.

Winning companies are realistic. They recognize that there is no way they can outperform their competitors in every facet of operations. So they determine which processes are most important to meeting their customers' needs and focus their energies and resources on making those processes as efficient as possible. They take the same critical eye to product and service quality as well. Evergreen winners deliver offerings that consistently meet customers' expectations, and they're very clear about the standards they have to meet. But they don't necessarily strive for perfection – unless perfection is explicit in their strategic value proposition, as it is at Federal Express and Tiffany. In fact, fully one-third of our winning companies offered only average product quality. Which goes to show that many customers don't care about a level of quality that goes beyond their needs and desires;

The Evergreen Project
Our Research

The Evergreen Project began in 1996 and lasted five years. It grew from our shared obsession with two questions: Why do some companies consistently outperform their competitors? And which of the hundreds of well-known business tools and techniques can help a company be great? We decided to carry out a search for evergreen business success. The project involved more than 50 leading academics and consultants using well-accepted research tools and procedures to identify, collate, and analyze the experiences of 160 companies over a ten-year period.

We selected hundreds of businesses that varied in terms of their total return to shareholders (TRS). Responding to concerns from some managers who view TRS as irrational and prefer to be measured by their operating results, we conducted a rigorous analysis of the financial statements of all the companies in our study. We found that the winning companies as measured by TRS were also winners when compared against almost every other meaningful measure. Since an individual company's TRS may reflect not so much its own performance as the state of its industry, our research compared a company's TRS with that of its peers within the same industry.

From the initial list of companies, we selected 160 for detailed study. The vast majority had market capitalizations between $100 million and $6 billion. We left out failing organizations as well as big conglomerates with dithey won't necessarily reward you for exceeding their expectations. They will, however, punish you severely if you don't meet their expectations. You tumble quickly when you fail on execution.

Culture

Develop and maintain a performance-oriented culture.

In some quarters of the business world, culture is still considered soft – it's not taken as seriously as, say, operations. In others, culture is considered important, but the emphasis is on making the work environment fun based on the theory that when employees enjoy themselves they're more likely to remain loyal to the company.

Our study made it clear that building the right culture is imperative, but promoting a fun environment isn't nearly as important as promoting one that champions high-level performance and ethical behavior. In winning companies, everyone works at the highest level. These organizations design and support a culture that encourages outstanding individual and team contributions, one that holds employees – not just managers – responsible for success. Winners don't limit themselves to besting their immediate competitors. Once a company has overmatched its rivals in, say, the effectiveness of its logistics, it looks outside the industry. Employees may ask, for instance, "Why can't we do it better than FedEx?" If the goal is unreachable, it still represents an opportunity for high-performing employees and managers: "If we can't be the best at logistics, why not outsource it to a partner that can?"

verse businesses that could not be meaningfully compared with one another. We divided the 160 into 40 groups, each comprising four companies in one narrowly defined industry. To keep the playing field level, we made sure that as of 1986, the start of our ten-year study period, the four companies in each industry group were reasonably equivalent – similar to one another in scale, scope, financial numbers, TRS, and apparent future prospects.

Although they began the study period as peer businesses in their own industries, the companies soon parted ways. We classified the four in each industry to represent four archetypes: winners, climbers, tumblers, and losers. Winners outperformed their peers in TRS during both the first and second five-year periods. Climbers lagged behind their peers in the first period but moved up in the second. Tumblers outdid their peers during the first period and faltered in the second. Losers scored lower than their peers through both five-year periods.

By simultaneously studying companies whose performance changed, for better or for worse, we were able to separate cause and effect. We could identify which management practices actually worked. In other words, we could conclude that improving on specific practices guarantees a company's superior performance – and that fumbling at those practices is bound to worsen performance. Our study used three distinct methodologies to determine which management practices truly influence a company's performance:

1. We began with a survey methodology. We identified more than 200 management practices that were thought to influence business success – broad areas such as strategy, innovation, and business processes; and specific practices including 360-degree feedback, supply chain management, and the use of intranets. All publicly available information on the 160 companies was collected and read by coders trained to score each organization on all 200-plus practices on a scale of 1 (poor relative to peers) to 5 (excellent relative to peers). We verified the reliability of the survey by obtaining additional information from dozens of people familiar with the companies – knowledgeable outsiders, senior executives, and former executives who had been present during the study period.

2. We pursued in-depth studies of several of the management practices that we had concluded played a major role in enhancing or weakening a company's performance. This second set of studies, many of which were done at our request by academic experts, allowed us to verify and extend the larger survey findings. In each case, though, the experts had to test their ideas on the same 160 companies included in our study.

3. We collected and analyzed hundreds of documents concerning these companies – newspaper and magazine articles, business-school case studies, government filings, analysts' reports. Each company accumulated a stack of paper three inches high, adding up to 60,000 documents filling 50 storage boxes. Supervised by William Joyce, 15 graduate students at Brigham Young University's business school coded the documents. This third data collection included market-shaping information, such as the opinions of analysts and journalists. (This sort of buzz or conversation has a huge impact on investors' perceptions and thus on every public company's stock price.) The data from the coding process further verified the results of the first two sets of analyses.

It should be obvious that the best way to hold people to such high standards is to directly reward achievement. But while nearly 90% of the winning companies in our study tightly linked pay to performance, only 15% of the losers did the same. The winners were scrupulous in setting specific goals, raising the bar every year, and enforcing those benchmarks. No bonuses, stock options, or other rewards were given when targets were missed. And the pay-for-performance commitment extended to the very top of the organization. During the period of our study, officers at steelmaker Nucor – a company that we classified as a winner – were rewarded largely through performance-based bonuses. Their base salaries were lower than those in the industry as a whole. They had no employment contracts, retirement programs, or annuities. And the amount of their bonuses depended on that year's return on stockholders' equity.

To complement any financial rewards, winning companies develop programs that recognize people's achievements and offer them opportunities to use their talents. Home Depot, for example, has gone to great lengths to give associates (a term universally applied to everyone

Making 4 + 2 Work for You

Besides identifying the management practices that can significantly affect a company's performance, we've developed a list of behaviors that support excellence in each practice. The practices and accompanying mandates are outlined below.

Primary management practices

Strategy

Whatever your strategy, whether it is low prices or innovative products, it will work if it is sharply defined, clearly communicated, and well understood by employees, customers, partners, and investors.

- Build a strategy around a clear value proposition for the customer.
- Develop strategy from the outside in, based on what your customers, partners, and investors have to say – and how they behave – not on gut feel or instinct.
- Continually fine-tune your strategy based on changes in the marketplace – for example, a new technology, a social trend, a government regulation, or a competitor's breakaway product.
- Clearly communicate your strategy within the organization and to customers and other external stakeholders.
- Keep focused. Grow your core business, and beware the unfamiliar.

Execution

Develop and maintain flawless operational execution. You might not always delight your customers, but make sure never to disappoint them.

- Deliver products and services that consistently meet customers' expectations.
- Put decision-making authority close to the front lines so employees can react quickly to changing market conditions.
- Constantly strive to eliminate all forms of excess and waste; improve productivity at a rate that is roughly twice the industry average.

Culture

Corporate culture advocates sometimes argue that if you can make the work fun, all else will follow. Our results suggest that holding high expectations about performance matters a lot more.

- Inspire all managers and employees to do their best.
- Empower employees and managers to make independent decisions and to find ways to improve operations – including their own.
- Reward achievement with pay based on performance, but keep raising the performance bar.
- Pay psychological rewards in addition to financial ones.
- Create a challenging, satisfying work environment.
- Establish and abide by clear company values.

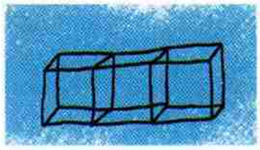
Structure

Managers spend hours agonizing over how to structure their organizations (by product, geography, customer, and so on). Winners show that what really counts is whether structure reduces bureaucracy and simplifies work.

- Simplify. Make your organization easy to work in and work with.
- Promote cooperation and the exchange of information across the whole company.
- Put your best people closest to the action.
- Establish systems for the seamless sharing of knowledge.

from the janitor to executives on the top team) a sense of ownership over the stores. Rather than insist that each outlet stock identical merchandise and conform to a prescribed layout, Home Depot gives those responsibilities to store managers. The practice is somewhat inefficient financially, but it makes the associates' work more interesting, exciting, and rewarding. Kmart's Antonini, in sharp contrast, believed strongly in command-and-control leadership: He put all of the merchandising and design decisions for all 2,200 Kmart stores into the hands of headquarters staff, keeping store employees completely out of the loop.

Evergreen winners establish and abide by clear company values, giving employees a reason to embrace the organization. These are not vague niceties; winning companies write down their values in clear, forceful language and demonstrate them with concrete actions. Home Depot has identified seven core values, including providing excellent customer service, creating shareholder value, doing the right thing, and giving back to the community. The company has given millions of dollars in grants to hundreds of organizations in four areas: affordable housing, at-risk youth, the environment, and disaster preparedness and relief. Team Depot, which is made up of thousands of associates, reinforces the commitment by pulling together volunteers to, for instance, rehabilitate housing for homeless and low-income families, build safe playgrounds, and run clinics to educate consumers in dealing with emergencies.



Structure

Build and maintain a fast, flexible, flat organization.

There's nothing wrong with bureaucracy per se. Procedures and protocols are necessary for any organization to function well. But too much red tape can impede progress, dampen employees' enthusiasm, and leach their energy. Winning companies trim every possible vestige of unnecessary bureaucracy – extra layers of management, an abundance of rules and regulations, outdated formalities. They strive to make their structures and processes as simple as possible, not only for their employees but also for their vendors and customers.

That said, no particular organizational structure separated the winners in our study from the others. It made little difference whether the companies were organized by function, geography, or product. And it didn't much matter whether or not they gave their business units P&L responsibility or their new businesses permission to adopt structures and processes distinct from the corporate

Secondary management practices

Talent

Winners hold on to talented employees and develop more.

- Fill mid- and high-level jobs with outstanding internal talent whenever possible.
- Create and maintain top-of-the-line training and development programs.
- Design jobs that will intrigue and challenge your best performers.
- Keep senior management actively involved in the selection and development of people.

Leadership

Choosing great chief executives can raise performance significantly.

- Closely link the leadership team's pay to its performance.
- Encourage management to strengthen its connections with people at all levels of the company.
- Inspire management to hone its capacity to spot opportunities and problems early.
- Appoint a board of directors whose members have a substantial stake in the company's success.

Innovation

An agile company turns out innovative products and services and anticipates disruptive events in an industry rather than reacting when it may already be too late.

- Relentlessly pursue disruptive technologies to develop innovative new products and services.
- Don't hesitate to cannibalize existing products.
- Apply new technologies to enhance all operating processes, not just those dedicated to designing new products and services.

Mergers and Partnerships

Internally generated growth is essential, but companies that can master mergers and acquisitions can also be winners.

- Enter new businesses that leverage existing customer relationships and complement core strengths.
- When partnering, move into new businesses that make the best use of both partners' talents.
- Develop a system for identifying, screening, and closing deals.

norm. What did matter was whether the organizational structure simplified the work.

Dollar General, in its mission to transform a small family-run enterprise into a modern corporation with professional management, never developed superfluous layers of bureaucracy–what Cal Turner used to call "staff infection." Its lean structure enabled it to shift gears quickly–a point of pride in an otherwise conservative corporate culture.

Nucor confined its management structure to four layers – foreman, department head, plant manager, and CEO – as compared to nine or more layers of management at other major steel companies. That streamlined structure was possible only because then-CEO Ken Iverson and his aides had pushed significant power and responsibility down the line to the plant managers and on to the foremen and frontline workers. As a result, managers at Nucor don't run meetings, write letters, and push paper. They answer questions from frontline teams and provide them with support and resources when they are asked–and only when asked, since the teams are assumed to be able to resolve most problems on their own. Managers at the steelmaker lead by staying out of the way.

Of course, frontline employees and managers can make good decisions only if they have access to relevant, up-to-date information. But sharing doesn't come easily, particularly in large businesses where divisions and departments compete for limited resources. Technical discoveries and best practices are held close to the vest. Just talking about how valuable knowledge sharing is won't be enough to overcome people's instinct to hoard. The winning companies in our study spent considerable time, money, and energy on programs and technologies designed to force open the boundaries and get divisions and departments cooperating and exchanging information – and it paid off. When he was CEO, Nucor's Iverson regularly toured the divisions, acting as a human sponge, absorbing news about the value being generated at different units and then disseminating it corporatewide. Nucor's department heads and plant managers are expected to be out in the shop on a regular basis, not just listening to problems but also keeping an eye out for ideas, technical developments, or new practices that might have wider application throughout the company.

Winning companies are convinced that their future rests not on the brilliance of their executives but on the dedication and inventiveness of their middle managers and employees. Decision making isn't bogged down by a lengthy chain of command, so employees are free to create and innovate. But such a structure isn't easy to maintain; bureaucracy has a way of creeping back into any organization. Texas-based insurer USAA calls the discipline of simplifying structure and processes "painting the bridge." That is, once you've finished painting a bridge, prudent maintenance requires that you go back to the other side and start over. So it is with bureaucracy: Once a company has assessed all its core processes and scraped off the bureaucratic barnacles, it's time to begin again.

Embrace Two of Four Secondary Practices

Many people would argue that among the secondary practices of evergreen business success–talent, innovation, leadership, and mergers and partnerships – excellence in at least talent and leadership is every bit as mandatory as excellence in each of the four primary practices. But that's not the case. The winning companies in our study complemented their strengths in the four primary practices with superior performance in any two of the secondary practices. It didn't matter which two areas they chose; we didn't detect any patterns in the combinations. Perhaps even more surprising, it doesn't seem to make any difference if a company excels in all four secondary practices rather than just two. There is, apparently, no reward for going beyond the 4+2 formula.

Talent

Hold on to talented employees and find more.

The best sign we could find that a company had great talent was the ease with which any executives who were lost to competitors could be replaced from within. The winners in our study hired chief executives from the outside half as often as the losers did. They seemed to understand that it's much cheaper to develop a star than it is to go out and buy one. It's also more reliable; you're getting a known quantity. What's more, worker continuity and company loyalty have taken on far greater importance post–Internet boom. So the winners that chose talent as one of their secondary practices demonstrated a distinct preference for developing and promoting their own stars and an ability to retain their top performers.

A commitment to promote from within is meaningless unless the company offers training and development that can prepare employees for new jobs in the company and creates conditions that encourage employees to enroll rather than penalize them for taking time away from their jobs. Not long ago, the assumption was that upwardly striving employees were solely responsible for preparing themselves for higher-level positions. No more. At pharmaceutical company Schering-Plough, for instance, between 75% and 80% of vacancies are filled from within, and more than 2,000 employees per year take production courses. Georgia-based Flowers Foods, one of the largest bakery foods companies in the United States, offers not only the usual training and education but also two programs that reinforce its commitment to employees' development. The first program prepares employees to become baking technicians. By providing workers with detailed knowledge about operations and equipment in its high-tech plants, the company prepares them to move off the production line and into technical roles. In the second program, Flowers sells its delivery routes to workers who have the requisite training and expertise to take them on. The goal is to give employees an opportunity to own their own businesses.

A talented employee can be just as valuable and hard to replace as a loyal customer. Yet many companies that go to great lengths to retain a customer won't lift a finger to hold on to a skilled, seasoned manager. About half the winners in our study excelled in the talent practice, and these companies dedicated major resources – including personal attention from top executives – to building and retaining an effective workforce and management team. It is a fallacy that companies must choose between promoting from within and hiring outside talent. Winning companies do both; a talent-rich environment tends to attract able people from outside a company.

Innovation

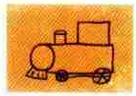
Make industry-transforming innovations.

What passes for technical achievement in most companies – marginal improvements to existing products, for example – would never satisfy organizations that excel at innovation. They're focused on finding altogether new product ideas or technological breakthroughs that have the potential to transform their industries. At these companies, innovation isn't just about turning out new products and services; they also apply new technologies to their internal workings, which can yield huge savings and can transform an industry. Innovation also includes the ability to foresee and prepare for disruptive events.

But the interesting thing about this practice is that despite voluminous research into which structures most effectively encourage innovation, we found no correlation between the sources the winners in our study used and the general sources of innovative business ideas. Neither internal R&D labs nor external labs, neither frontline employees nor management, neither customers nor suppliers were necessarily where winning companies found their key innovations. Any one of the winners might have relied successfully on one or more of those sources, but none proved essential to the winners as a group. What the group had in common was the ambition to lead the way with major, industry-changing innovations and a willingness to cannibalize offerings, resisting the temptation to wring every last cent out of an existing product before introducing another to take its place.

Schering-Plough, for instance, is a confirmed cannibal. It actively turns its prescription-only medications into lower-priced, over-the-counter ones, automatically displacing the originals. But sales of OTC drugs typically double or triple quickly. At Home Depot, as well, cannibalization is routine. When a store becomes so popular that employees can no longer maintain a customer-friendly atmosphere, the company opens another outlet nearby.

Given the copious literature on corporate innovation, it might be expected that most of our winning companies would have excelled at innovation. In fact, a bare majority did so–which underscores how difficult this practice is. Innovation is not to be entered into lightly.



Leadership

Find leaders who are committed to the business and its people.

It's no longer fashionable to accord celebrity status to the chief executive, but there are few events of greater significance to an organization than its selection of a CEO. In a study conducted by one of us, it was shown that CEOs influence 15% of the total variance in a company's profitability or total return to shareholders. To put that into perspective, the same study found that the industry in which a company operates also accounts for a 15% variance in profitability. So the choice of a new chief executive is just as important as the choice of whether to stay in the same industry or enter a new one.

As vital as a company's senior leadership team can be, we found that some common beliefs about leadership actually had little to do with a company's becoming and remaining a winner. For example, it didn't matter whether the leader made his or her decisions independently or in collaboration with the top management team. It made little difference whether senior managers relied on quantitative or qualitative assessments to make key decisions. Nor was there any correlation between the personal characteristics of the CEO–whether he or she was viewed as a visionary or detail-oriented, secure or insecure, patient or impatient, charismatic or quiet–and a company's success.

Certain CEO skills and qualities do matter, however. One is the ability to build relationships with people at all levels of the organization and to inspire the rest of the management team to do the same. CEOs who present themselves as fellow employees rather than masters can foster positive attitudes that translate into improved corporate performance. When David Johnson was chief executive at Campbell Soup, a winner in our study, he constantly sought ways to reach out to employees. He organized rallies where he sometimes donned a red-and-white apron and chef's hat. He led managers on wilderness trips to build esprit de corps. Meanwhile, Kmart's string of CEOs failed to break from the company's top-down, strictly hierarchical culture. Even the best-intentioned among them made little effort to reach out to the front line.

Another important quality is the leader's ability to spot opportunities and problems early. Some leaders rely on intuition. Others create special groups within the organization assigned to stay abreast of changes in everything from politics to demographics. Still others engage outside consultants or academics to watch for changes in the marketplace. Though their methods vary, effective leaders help their companies remain winners by seizing opportunities before their competitors do and tackling problems before they become troublesome nightmares. Cisco's John Chambers is a good example. He was quick to realize when the Internet bubble burst that Cisco would have to write off inventory and otherwise restructure itself. His willingness to react swiftly allowed Cisco to bounce back much faster than its rivals did.

No discussion of leadership would be complete without mentioning the board of directors, not least because good boards tend to choose good CEOs. And what defines a good board? Our results suggest that most of the current recommendations being championed by governance-reform advocates don't matter. Only two characteristics really matter: The board members should truly understand the business, and they should be passionately committed to its success, which is best accomplished by giving members a substantial stake in the company's financial performance.

Mergers and Partnerships

Seek growth through mergers and partnerships.

Innovation is one way to drive growth. Pursuit of mergers and partnerships is another. While many of our companies engaged in some merger activity, only a small number (22%) were able to make this a winning practice. Our research indicates that companies that do relatively small deals (less than 20% of the acquirer's existing size) on a consistent basis (about two or three every year) are likely to be more successful than organizations that do large, occasional deals. The winners in our study appeared to make better choices: In the deals we analyzed, they created value in most of the deals they struck, generating returns in three years that exceeded the premium paid. By contrast, the losers destroyed shareholder value in most of the deals they did.

Winners and climbers shared no single motivation in their determination to buy or join with other organizations. Some were seeking cross-selling opportunities, others wanted economies of scale, while still others were simply chasing market share. What they didn't do was enter deals in order to diversify into areas far removed from their core business – generally a losing proposition.

A merger or acquisition makes sense only when the move leverages the buyer's or seller's existing customer relationships or complements both companies' existing strengths. In 1994, Cardinal Health, an Ohio drug wholesaler, took over Whitmire Distribution, based in California. It was Cardinal's 11th acquisition in a decade, and it effectively doubled the company's sales. Cardinal had become an industry leader in quality service, and Whitmire had a high-quality customer base. The deal allowed Cardinal to bring its services to a new set of customers, lifting the company into the upper ranks of its industry.

As an alternative to an outright acquisition, some companies enter into partnerships, which can yield growth by allowing two companies to move into new businesses using the talents of both, uniquely combined. (Think of Dow Chemical's partnerships with Asahi Glass and Owens-Illinois.) Partnerships provide some of the same advantages that mergers do and lack many of the disadvantages. Partners aren't expected to accommodate all of each other's idiosyncrasies, for example. They remain separate entities, united in the expectation that their individual talents can be combined in a new business venture that will benefit both beyond what either might have gained alone.

The winners and climbers in our study didn't treat acquisitions and partnerships casually or as one-off deals. They invested substantial financial and human resources in developing an efficient, ongoing process for deal making – for instance, establishing dedicated teams comprised of individuals with the requisite investigative, financial, business, and negotiation skills. Winning companies often have codified principles – lessons drawn from experience – that enable them to more consistently choose the right partners and integrate them quickly.

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Our research makes it clear why so few companies maintain a steady lead. Business success requires unyielding vigilance in six management practices at once and constant renewal to stay on top. Falling down is easy; climbing back up is not.

Nike, for example, was a high flier at the beginning of our research period but lost sight of the business basics and became a tumbler. In its strategy practice, for instance, Nike failed to notice and respond appropriately when the tastes of its target customers – urban teenagers – shifted from sneakers to casual wear. In an attempt to regain market share, the company pushed into brand extensions, losing focus completely. And in its utter dedication to unlimited expansion, Nike lost sight of the primary practice of execution, neglecting to ride herd on workplace efficiency and cost controls.

But cautionary tales aside, we believe our study offers hope. In the hurly-burly of business competition, managers yearn for clarity, certainty, and solid directions for success. The 4+2 formula is intended to provide just that; it tells managers which management practices they need to focus on and which they can ignore. The formula is a true-north compass that works in any business climate.

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