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Harvard Business Review

JULY–AUGUST 2015

IT'S TIME TO BLOW UP HR

AND BUILD SOMETHING NEW.

HERE'S HOW

PAGE 53


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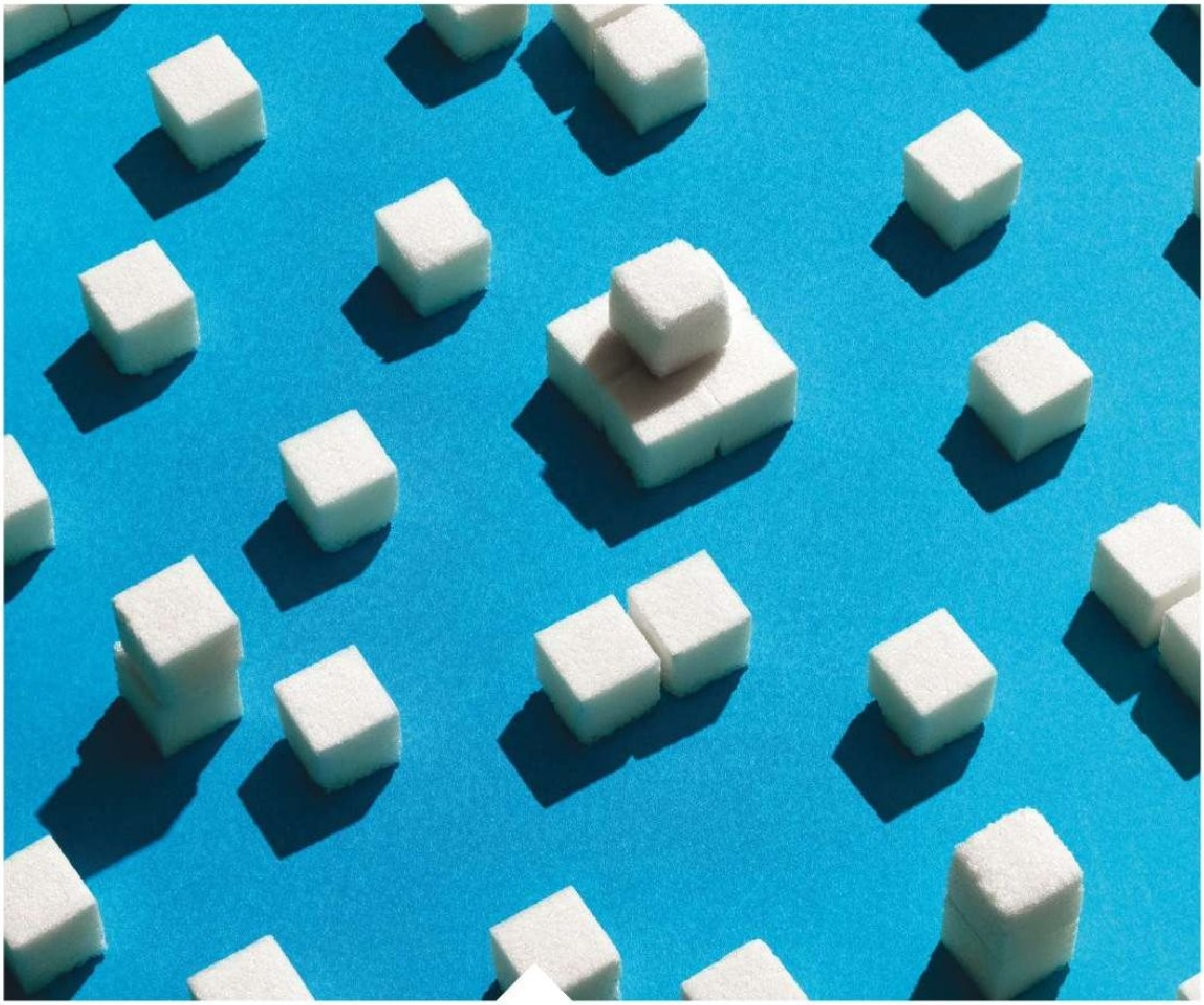
SPOTLIGHT ON RETHINKING HUMAN RESOURCES

ABOVE
Do Ho Suh
Karma, 2003
Urethane paint on glass fiber reinforced resin
389.9 x 299.7 x 729.1 cm
Installation view at Artsonje Center, Seoul, Korea

Features July–August 2015



THE VOORHEES


THE HEAD SAYS
YES.
THE HEART SAYS
DEFINITELY, YES.

Departments July–August 2015

IN EVERY ISSUE

IDEA WATCH

EXPERIENCE

MAARTEN KOOLS

Mondelēz International is reinvesting savings to grow. And guess how much we're helping them save?
$1,000,000,000
OREO
Snack food powerhouse Mondelēz International® faced roadblocks to growth, from shifting tastes to a slowdown in consumer spending. To master these challenges, we helped them design and implement a strategic operating model and cost control strategy. Today, Mondelēz International is on track to save $1 billion in just 3 years. Now they can focus on what matters most – creating delicious moments of joy. That's high performance, delivered.
High performance. Delivered.
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From the Editor
Rethinking HR

It might seem that we have it in for human resources. An article in our April issue urged companies to scrap a cherished HR practice: the forced ranking of employees. And this month our Spotlight advocates rethinking HR from top to bottom. It's not that we don't like HR; it's just that we believe it can be improved.

In the lead article, "Why We Love to Hate HR...and What HR Can Do About It" (page 54), Wharton's Peter Cappelli argues that HR should scrap many long-standing "best practices" and set a forward-looking agenda instead.

Juniper Networks, in Silicon Valley, is already doing so. In "Bright, Shiny Objects and the Future of HR" (page 72), John Boudreau, a professor at USC Marshall School of Business, and Steven Rice, a former executive vice president of HR at Juniper, describe how the company created an innovative HR operation that delivers exciting, consistently business-aligned results.

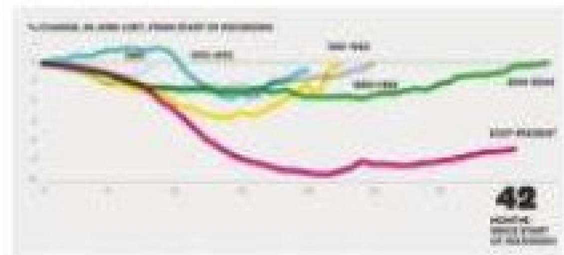
The remaining piece in the package, "People Before Strategy: A New Role for the CHRO" (page 62), is a collaboration by the influential business adviser Ram Charan; McKinsey & Company's global managing director, Dominic Barton; and Korn Ferry's vice chairman, Dennis Carey. They contend that companies need to take HR more seriously and should make the chief human resources officer a true strategic partner of the CEO.

Meanwhile, the transformation of our website continues. I encourage you to take advantage of our newest offering—the **HBR Visual Library,** an online repository of graphs, slide decks, and even cartoons. Subscribers can view the images, save them to their own online libraries, download them to share with colleagues, and adapt slide decks for customized presentations.

And if you're a registered user and you visit HBR.org during July or August, you'll have unlimited free access to the Visual Library and our archive of articles.

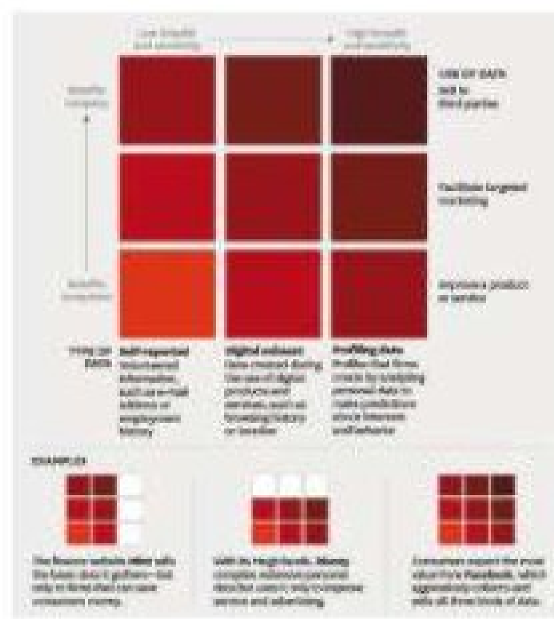
Check it out. And let us know what you think.

Adi Ignatius, Editor in Chief



JOB LOSSES OVER SIX RECESSIONS

ACTUAL, ESTIMATED, AND IDEAL PAY RATIOS OF CEOS TO UNSKILLED WORKERS



SWAPPING VALUE FOR DATA

JOHN VON PAMER


Morgan Stanley
Capital Creates More Commerce
New technology can make even small businesses big. E-commerce leader Alibaba Group built an online and mobile marketplace connecting small businesses to customers in China and beyond. Morgan Stanley helped take the company public, leading a $25 billion IPO — the largest in history. Alibaba's subsequent growth is helping fulfill the company's ambition of giving rural communities access to goods and services once considered out of reach. Across the globe, we're working to advance the technologies that help more people to prosper. Capital creates change.
morganstanley.com/alibaba
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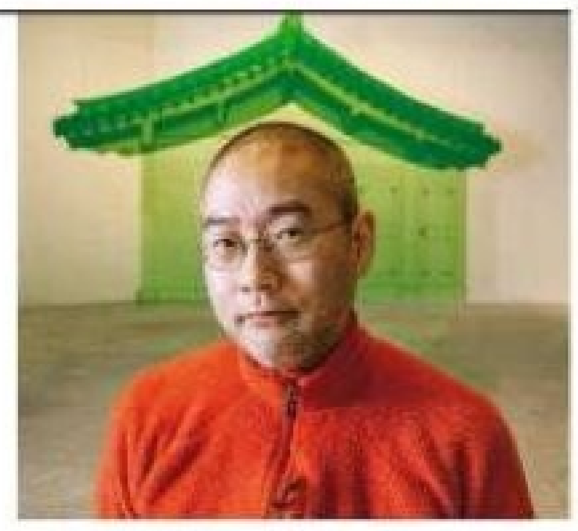
Contributors

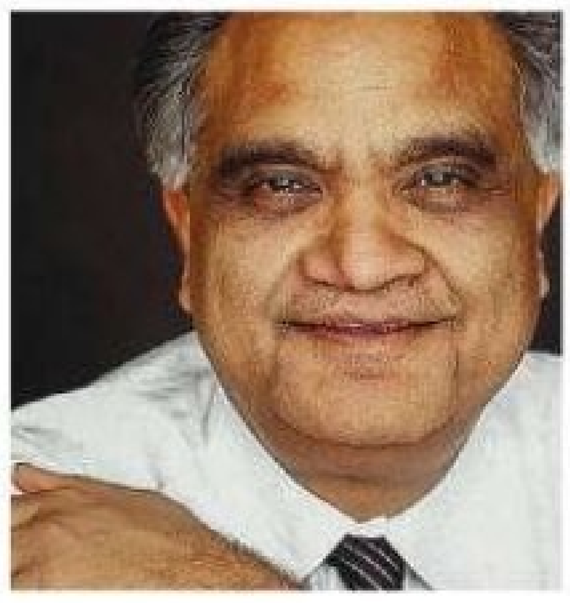
Early in her career at Intel, **Patricia McDonald** read about a child who died because of an incorrect prescription, and wondered how that could happen with the technology and management know-how at our disposal. Years later, while drawing on the Toyota Production System to reduce defects and waste at the chip plant she headed, she discovered that Virginia Mason Medical Center had used TPS to improve health care delivery in Seattle. Inspired, she—and Intel, where she's now vice president of HR—launched an initiative in Portland, Oregon, that could accelerate the transformation of health care in the United States and beyond. It's described on page 38.

Tomas Chamorro-Premuzic, the author of "Ace the Assessment" (page 118), grew up in the "Villa Freud" area of Buenos Aires, said to have more psychoanalysts per capita than any other neighborhood in the world. That sparked his interest in personality profiling. He has found that personality is key to understanding and predicting job performance, leadership talent, and organizational effectiveness.

Vijay Govindarajan studied strategy and innovation for many years, but it wasn't until the mid-2000s, when he worked with Jeff Immelt on GE's innovation agenda, that he took an interest in reverse innovation—the subject he and his coauthor explore on page 80. He realized that developed countries' approaches to problems such as infant mortality would not work in poor countries. The answers would come from innovators in those countries, whose ideas could succeed despite—or perhaps because of—the many constraints.



Do Ho Suh, the artist featured in this month's Spotlight package (page 53), is a Korean-born sculptor who works in London, New York, and Seoul. His pieces explore themes including the ways viewers occupy public space, the role of the individual in society, and power and the collective.



As an adviser to corporate executives, **Ram Charan** has long argued that any successful enterprise puts people before numbers or even strategy. A leader's most important job, he says, is to select and develop the right employees to move the organization forward. On page 62 he and his coauthors offer a plan for giving HR chiefs the influence and authority to do so.

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Interaction

Restructuring Work for Better Decision Making

HBR article by **John Beshears** and **Francesca Gino,** May

Everyone makes preventable mistakes—partly because it's extraordinarily difficult to rewire the brain to undo the patterns that lead to them. Besheárs and Gino propose a solution: Alter the environment in ways that encourage people to make wiser choices. They argue that leaders can do this by following a five-step process for restructuring an organization's work.

Could adding technology to the mix help improve decision making? Suppose we add big data and an analytical layer to a company's enterprise resource planning or financial systems. Designed to flag outliers—positive or negative performances outside acceptable norms—a technologically augmented system could generate alerts or highlight points middle management should focus on daily. Senior managers could do trend analysis of those data points and review the results of middle management's operational decisions. By implementing the correct analytical layer and constantly refining it, you could perpetually create "opportunities for reflection."

James Gingerich, academic account manager, Maplesoft

As I read it, there are two distinct issues here: changing the way people make decisions, and changing the way they implement decisions. In both cases we're asking people to alter their behavior, but in different ways. Making decisions is an intellectual exercise, and we can teach people sound principles and practices for avoiding System 1 errors in thinking. This is not necessarily a big ask; the effort required to gather information to make wise decisions is not exponentially greater than the effort required to gather data confirming our biases. But implementing decisions is an operational exercise; people will have to put extra effort into changing the way they work. That can be a big ask if it requires them to accept perceived risk. Now we need to consider behavioral economics: How much do the incentives for implementing the choice outweigh the incentives for not implementing the choice?

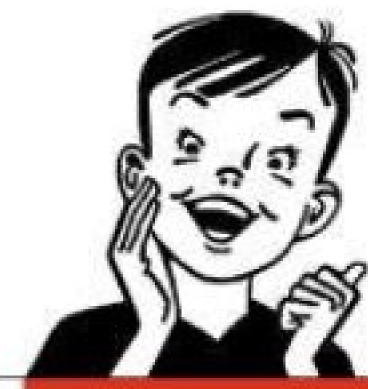
John Ager, consultant, Kepner-Tregoe

Who decides what a "good" decision is? The examples presented all reflect preferred decisions that most people would classify as good, but such decisions aren't always wise ones. For instance, Enron would have had its decision architect create a process in which the preferred choice for employee 401(k)s was to invest in Enron stock. That would not have been a good decision. That said, the alternative to a decision architect is defaulting to some random process based on "whatever." I don't think that is acceptable either, but at least it doesn't generate intentionally selfish decisions.

Guy Higgins, principal, Performance²

Instead of concentrating the architect role among a few key "deciders," why not leverage business intelligence systems and put the data in front of people at all levels of the organization? Google calls this principle "defaulting to open communication."

Matthew J. O'Brien, leadership coach and engineering consultant, Boeing



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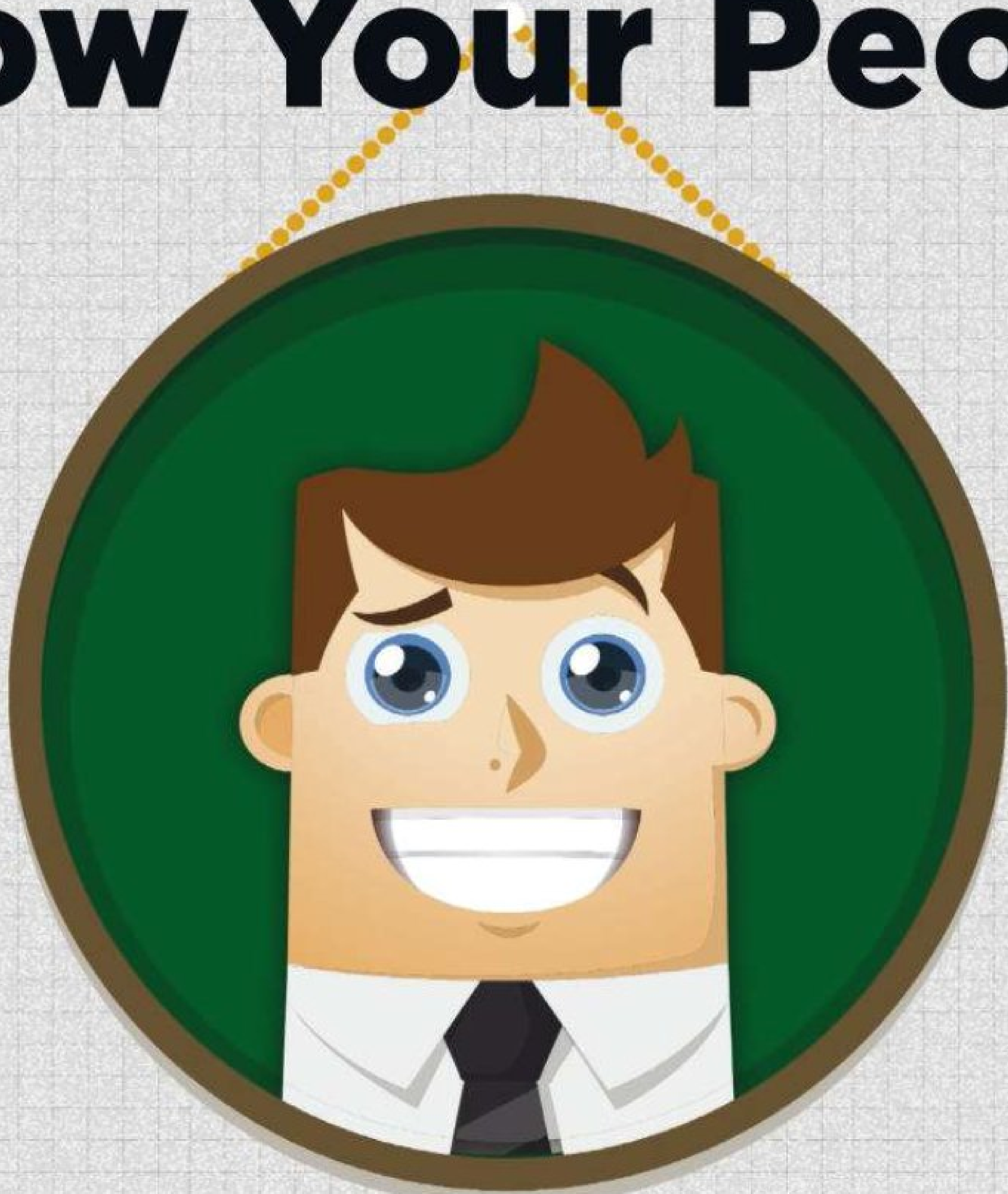

Interaction

Tesla's Not as Disruptive as You Might Think

HBR article, May

To determine whether Tesla is creating a new, top-down model of disruption, Clay Christensen asked his HBS colleague Tom Bartman to conduct an in-depth study. Its conclusion: Tesla isn't a disrupter. It's a sustaining innovation—a product that offers incrementally better performance at a higher price.

Christensen coined the term, so he has every right to deliver such a verdict. Still, my opinion is that Tesla is offering a totally different customer experience that car manufacturers cannot copy or compete with. In our own research we've found that people are not buying "vehicles" when they buy Teslas. They're buying into a futuristic experience—what we call "the spaceship program." Customers aren't comparing Teslas to anything at all.

Key elements of the Tesla experience include the buying process, the lack of refueling costs (if you pay in advance when you buy), the lack of mandatory service checkups, the air improvements, lower depreciation, and the driving experience. Tesla has totally redefined the customer experience, and it will be hard for anybody to follow it.

Akos Tolnai, CEO, AbilityMatrix

A snapshot of Tesla in 2015 misses the point. You could have come to the same conclusion about flat-screen televisions in 1997, when they cost $15,000. Now you can buy one for less than $500. The same thing will happen with electric cars.

Golf carts are a substitute for bicycles, not automobiles. People in China use golf carts because car registrations are very difficult to obtain. In the U.S., however, towns and cities are architected around the automobile. For an electric car to be a worthy substitute, it must have a range of at least 200 miles. At the moment, Tesla is the only manufacturer producing such a vehicle.

Todd R. Lockwood, writer/photographer

The article overlooks the rapid changes in battery technology—which increase the potential of electric vehicles. Having heavily invested in batteries, Tesla is poised to ride this wave. And the experience Tesla has gained in EVs' core electrical engineering and electronics technologies will help it stay ahead of the curve. When the demand for EVs picks up, the field will not be level for all the players. Tesla may not be a disruptive innovation, but it has a smart strategy.

Regi V. Mathew, professor of business analytics, Narsee Monjee Institute of Management Studies

Although I was impressed by Christensen's theory on disruptive technology and how to classify it, I was disappointed with the narrow view taken on its application. The assumption is that Tesla is an automobile company—but what if it's a battery company that has placed its technology in automobiles? What if it also applied its technology to our homes, as recently announced, giving us the potential in the near future to unplug ourselves from the national power grid using a battery charged with a solar cell?

Tesla may very well alter the way we generate and consume power. The disruption won't be to the automobile industry. The tectonic shift that is starting to take place will affect the major power generators and energy companies. The effects will trickle down through every sector of the energy industry and those involved with its distribution.

Cameron Tipping, president, IIBD; and president, Sabre Simulation

Bartman responds: *When evaluating disruptions, it's important to analyze industry-level and firm-level dynamics separately. The price of flat-screen TVs dropped because low-end disrupters forced many original high-cost manufacturers to exit the market. And while Tesla may be an energy company, rather than a car company, it doesn't produce batteries—it purchases industry-standard cells from Panasonic. Tesla's innovations lie in the assembly of the battery pack, but most of the potential future technology and cost improvements reside in the cells. Therefore one would expect gains from those improvements to accrue to the entire industry. Beyond its fantastic brand, it's not clear that Tesla has a sustainable competitive advantage over other energy storage companies or utilities.*

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HBR SURVEY

It's 11 PM. Are You Still Checking Your In-Box?

When we asked our readers about nighttime work e-mails...

78% SAID THEY CAUGHT UP ON E-MAIL DURING AFTER-WORK HOURS.

63% FELT THAT AFTER-HOURS E-MAILING AFFECTED THEIR CAREERS OR WAS NECESSARY FOR THEIR SUCCESS.

56% THOUGHT LATE-NIGHT E-MAILING MADE THEM LESS PRODUCTIVE THE FOLLOWING DAY.

59% SAID THEY DIDN'T MIND AFTER-HOURS E-MAILS.

SOURCE "SURVEY: HOW DOES LATE-NIGHT EMAILING AFFECT YOU?" BY NICOLE TORRES

Idea Watch

Compiled by HBR editors

MIEKE DALLE/GETTY IMAGES

DON'T BE SO CONFIDENT
page 26

STRATEGY
HOW TO LIVE WITH RISKS

You can't get rid of them all.

Following a crisis, regulators and managers naturally take steps to prevent a recurrence. In 2002, after Enron and WorldCom succumbed to massive accounting fraud, U.S. legislators passed the Sarbanes-Oxley Act, which gave directors and executives new oversight responsibilities. In the wake of the 2008 financial crisis many large banks changed their business models, and other companies implemented systems to better manage credit risks or eliminate overreliance on mathematical models.

But there's a problem with managing risk retrospectively: It's a variation on what military historians call "fighting the last war." As memories of the recession fade, leaders worry that risk management policies are impeding growth and profits without much gain. "Firms are questioning whether the models they put in place after the financial crisis are working—and more fundamentally questioning the role of risk management in their organizations," says Matt Shinkman of CEB, a Washington-based firm that researches and disseminates best practices among its 10,000 member companies.

New research from CEB highlights the concern. Fully 60% of the corporate strategy officers surveyed said that their company's decision-making process is too slow, in part because of an excessive focus on preventing risk. They added that if this "organizational drag" were reduced, the rate of revenue growth might double. Just 20% described their companies as "risk seeking." Executives also reported that risk managers and auditors spend more than half their time on financial-reporting, legal, and compliance risks, even though the vast majority of big losses in market value occur because of mismanaged strategic risks. Most companies—91%—plan to reorganize or reprioritize risk management in the next three years and have already begun increasing budgets to that end.

The researchers identify three best practices for assessing and managing risk:

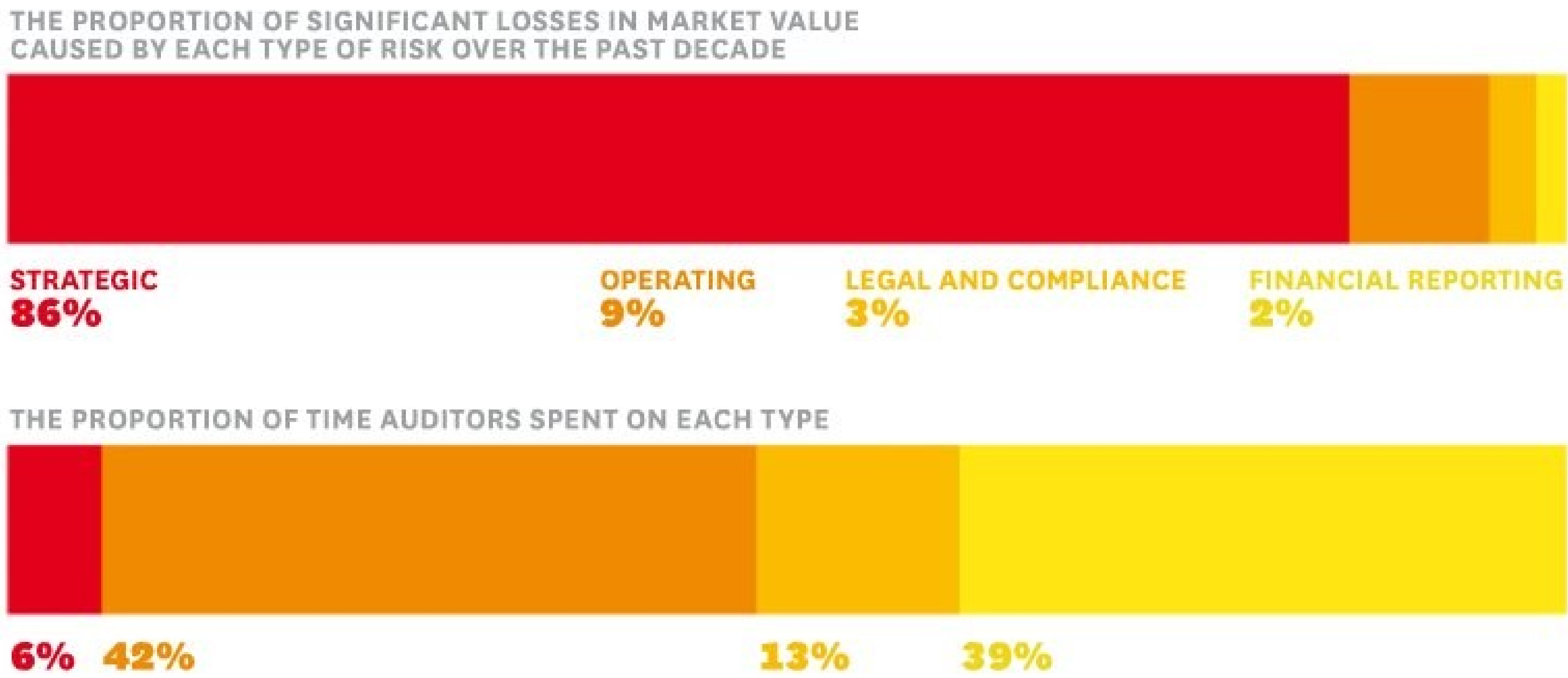
Strike the right balance between risk and reward. "Risk management" is often synonymous with "risk prevention." But as any portfolio manager knows, lower risk often means lower returns. Today's risk managers see their role as helping firms determine and clarify their appetite for risk and communicate it across the company to guide decision making. In some cases this means helping line managers reduce their risk aversion. For example, one large company decided to terminate the policy of a client it had insured for 35 years. The client wasn't very risky, so profits on its policy were negligible.

Focus on decisions, not process. Many employees associate risk management with compliance-driven busywork, such as annual IT security quizzes. Although cybersecurity is certainly important, such exercises might not reduce risk. In addition to relying on paperwork or process, risk managers are turning to tools (such as dashboards that show risks in real time) and training that help employees assess risk. They are also helping companies factor a better understanding of risk into their decision making. At Lego, for instance, the senior director of strategic risk management is included in all decisions involving capital above a certain amount. He helps colleagues spot potential problems and managers see how their projects fit into the company's overall portfolio of projects, each with its own set of risks. "This is less about listing risks from a backward-looking perspective and more about picking the right portfolio of risky projects," Shinkman says.

Make employees the first line of defense. Decisions don't make themselves—people make them, and there isn't always a chief risk officer present when they do. So smart companies work to improve employees' ability to incorporate appropriate levels of risk when making choices. This might begin during the hiring process: Some firms now use "risk screens" or other types of assessments to gauge candidates' appetite

Looking for Risk in All the Wrong Places

Risk management has historically focused more than half its time on legal, compliance, and financial-reporting functions. That's starting to change as companies realize that most big hits to shareholder value come from strategic and operating risks.



SOURCE CEB

1958

FROM THE ARCHIVE

"The Internal Revenue Service also considers the expense account a major problem....The increasing tendency to misstate, 'pad,' and even cheat in handling these expenses reduces tax revenues, thus placing an added burden on the honest taxpayer."

"WATCH YOUR EXPENSE ACCOUNTS," BY HENRY CASSORTE SMITH (HBR, JANUARY–FEBRUARY 1958)

for risk. By bringing in people with an aptitude for risk assessment, they reduce the need for training or remediation later. Companies are also trying to identify which types of jobs or departments face a disproportionate share of high-risk decisions so that they can aim their training at the right people. They're focusing that training less on risk awareness and more on simulations or scenarios that let employees practice decision making in risky situations. Finally, risk managers are becoming more involved in employee exit interviews, because people leaving an organization often identify risks that others aren't able or willing to discuss.

To direct risk managers to the right activities, many firms are changing their organizational structure. For instance, some now have risk managers report to the strategy officer or the chief operating officer instead of to the general counsel or the compliance officer. Other firms, which have historically spread responsibility for risk management across multiple departments—security, compliance, legal, audit, safety, quality, and so on—are establishing enterprise risk management functions to provide coordination.

FURTHER READING
For a look at how Shell uses scenario planning to manage risk, see "Living in the Futures," by Angela Wilkinson and Roland Kupers (HBR, May 2013).

The goal is to transform risk management from a peripheral function to one with a voice integrated into day-to-day management. "Leading companies view every decision they make as a risk decision [and] choose their risks with great calculation," according to the CEB white paper outlining this research. "They [use] risk management as a protection shield, not an action stopper." The paper notes that the English word "risk" shares roots with the Italian word *rischiare,* meaning "to dare." Keeping the latter sense in mind may help companies counter old-school tendencies to simply run in the opposite direction when encountering risk.

ABOUT THE RESEARCH "Reducing Risk Management's Organizational Drag," by CEB.

ANDRÉ METZGER

THE IDEA IN PRACTICE

"THE FUN PART IS FOCUSING ON VALUE CREATION"

IBM has been managing risk since its founding, in 1911, but in 2006 it created an enterprise risk management function to help its 380,000 employees become more "risk aware." HBR spoke with Luis Custodio, IBM's chief risk officer, about the endeavor. Edited excerpts follow.

What's the role of the enterprise risk management function? We have risk leaders throughout the company—it's not as if we brought a lot of people together in a new department. Our philosophy is that risk management should be centered in the businesses, which need to understand risk and make trade-offs in pursuit of strategic gains. Risk management is the responsibility of every IBMer. Our role is to support senior managers, risk leaders, and all employees with targeted resources, education, and training.

What's an example? We have about 30 online courses available to all employees. We've added gamification. We have a simulation in which you're a business leader developing a customer proposal and you have to consider different risks—how to account for them, how to mitigate and control them. People find it fun and engaging.

Risk management has historically been more about defense than offense. How is that changing? Some companies still focus on value protection, and that's critical—I don't want to downplay the importance of strong internal procedures, audit teams, and compliance officers. But at the enterprise level we spend more time on the strategic side, engaging with risk leaders and ensuring that they're thinking about things like technology shifts, industry disruptions, and the risks of mergers and acquisitions. The more fun part of our job is when we focus on value creation. We want risk management to be engrained in the fabric of the business, not a separate check-the-box process.

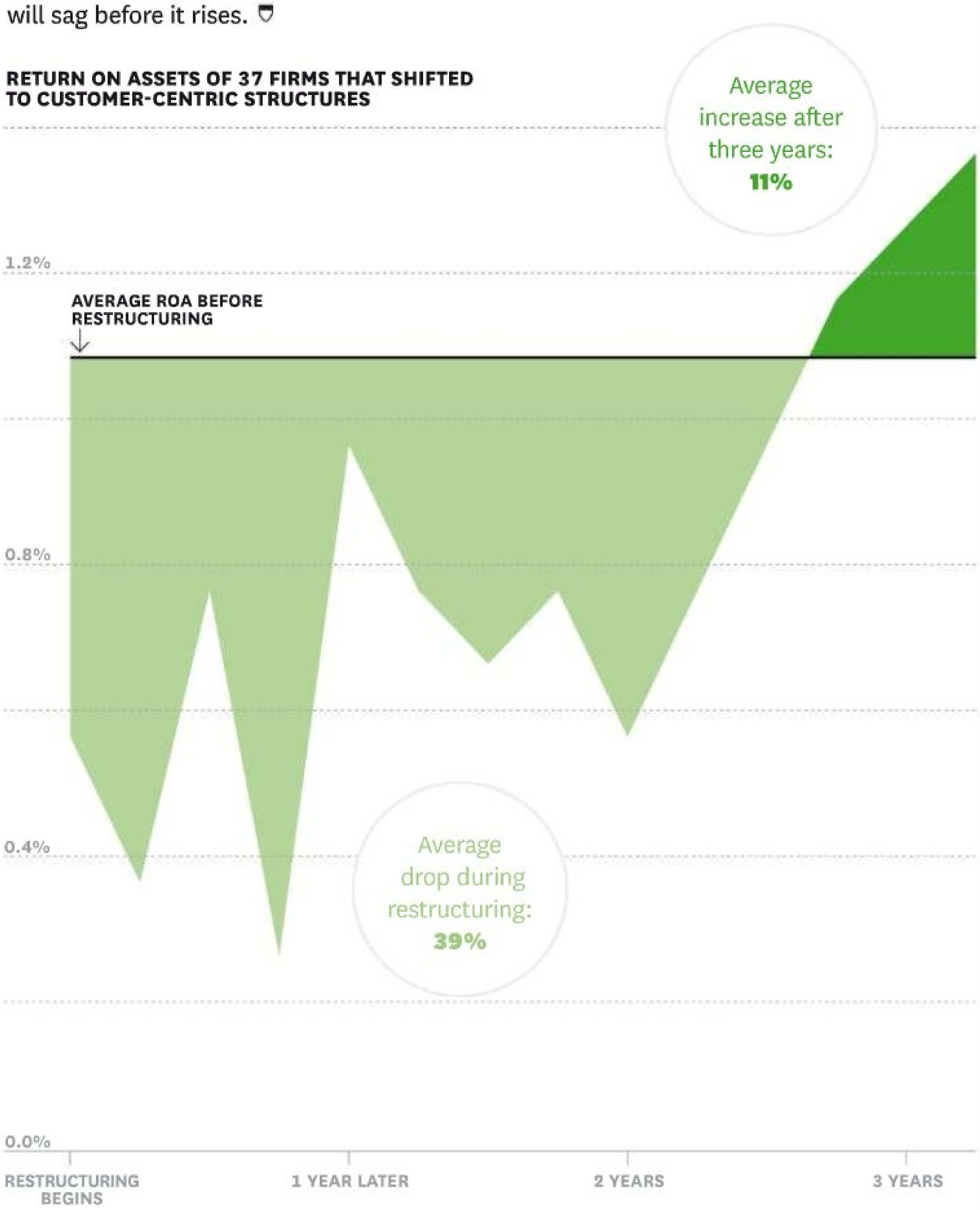
CUSTOMER CENTRICITY
FIRST, THE PAIN

Over the past decade many companies have refocused their structures on customer segments rather than products—about 30% of the *Fortune* 500 firms, including Intel, IBM, and American Express, have done so. But research led by Ju-Yeon Lee, of Lehigh University, shows that the benefits tend to kick in only after a couple of years of turmoil.

At 37 *Fortune* 500 firms that made the shift, ROA initially dropped by 39%, on average, recovering only after 10 quarters. Sometimes gains never materialized; this happened when competitors were meeting customers' needs or when customers were indifferent to greater customization and responsiveness. The good news is that improvement, if and when it came, was significant, averaging 11% over pre-restructuring levels.

CEOs should look carefully at the competitive landscape before embarking on a customer-centric restructuring and make sure everyone understands that performance will sag before it rises.

RETURN ON ASSETS OF 37 FIRMS THAT SHIFTED TO CUSTOMER-CENTRIC STRUCTURES



SOURCE TEXT AND GRAPHIC ARE BASED ON A STUDY BY JU-YEON LEE, SHRIHARI SRIDHAR, ROBERT W. PALMATIER, ET AL.

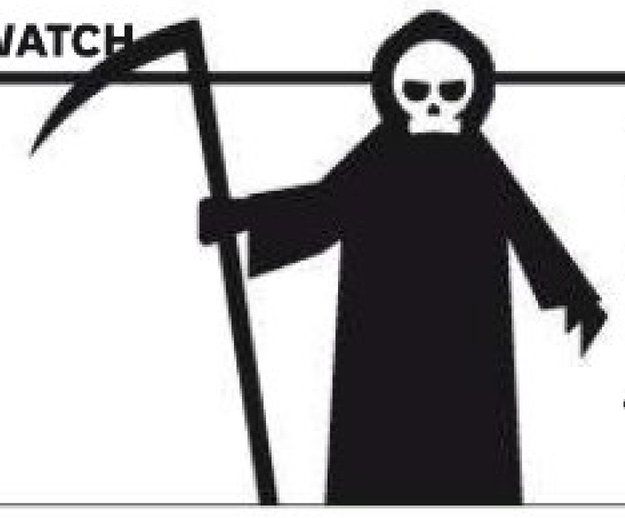
ENTREPRENEURSHIP
FOR FOUNDERS, PREPARATION TRUMPS PASSION

Many would-be entrepreneurs see their passion as the ticket to success. For example, on crowdfunding sites they vie to outdo one another in emphasizing their enthusiasm for their projects. And when it comes to fundraising, that approach can work: Passion tends to appeal to nonprofessional investors eager to fund the next great idea.

But it's a different story when it comes to long-term success. New research on hundreds of founders reveals that passion has nothing to do with results a few years out. What matters is preparedness—whether founders have fully fleshed out their ideas, gained a deep understanding of their markets, and created plans for overcoming obstacles and exploiting contingencies.

A team led by Utpal M. Dholakia, of Rice University, conducted a series of studies (as yet unpublished) of projects entered in the largest university-level student entrepreneurship competition in the United States (held at Rice), in fields ranging from biotech and life sciences to consumer products and retail. At the outset the entrants cited passion

MARIE ASSÉNAT



To assess how time away from work affects performance, researchers studied 188 heart surgeons and found that each day out of the operating room above the mean (1.99 days) **raised patients' one-day mortality rate by 7.4%.**

"THE NATURE OF SURGEON HUMAN CAPITAL DEPRECIATION," BY JASON HOCKENBERRY AND LORENS HELMCHEN

as a key factor when predicting their success, and looking back after three years, the small fraction whose ventures were doing well cited that factor again. But the researchers' analysis showed that in fact the entrepreneurs' passion played no role in their projects' fates. It was preparedness that enabled certain ventures to fly.

The research team also studied 522 projects posted on Indiegogo, the largest global fundraising site. Founders' videos and written statements were analyzed and coded for expressions of passion, such as "very enthusiastic," "devoted," and "dedicated" (along with, of course, "passion" itself), and for evidence of preparedness, such as reports of having found the resources needed to make the concept work. The findings showed that more-passionate entrepreneurs were about three times as likely as others to reach their funding goals, while evident preparedness had no effect.

A further study by the team showed that professional investors have a very different perspective: They typically discount founders' passion and pay the most attention to preparedness. But given that entrepreneurs are increasingly bypassing professional investors and appealing directly to the crowd, and that the crowd loves a passionate founder, what's an entrepreneur to do?

The researchers aren't suggesting that founders downplay their passion—after all, a project probably won't attract much funding unless it's put forward with enthusiasm. But passion often becomes a negative if it's given too much emphasis, either in the entrepreneurs' minds or in their communications with potential funders. Instead, founders should balance their expressions of enthusiasm with clear indications of preparedness—signs that they know how to find and hire the right people and take care of the other details that will be critical to success. Both entrepreneurs and their audiences should be aware that without preparedness, passion is worth little.

ABOUT THE RESEARCH Based on a series of studies by Utpal M. Dholakia, Michal Herzenstein, and Scott Sonenshein

COMPENSATION
STRONG BRANDS, WEAK PAY

It's a fundamental tenet of marketing: Consumers believe, on some level, that using a prestigious brand enhances their own image, so they're willing to pay more for one. Similarly, executives like to be linked with employers that have well-known brands—and it turns out that they're willing to "pay" for the association by accepting substantially lower compensation.

A team led by Nader T. Tavassoli, of London Business School, reached this conclusion after mapping the compensation of 2,717 U.S. senior executives against the brand strength of their firms' leading products. For pay figures, the researchers used Standard & Poor's ExecuComp database; for brand strength, BAV Consulting's consumer surveys. They examined the data for 2000 to 2010, making more than 10,000 compensation-brand observations in all.

CEOs' pay dropped by **12%** for each standard-deviation increase in brand strength, saving their companies an average of **$1.3M** a year.

With each standard-deviation increase above the mean for brand strength, non-CEO executives earned, on average, 2% (about $90,000) less a year. The effect was far larger for CEOs: Their pay dropped by 12% for each standard-deviation increase, saving their companies an average of $1.3 million a year. The larger effect, the researchers say, can be explained by what psychologists call "identity theory": CEOs are typically the most prominent members of their organizations, so for them the self-enhancement from brand association is particularly robust.

The effect on pay was also more pronounced among another subgroup: younger executives. The researchers theorize that younger people have had fewer chances to define themselves professionally, so they see an immediate benefit to being identified with a respected brand. Also, experiments indicate that working for a firm with a powerful brand signals competence to future employers—and with longer careers ahead of them, younger executives especially value this boost.

Companies often spend a lot of time and money trying to become "employers of choice" by landing on Best Places to Work lists and the like. This study approaches employer attractiveness from a different angle, showing that strong brands can provide a competitive edge when negotiating with potential employees. A well-regarded brand can do more than help recruit top-quality executives; it can bolster the bottom line by significantly lowering payroll expenses. HR departments should leverage brand strength just as they leverage more-traditional benefits.

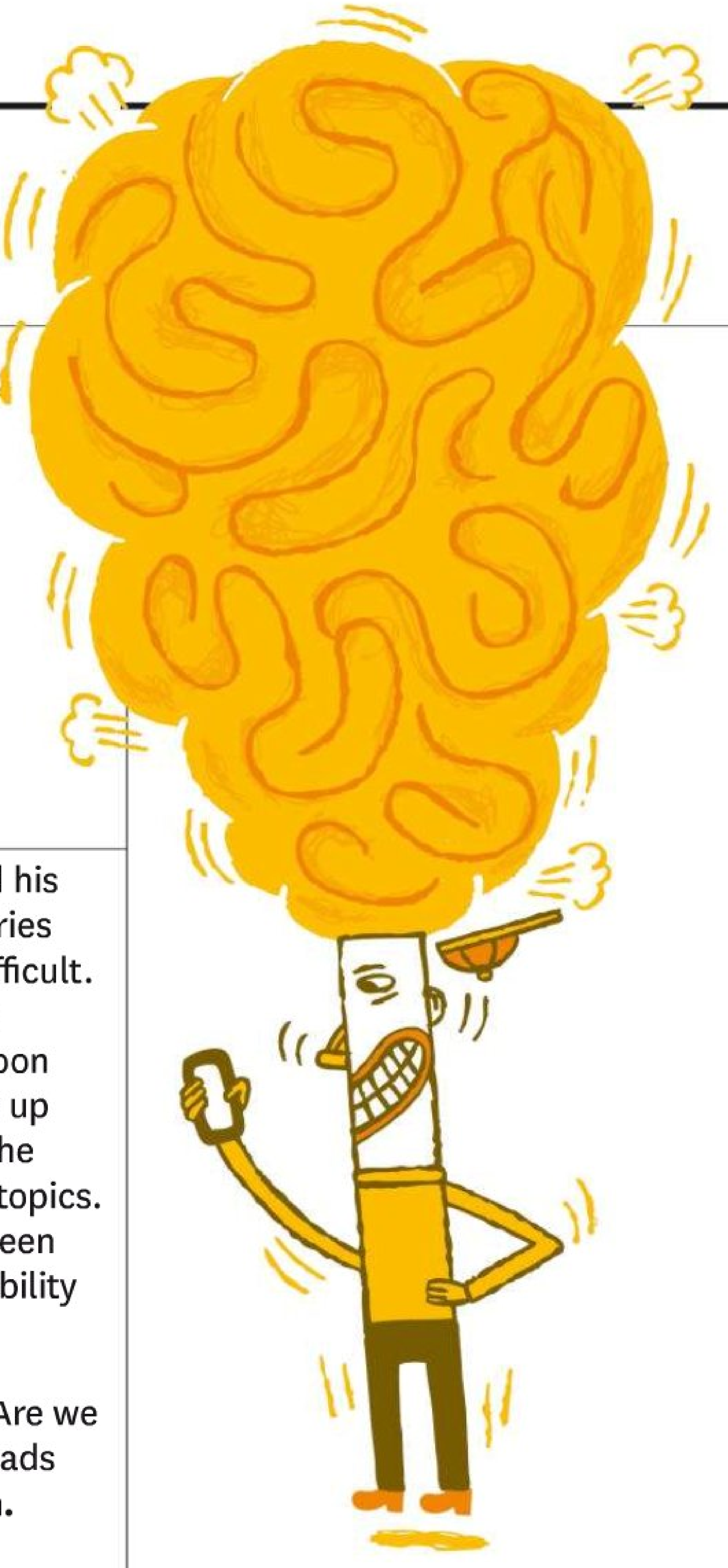
And at a time when many are calling for increased governmental regulation of executive compensation, these findings suggest an additional, market-based approach. "If top executives are prepared to accept lower pay for the privilege of running firms with strong brands, pay levels can be grounded, at least to some extent," the researchers say.

ABOUT THE RESEARCH "Employee-Based Brand Equity: Why Firms with Strong Brands Pay Their Executives Less," by Nader T. Tavassoli, Alina Sorescu, and Rajesh Chandy

HBR Reprint F1507A
Some of these articles previously appeared in different form on HBR.org.

MARIE ASSÉNAT


HITACHI
Inspire the Next
"WHAT IF WE COULD ALL BE DOCTORS?"
Good question. But with so many healthcare issues facing our cities like the challenges of an aging population, lifestyle-related diseases and soaring costs, doctors alone are not the answer. That's why Hitachi has an innovative approach that looks at the big picture. From prevention and examination to therapy and rehab, we're using our information technologies along with medical equipment to make things better for caregivers and patients. For generations to come. Hitachi Social Innovation.
social-innovation.hitachi.com
SOCIAL INNOVATION
IT'S OUR FUTURE



DEFEND YOUR RESEARCH
THE INTERNET MAKES YOU THINK YOU'RE SMARTER THAN YOU ARE

The research: Yale doctoral candidate Matthew Fisher and his colleagues Mariel Goddu and Frank Keil asked people a series of questions that seemed answerable but were actually difficult. The questions concerned things people assume they know but actually don't—such as why there are phases of the moon and how glass is made. Some people were allowed to look up the answers on the internet, while others were not. Then the researchers asked a second set of questions on unrelated topics. In comparison with the other subjects, the people who'd been allowed to do online searches vastly overestimated their ability to answer the new questions correctly.

The challenge: Does the internet make us overconfident? Are we unable to distinguish between what's stored in our own heads and what's in the cloud? **Mr. Fisher, defend your research.**

Fisher: We've zeroed in on access to this massive online database of information as the cause of an illusion of understanding. Even when people did searches and got irrelevant or no results, they were far more confident that they'd know the answers to unrelated follow-up questions.

HBR: What if those who got internet access just happened to know the answers to the follow-up questions better? Randomly assigning participants to one of the two conditions took care of that worry. All the potential differences between the groups, such as previous knowledge, were then randomly distributed across the groups, so the only difference between the two groups was whether they used the internet to look up the answers to our initial questions.

In some ways this seems obvious. If I know I have access to a mechanic, I'll be more confident that I can keep my car running. We're making a crucial distinction here. We didn't see that people were more confident that they could *find* answers if they had access to search. We saw that people were more confident that they *knew* the answers—had the information in their heads—if they had access to search. It's more like thinking you know how to fix a car if you have access to a mechanic.

How could you tell people thought they had the information in their heads? Couldn't they have been more confident because they knew they could look things up? In one experiment we simply asked them how well they could explain answers without using any outside sources. In another, instead of asking about their confidence, we told them that people who could give better answers would show more brain activity while answering. Then, instead of having them rank their confidence on a scale, we showed them a series of brain scans that depicted less to more brain activity. We asked them to indicate how much brain activity they'd use to come up with

KENNETH ANDERSSON

their answer. People who had been given access to search consistently chose images with more brain activity.

That's clever. Yeah, I think we made that technique up.

So what's actually going on here? There's a lot of research about transactive memory partners. Take an old married couple recalling their first date. In isolation neither recalls much, but if you put their memories together, they can re-create a richer memory that's more than the sum of each person's fragments. Now it looks like a machine can be that transactive memory partner. You plus a search is more than you or the search. It's just that we think it's only us.

Plus, searching the internet is almost effortless, and it's almost always accessible. You never face your ignorance when it's there. Because we're so deeply plugged into it, we misattribute the connection to knowledge to actually having the knowledge ourselves. It becomes an appendage. We like to use the term "cognitive prosthesis."

But is it so bad to have this prosthesis? It's like a bionic arm. Bionic arms are cool! Except what happens when it doesn't work? Or when you can't access the knowledge? With some professions, we want people to be truly knowledgeable, not have a false sense of their knowledge. Surgeons, for example. At the very least we have to start structuring our world so that if such people rely on this appendage, they're never cut off from it. Look, it's obvious the internet has benefits. We think there's an inherent trade-off between learning about the world yourself and storing information about the world somewhere else besides your head. The more we use the internet, the harder it will be to assess what people truly know. And that includes assessments about ourselves.

How have people reacted to your findings? They've resonated a lot more than I anticipated. Because there are so few places now where we can't access the internet, we do feel it when it happens. On a plane or in a conversation where it would be rude to pull out a mobile device, you run into this roadblock. Suddenly, we don't feel as smart. But we never were smarter, really; we just thought that what we could search for was actually something we already knew.

So the internet makes us feel like know-it-alls? Didn't I already know that? Psychologists have actually studied this "I knew it all along" phenomenon. When someone with credibility explains something to a layperson, a common reaction they get is "That's obvious" or "Oh yeah, I knew that." So one common ploy of psychologists is to describe their findings as the exact opposite of what they are, and people will react with "Yeah, that's right—that makes sense." I could have played this game and said to you, "We found that people feel dumb when they use the internet, that they know nothing compared to this vast resource." And you would have said, "Yeah, duh, of course."

Wait, how do I know you didn't actually do that? Which is the real finding? You have the paper.

What made you want to study this? It was a nice real-world way to look at what I'm most interested in: metacognitive awareness, or people's ability to assess how well they can explain things around them. Emotional investments can give people the illusion of insight. This happens in politics a lot. You end up thinking you know arguments better than you do. Our research has shown that when college students are asked to assess their knowledge of topics, they are least accurate about how much they know about their own majors. When you're invested in something, you like to think you know a lot more than you do.

I definitely know more about Q&As than most people! I'm sure you think you do.

Interview by **Scott Berinato**
HBR Reprint F1507B

VISION STATEMENT
MARKET INDICATORS

The marketplaces of Renaissance Europe were polyglot bazaars, attracting traders from across the Continent and beyond, who spoke different languages and carried different currencies. How did businessmen communicate? And how did they stay abreast of exchange rates?

They relied on tools like the ones shown here to bridge the divides. The hand signals, published in an Italian mathematics textbook, gave merchants a universal language for numbers similar to that used in today's stock exchanges. The handbills (known as *currents*) listed exchange rates for the ports of call represented at each market. These are just two of the innovations that lubricated the gears of preindustrial European commerce.

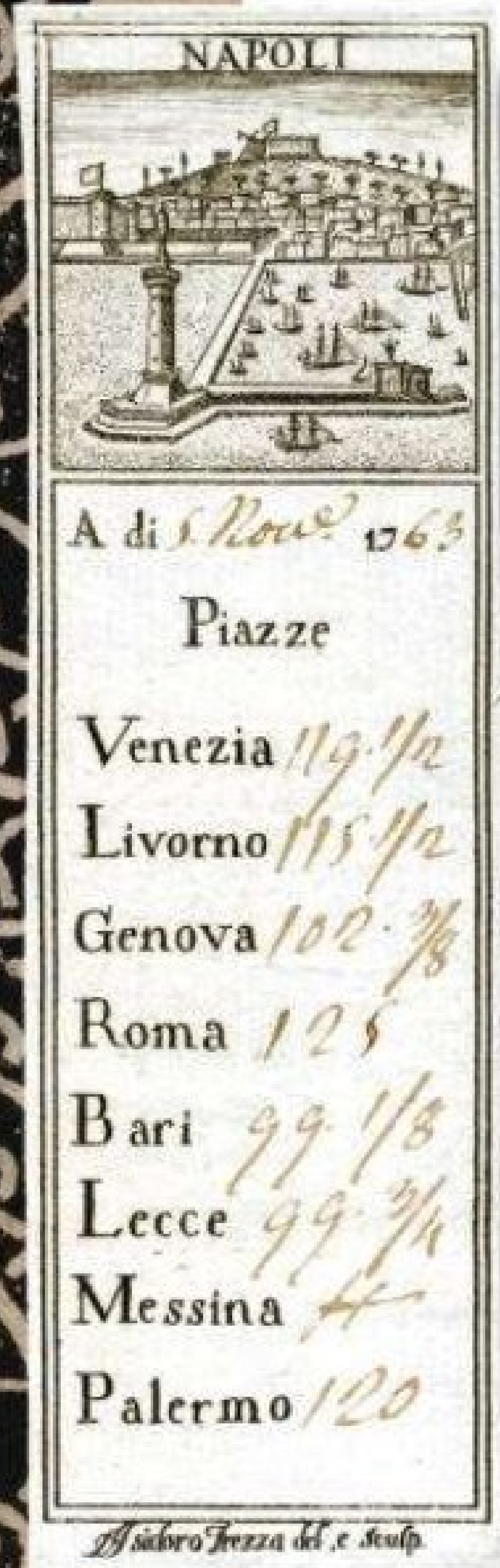
HBR Reprint F1507Z

THE TEXTBOOK in which these hand signals appeared was written by Girolamo Tagliente in Venice in about 1515. According to one scholar, Tagliente's book was printed throughout the 16th century and did much to shape the teaching of math—a vital discipline for merchants and tradesmen.


IN GENOVA

Adi 31. 8bre 1739

Argento	
Venetia	182. 1/2
Milano	44 3/4
Roma	208. 1/8
Napoli	83. 1/3
Mesina	
Palermo	
Liuorno	93. 1/5
Londra	52. 3/8
Amsterdã	93. 1/2
Parigi	101
Lione	
Marsiglia	
Cadice	631
Madrid	632
Lisbona	810
Vienna	
Augusta	
Reali Mes	
Reali Col	


NAPOLI

A di 5 Nove 1763

Piazze

Venezia	119 1/2
Livorno	115 1/2
Genova	102 3/8
Roma	125
Bari	99 1/8
Lecce	99 3/4
Messina	4
Palermo	120

Isidoro Frezza del. e sculp.


Venetia 1743

Adi 27 7bre

Letta		D.
Bñe	192 1/2	
Lione		60 3/4
Bño	134 1/2	
Roma		60 1/4
Nap.	117 3/4	
Fir.		78
Liv.		101 7/8
Mil.	155 1/2	
Anc.	91 1/2	
Gen.	103 3/4	
Bari	118	
Lecce	119	
Anv.	93 1/2	
Am.	91 5/8	
Amb.	88	
Lond.	53	
Aug.	97 1/4	
Vña	189 1/4	

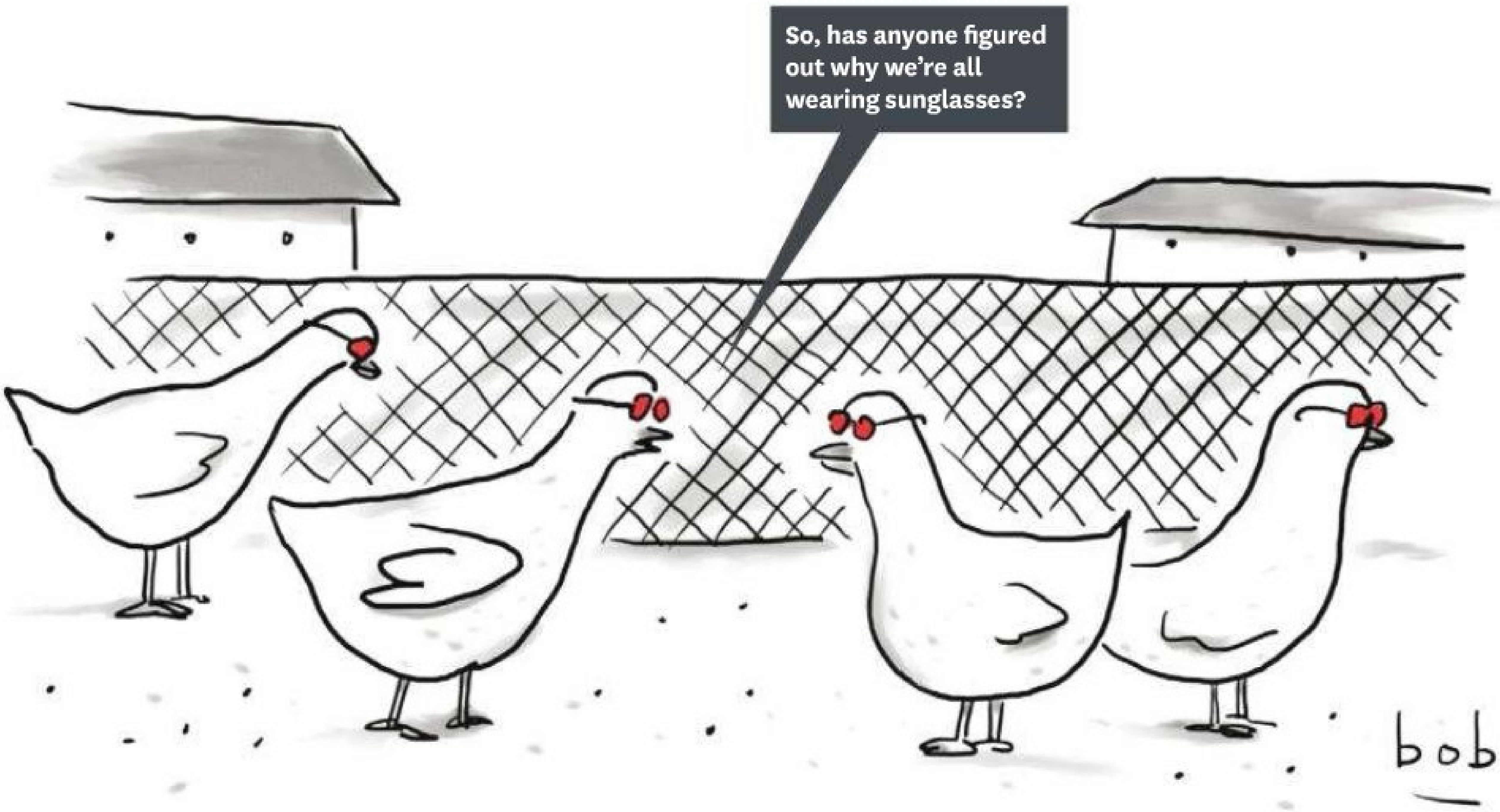
Mª Cor. 129

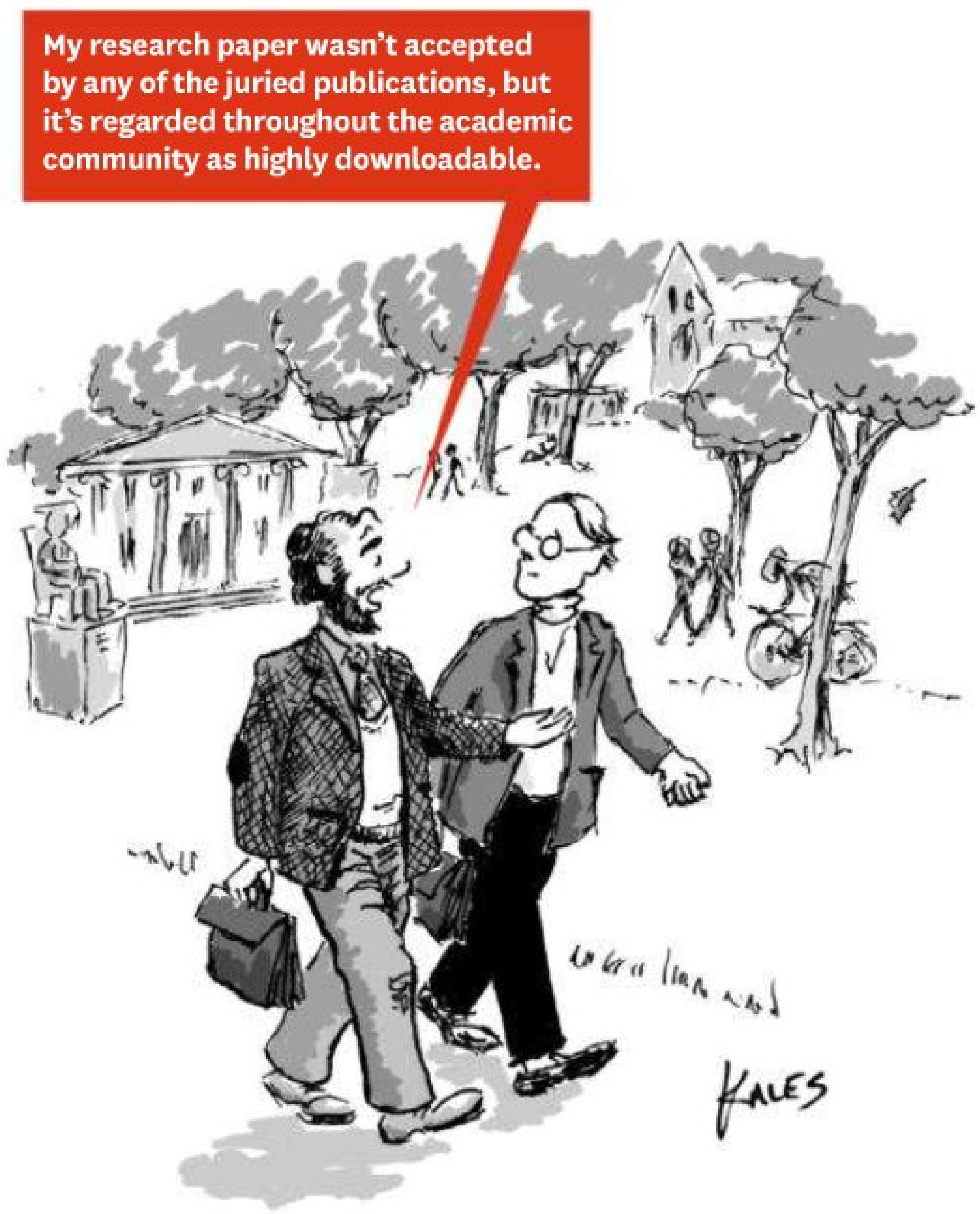
THE "CURRENTS" above were used in the markets of Genoa, Naples, and Venice. Updated every week or so, they listed the exchange rates for livres, florins, guilders, piastre, and other currencies then in use. The engravings at the top depict the Piazza Banchi in Genoa, the Bay of Naples, and Venice's Rialto Bridge. Currents were sized for easy reference, measuring about 5 cm wide and 8 to 15 cm long.

SOURCE IMAGES COURTESY OF THE KRESS COLLECTION OF BUSINESS AND ECONOMICS IN BAKER LIBRARY AT HARVARD BUSINESS SCHOOL

STRATEGIC HUMOR

To enter our caption contest, go to **HBR.org**.





CAPTION CONTEST

"Our VC firm takes a two-tier approach: first the seeds, then the money."

This month's winning caption was submitted by **Laren Hagen** of Seattle, Washington.

BOB ECKSTEIN, PAUL KALES, JOHN KLOSSNER

HOW I DID IT...
TOMMY HILFIGER'S CHAIRMAN ON GOING PRIVATE TO SPARK A TURNAROUND

by Fred Gehring

MAARTEN KOOLS

The Idea

The fast rise of the preppy fashion brand in the 1990s led to a steep fall after it oversaturated the U.S. market. Gehring reacted by leading a private equity buyout that gave him room to shrink the business in the short term so that it could grow in the long term.

I first met Tommy Hilfiger around 1990, when he was already well known in the fashion industry. In the late 1960s he'd been a teenager in upstate New York, but he wanted access to fashionable clothing that he couldn't find in local stores. So he and some friends would drive to New York City, buy dozens of pairs of bell bottoms and other hippie clothing, drive back upstate, and sell the clothes from the trunk of his Volkswagen. Before he was 20 Tommy and a partner had opened a basement shop called People's Place, which grew into a small chain of stores. By the mid-1980s Tommy had moved to New York City and found a backer to launch his own brand: classic East Coast clothing with a casual, carefree twist inspired by time he'd spent in California. In 1985 his ad agency put up a billboard in Times Square that compared Tommy Hilfiger to Calvin Klein, Ralph Lauren, and Perry Ellis. It was a bold statement, but it put him on the map—and he had the creative vision to deliver on it.

During the 1990s Tommy Hilfiger became one of fashion's hottest brands. I got involved in 1996, when I became a partner in a start-up company that signed the license to sell Hilfiger products in Europe. During that period the U.S. business really took off: From 1997 to 2000 the company's overall sales more than doubled, and it was a stock market success as well. But that came at a price. The brand was too hot, too hyped, and grew too fast. In the United States its products drifted away from its core values, and when demand fell and they began to sell at a discount, the company's designers started creating stuff that felt like discount clothing—a vicious cycle. By the early 2000s Hilfiger's U.S. sales were falling every year. A new CEO came in with a turnaround plan that called for bold acquisitions to make Tommy Hilfiger a multibrand company. To me, that seemed unlikely to work.

One challenge of executing a turnaround in this situation is that when you're a public company, the expectation is that you'll grow every quarter. Sometimes the best way to create a profitable and sustainable business is to shrink, but it can be difficult to do that in the glare of the public markets. When I began envisioning a strategy for Tommy Hilfiger, it wasn't in my wildest dreams to find a private equity firm that would buy the company and take it private. But ultimately I realized that selling the board on that very plan was the most viable way to rebuild the core of this brand. I still believe that was right.

1996
STREETWEAR AT A FUNDRAISING RACE

S. GRANITZ/GETTY IMAGES

Although Tommy and I came to work together very well, my background was quite different from his. I grew up in Holland and earned a degree in business administration there. After college I worked abroad. I spent a year in Hong Kong and another in Honduras before arriving in New York. From 1980 to 1983 I worked in a business that traded investment-grade diamonds, but after that market crashed, the business was shut down. For the next four years I worked as an independent consultant, helping European companies that wanted to enter the U.S. market. During that time I had my first exposure to the apparel industry. In 1985 I met Silas Chou, a legendary Hong Kong investor who's been involved with a number of apparel companies, from Ralph Lauren to Michael Kors. In 1987 Silas asked me to move back to Amsterdam and get involved with Polo Ralph Lauren's European operations, in which he'd acquired an interest. I did that for four years, and then I joined Silas and his partner, the Canadian apparel entrepreneur Lawrence Stroll, when they acquired a company in England called Pepe Jeans, which I ran from 1992 to 1999.

In the late 1980s Silas and Lawrence sold their European Ralph Lauren business and became the majority owners of Tommy Hilfiger. Although Tommy had the creative vision and the merchandising sense to oversee brand and product strategy, he realized the value in working with great business partners to grow the company, and Silas helped provide that expertise. In 1992 they held an IPO, which was very successful.

When the Brand Erodes

Over the next few years we at Pepe Jeans began to see many of our European fashion customers travel to New York and come back with Tommy Hilfiger products. The brand had incredible cachet in Europe. So Silas and I started talking about

2015
MEN'S FALL-WINTER
TAILORED
COLLECTION

acquiring a license to sell Hilfiger in Europe, and we signed a deal in 1996. Over the next few years we made a critical decision to stay focused on our core DNA of classic, premium products. In the United States, Tommy Hilfiger had expanded into streetwear—baggy jeans and clothing with very large logos, which overshadowed the traditional products on which the brand had been built. When a brand becomes too big and too visible, giant logos and apparent ubiquity can start working against it. By 2000 the brand had peaked in the U.S., and the company began to face market resistance.

In the fashion industry, weak demand leads to discounting. If the discounting goes on too long, it can become structural, which means it gets factored into the design process. Let me give you an example. For years Tommy Hilfiger's designers had been creating shirts that would sell for $79 but would offer the look and quality of shirts that might sell for $89. But when the market started to turn against the brand, retailers had to mark down those shirts to $49 in order to sell them. To be profitable at $49, you need to make very large compromises on materials, styling, and quality. They began designing into the discount environment, and the brand eroded further.

In the European division, which I was running, we chose not to sell the lower-quality product. To succeed in Europe, we needed a $99 shirt that looked as if it cost $150. By 2001 we'd taken steps to reduce our reliance on the brand's U.S. operations. We created our own design center and supply chain. From 2000 to 2006, while Hilfiger's U.S. sales fell every year, European sales grew by roughly 50% every year. At first few people noticed our success, because we'd started as a $200 million division of an almost $2 billion company. As U.S. sales fell below $1 billion and then to about $800 million, however, and our sales rose to $400 million and then $500 million, I expected people to conclude that our strategy would be a smarter one for the entire company. But global leadership and the board were all in New York and were overly focused on the U.S. business, and they faced a lot of pressure from public shareholders. They felt they needed to try to regain what had been lost and to find a way to grow U.S. revenue again. In 2003 the company hired the CEO who wanted to grow through acquisitions. He began putting together a team to execute his M&A strategy.

I was thinking and talking about a different strategy: focusing resources on profitable divisions that had momentum rather than trying to regain lost ground in the U.S. wholesale channel, which should be shrunk further and made less important. I arrived at this idea partly by studying the company's publicly available financial statements and making some back-of-the-envelope calculations. Hilfiger's operations in Canada as well as in Europe were profitable. The company had 125 outlet stores in North America that created their own products, and those were profitable too. But its U.S. department store business was a disaster. And a lot of expensive overhead—part of it left over from when the company's revenue was much higher and part related to executing the M&A strategy—could be cut to help restore profitability.

Private Equity to the Rescue

You couldn't do this kind of turnaround at a publicly traded company. It would be too extreme, and you'd shrink the top line too dramatically. Shareholders would struggle with it. But some of the savings we hoped to achieve would come from avoiding the costs of being a public company. People may not realize how many legal and advisory costs stem from being publicly traded.

I tried to sell this vision to the board. The former CEO, who was now the chairman, was in favor of my plan. Tommy spoke in favor of it. But the sitting CEO was against it, and a lot of other board members were neutral. I hadn't had a lot of prior exposure to the board, whereas the CEO had been recruited by these directors and had spent 18 months selling them on his vision. They were legitimately concerned about embarking on what they saw as a superaggressive restructuring. They seemed to be focusing on their legal duty to shareholders rather than approaching the strategy problem with what was in my view entrepreneurial common sense.

COURTESY OF TOMMY HILFIGER

The board's response was that if I wanted to pursue the strategy I had outlined, I should come back with an offer to buy the company. So I began talking with various private equity firms, and eventually the board put the company up for auction. The process took about six months. The winning bid came from Apax Partners, a private equity firm. Its base was in Europe, where the brand was strong, giving Apax the perspective to look beyond the troubled U.S. business. We closed the deal in May 2006.

We embarked on a dramatic restructuring. We had to make tough decisions to reduce the U.S. head count by 40%, and the majority of global management team positions began to transition to our global headquarters, in Amsterdam. As a private company, we were relieved of pressure to achieve artificial short-term objectives. We could focus on finding the right structure and long-term strategy instead of worrying about the next quarter's sales report. We also formed a strategic alliance that made Macy's our exclusive U.S. retail partner. Macy's already accounted for 75% of our U.S. wholesale business; by making it 100% we gained even more cooperation.

The strategy to scale back the U.S. business in the short term laid the groundwork for the brand's turnaround in the market in less than four years. Through smart investments in our collection design and fashion shows and continuing high-profile collaborations with icons from the worlds of art, sports, and entertainment, the brand perception was elevated to realign with the premium image we maintained in other markets around the world. At the same time, we were able to balance our internal resources to continue the uninterrupted momentum of our global growth and business expansion.

Working with Apax was a phenomenal learning experience. The typical private equity story is that the partners overleverage companies and strip out costs too dramatically, but that's not our experience. That may be in part because private equity firms never identified Tommy Hilfiger as a fat target—we came to them with our own plan for cutting costs, and they actually thought our targets were too aggressive. But because our plan showed early results, they were willing to keep investing in the brand. For instance, we opened a 20,000-square-foot flagship store in Manhattan. It's a brand-enhancing presence and a marketing expense. Apax didn't resist that at all. We also gained discipline in cash management and capital management; I thought we'd done a good job in those departments, but in retrospect we were actually amateurs, and Apax taught us a lot.

Eighteen months after the deal that took the company private, we were planning the road show for a new IPO.

A Good Home for Success

One of the stereotypes about private equity firms is true: They are very much focused on how and when they'll exit an investment. As soon as we had completed our reorganization, just months after taking ownership, we began talking about going public again. Eighteen months after the deal that took the company private, we were planning the road show for a new IPO.

When the stock markets and the economy softened in early 2008, we put the road show on hold; and months later, after Lehman went under and the markets froze completely, that discussion ended. During that period we definitely had a survival mindset, but in fact our business remained stable. After conditions eased and we began growing again, our earnings ignited. By the end of 2009 we'd begun negotiations to sell the company to PVH, which also owns Calvin Klein, Izod, and Van Heusen. That deal closed in May 2010, four years after Apax's original purchase.

Since the sale to PVH, our business has remained incredibly strong everywhere in the world. Our flagship footprint continues to expand, bringing the full Tommy Hilfiger lifestyle to cities across the globe. With PVH's support we've been able to substantially step up investments in marketing and retail development and to acquire either direct ownership or joint venture interest in the brand in key high-growth markets, including India, Brazil, and Russia. The brand continues to be a driver of PVH's expansion into emerging markets. Tommy Hilfiger's success is mentioned in every PVH earnings release, and it's part of the reason PVH's share price has performed so well.

Looking back, one of the lessons I take is that even in a global world, markets are very different from one another. Cultures are different. What works in the United States may not work in Europe or Asia, and vice versa. The number of big American fashion brands that do a really substantial business in Europe is fairly small—and once you get beyond New York, Chicago, and Los Angeles, the number of European companies that do a substantial business in the United States is fairly small too. Sometimes you need to accept that a strategy that works in one part of the world may not succeed in another if you're not willing to adapt.

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SHAW NIELSEN

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The Employer-Led Health Care Revolution

Medical outcomes in Portland are improving dramatically—and Intel spearheaded the transformation.

BY PATRICIA A. MCDONALD, ROBERT S. MECKLENBURG, MD, AND LINDSAY A. MARTIN

In the years leading up to 2009, Intel tried a number of popular approaches to tame its soaring health care costs. To encourage employees and their families to be more involved in the purchase of their care and aware of its actual cost, the company implemented "consumer-driven health care" offerings such as higher-deductible plans with lower premiums, tax-advantaged accounts, and tiered-provider options. To save employees time and improve access, it opened primary care clinics at Intel work sites in Oregon, New Mexico, and Arizona. It offered wellness and fitness incentives, including optional annual health checks that would reduce premiums or deductibles, health coaches, and free on-site fitness classes.

While those programs generated improvements in employee awareness, engagement, and accountability, it had become clear by 2009 that they alone would not enable Intel to solve the problem, because they didn't affect the root cause: the steadily rising cost of the care that employees and their families were receiving. Intel projected that expenditures for its 48,000 U.S. employees and their 80,000 dependents would hit $1 billion by 2012—triple the amount it spent in 2004. Intel's leaders were torn: They wanted to protect the bottom line but were reluctant to shift more of the cost to employees, concerned that it would become harder to attract and retain top talent.

Intel rigorously managed its equipment suppliers, monitoring quality and cost, but was not doing the same with its health care suppliers.

One of us (Patricia McDonald) suggested another option: Intel could use its purchasing power in markets where it had operations to influence health care players—care providers, health plan administrators or insurers, and other employers—to rise above their competing self-interests and work together to redesign the local health care system. Specifically, the company would use its deep expertise in supply chain management to improve quality, remove waste, and thereby reduce costs in both the clinical and administrative sides of local health care enterprises while putting the needs of their customers—patients—at the center of everything they did.

Intel would urge the health systems to standardize work by adopting best-practice clinical processes and adapting them to their own situations. In this case, the source would be Virginia Mason Medical Center, a health system based in Seattle. It was one of several providers in the United States that employed a version of the famed Toyota Production System to make its processes "lean"—in other words, strip them of activities that did not add value and caused delays or waits in patient care. Intel would pay for the clinical processes and Virginia Mason's expertise in installing them and would train people at the local health systems to use Intel's version of TPS to adapt them. Finally, Intel would enlist its health plan administrator, Cigna, to contribute the claims data required to establish priorities and track progress.

Intel's pilot Healthcare Marketplace Collaborative (HMC) was launched in metropolitan Portland, Oregon. Over five years, it successfully implemented new clinical processes for treating six medical conditions and for screening patients for immunizations status and illnesses such as diabetes and high blood pressure. Although assessing the HMC's full impact was not easy—and in a number of cases impossible given how the experiment was designed—the results that could be measured were significant: The HMC reduced the direct costs of treating three of the conditions by 24% to 49%—a tremendous accomplishment in an industry where slowing the rate of cost increases is considered a major achievement.

The HMC also emphasized evidence-based care (clinical decision making backed by validated research); eliminated unnecessary care; allowed patients to access care and return to work faster; generated high levels of patient satisfaction; and cut more than 10,000 hours of waste in business processes. (See the exhibit "Measuring Results.") What's more, it did all this within the confines of today's fee-for-service reimbursement system, which is widely considered a major impediment to improving the U.S. health care system.

The need to accelerate the transformation of health care in the U.S. is urgent—for both patients and employers. We have seen some hopeful signs that the tide may be turning: Thanks to the Affordable Care Act, the proportion of adult Americans without health care coverage fell to 12.9%

Idea in Brief

THE PROBLEM
Like most U.S. companies in 2009, Intel faced soaring health care costs—estimated to reach $1 billion by 2012. None of the popular approaches it tried—high-deductible/low-premium plans, on-site clinics, employee wellness programs—addressed the root cause of the problem: the steadily rising cost of care.

THE SOLUTION
The company decided to tackle the problem as it would a manufacturing challenge: by using lean improvement methods to rigorously manage the quality and cost of its health care suppliers.

Intel led a health care collaborative that focused on six clinical processes for treating conditions such as diabetes and lower back pain.

THE RESULTS
The results were significant: Treatment costs of certain medical conditions fell by 24% to 49%, patients could access care and return to work faster, patient satisfaction improved, and more than 10,000 hours' worth of waste in health care suppliers' business processes was eliminated.

in 2014 from 18% in 2013. And the rate of increase in U.S. health care spending has recently slowed, although it's hard to know whether that's simply a by-product of the Great Recession. Still, the crisis is far from over.

The Healthcare Marketplace Collaborative model has the potential to be a game changer. One of us (Lindsay Martin) led a two-year research project by the Institute for Healthcare Improvement to identify initiatives in which employers or unions, health plans, and care providers joined forces to redesign the local health care system to achieve the triple aim of improving the health of the local population, reducing the per capita cost of care, and enhancing the patient experience. Of the dozen efforts that IHI studied, the HMC model stood out in terms of its results and its potential to be replicated.

We believe that other large employers can and should follow Intel's example. As large purchasers of health services and experts in quality improvement and supplier management, corporations are uniquely positioned to drive transformation of health care in the United States.

The Birth of the Portland Collaborative

In 2007, Pat McDonald was the manager of what was then Intel's highest-performing chip factory in the world: Fab 20, in the Portland suburb of Hillsboro. While exploring how her plant might apply a lean approach to solve problems in complex engineering processes, Pat attended a conference whose speakers included another coauthor of this article, Robert Mecklenburg, of Virginia Mason.

A leader in applying lean techniques in health care, Virginia Mason had persuaded Starbucks, Aetna, and (later) other major employers to collaborate in a successful effort in Seattle to improve the processes for treating a number of conditions. The health system had done this in response to a threat by Aetna to exclude Virginia Mason from its provider network because the prices it was charging for some specialties were higher than competitors'. McDonald toured Virginia Mason's facilities and was amazed at what she saw. For instance, the flow of work in the pediatric clinic was so efficient that the waiting room was empty.

In 2009, McDonald was invited by Richard Taylor, Intel's senior vice president and director of HR, to join a committee charged with figuring out how to bring the company's health care costs under control. "Why not solve the health care problem the same way we would solve manufacturing problems?" she said. She pointed out that Intel rigorously managed its equipment suppliers, monitoring their safety, quality, and costs, but not its health care suppliers, because like most large employers outside health care, it felt it lacked the expertise.

McDonald insisted that wasn't true. She told the committee about the Seattle effort and suggested that Intel create a health care collaborative in metropolitan Portland, where its health plan covered nearly 18,000 employees and their nearly 21,000 dependents. The committee agreed, and the Healthcare Marketplace Collaborative was born. McDonald was called on to lead the initiative. She enlisted two key champions: one from HR (Taylor) and one from manufacturing (Steve Megli, a vice president of the Technology Manufacturing Group, who was interested in applying the lean approach to health care).

Mecklenburg, the leader of the Seattle initiative, was brought on as a key adviser. Previously Virginia Mason's chief of medicine, he had recently become the medical director of its new Center for Health Care Solutions, a unit formed to encourage employers to

use a collaborative model with providers and health plans to drive improvements in health care.

Mecklenburg strongly believed that for the approach to spread throughout the country, employers—not health care systems or insurers—should be the driving force. He felt that on the whole, neither providers nor health plans were consistently acting in the best interests of employers or their workers. Providers' services were too costly and their quality variable. Health plans weren't reimbursing providers on the basis of quality and were willing to pay for unnecessary visits, procedures, and medicines. Without strong pressure, they would not make enough effort to provide the highest-quality, lowest-cost care possible. Although Mecklenburg was hopeful about many elements of the legislation that would become the Affordable Care Act, he feared that it would not generate relief fast enough. He concluded that only employers, with their purchasing power, were in a position to accelerate the pace of change. McDonald's invitation to join the HMC experiment presented an opportunity to put his ideas to the test.

Let's take an in-depth look at the Healthcare Marketplace Collaborative model and the elements that were critical to its success.

1 Make explicit what each player is bringing to the effort

Intel initially invited Cigna; Providence Health & Services, a multistate health care system; and Tuality Healthcare, a small local system with two community hospitals, to join the collaborative. On Providence's recommendation, two state agencies, Oregon's Public Employees' Benefit Board and the Oregon Educators Benefit Board, were asked to participate in 2010. Each organization that joined the collaborative brought skills and capabilities that the others lacked and information that players in conventional health care systems rarely share for the betterment of the overall market. It was important that each group's unique value be recognized so that all team members would feel they were equals and would be motivated to fully engage. Making explicit what each player brought to the table helped forge a strong partnership, which was necessary to overcome the natural challenges and conflicts over priorities.

Employers. Intel brought a huge customer base—its employees and their families constituted a significant proportion of the health care customers in the Portland area. It also contributed its deep expertise in system engineering, improvement methodology, and supplier management. The state agencies—which together provide health care coverage and other benefits for 270,000 active and retired employees of state agencies and universities, school districts, and community colleges and their dependents—extended the endeavor's reach in the region and added another employer perspective. Perhaps more important, their involvement showed the greater community that the work was being done to benefit everyone, not just Intel employees.

Providers. Providence and Tuality each brought a unique perspective and, because of their differing sizes, were critical in demonstrating that standard, lean processes for health care could be created and applied in a range of environments. Having both providers as part of the initiative also broadened access for employees and accommodated their preferences for big or small institutions.

Insurers or administrators. Cigna played a limited but crucial role: It provided the claims data essential for identifying which conditions should be priorities, establishing baselines for improvement efforts, and tracking progress—something that insurers and administrators generally don't do. Cigna's involvement ensured that patients' privacy rights would not be violated. It should be noted that while the information shed light on the costs and utilization of health care in the region, it was raw data. Intel had to hire a third-party vendor to analyze the data and turn it into actionable information.

Physician leader. Keenly aware that it had limited knowledge of health care, Intel felt it needed a hands-on adviser to help guide the initiative, so it asked Mecklenburg to serve as physician leader. He was an expert in applying lean techniques to health care, and as a clinician, he would be effective in explaining the approach to the care providers and getting them to engage.

The role of physician leader is critical in an employer-led collaborative. Candidates may come from inside or outside a participating health system. They must have a track record in leading change and be advocates of collaborative decision making. And they must be driven by dissatisfaction with the current state of medicine and the belief that care provider organizations today are wasting employers' and taxpayers' money and are not doing their level best for patients.

Among all the players in a collaborative, the anchor should be the employer. In many cases it will be a large corporation, but state governments, pressured by their tight budgets, are also ideal. (The ongoing Bree Collaborative in Washington State is a good example.) The founding employer can invite other like-minded employers, providers, and health plans to come to the table. Upon seeing the results, additional employers may seek to join the effort—or begin to purchase health care differently.

Such an endeavor must be organized as a serious enterprise, not treated as an "extracurricular activity" that employees have to squeeze into their already-full workloads. It requires significant personnel resources. Management and operating teams are needed to bring the stakeholders together and establish a healthy operating rhythm. (For a look at how the HMC was staffed and organized, see the exhibit "Building a Collaborative.")

2 Establish a shared aim

The purchase of health care services for employees is often a game in which each player—employer, payer, or health care provider—tries to use its market power to secure the best deal for itself in annual negotiations. Payers (insurers or third-party administrators) attempt to wrangle discounts from providers. Providers strive to raise prices independent of cost or quality. Payers and employers try to shift actuarial risk—the risk that the assumptions built into models for pricing insurance policies may turn out to be wrong—to providers. And to offset rising costs, employers force workers to pay more for premiums and shoulder higher deductibles and copays.

Making matters worse, little information is shared among key local players. Health plans and providers often shut employers out of the discussion of costs. Health plans may be contractually prohibited from disclosing negotiated rates with providers. And although progress in getting health systems to share learning has been made via government and nonprofit initiatives, providers within a given market rarely share data on outcomes. The grand result is a system in which it is rare for all the local players to work together in a transparent way to improve the quality and cost of health care and enhance the patient experience.

To break this dynamic, the HMC's members agreed to focus on an aim that would be in the interests of all the stakeholders, including patients: providing the right care in the right place at the right time and the right cost for Intel employees and families and all other Portland-area health care users. They would strive to eliminate waste, achieve zero defects, and, where possible, focus on keeping people well, reducing the need for reactive care.

When Intel approached Tuality and Providence about joining the collaborative, each asked—reacting to past experiences with employers—"Does Intel want a separate system for its employees alone?" Intel realized that would undercut the goal of establishing a shared aim and responded with a resounding no. Creating special care for Intel employees would not be beneficial for the health care providers: It could result in parallel clinical and business work processes, which would be inefficient and, in health care, could lead to an increase in "adverse events or errors"—patient injuries due to medical interventions rather than to underlying medical conditions. Moreover, a separate system might limit employees' choices and would not be in the best interests of the greater community.

Only large corporations, with their vast purchasing power, can accelerate the transformation of health care.

3 Don't reinvent the wheel

Rather than develop new protocols from scratch, the HMC's two health systems accepted Intel's proposal to start out by acquiring proven clinical content and work processes—or, to use lean lingo, "value streams"—and quality metrics from Virginia Mason, whose lean clinical processes were evidence based and focused on the patient, addressing convenience, rapid access, cost, patients' lifestyles, and family considerations as well as quality of care. All this appealed to Intel, which was accustomed to finding the best in the industry and buying it. Intel opted to cover the full price of the value streams, because it believed they would benefit its employees and accelerate the standardization of care in the health systems. Intel also provided training for employees at the health systems in using its proprietary Rapid Integrated Lean version of the Toyota Production System to adapt the Virginia Mason processes to fit their own contexts.

Employer-led collaboratives can draw on a number of sources of processes and expertise. For example, Bellin Health Care Systems, in Wisconsin works directly with employers to drive down costs; ThedaCare, which is also in Wisconsin, offers courses and direct coaching on lean health systems and improvement methodologies; and Salt Lake City–based Intermountain Healthcare, well known for standardizing care, teaches courses in health care quality improvement.

4 Make it flexible

No two health care providers are exactly the same in terms of size, structure, and operations. In some instances, a provider may already have an effective method of treating a targeted condition. In others, internal or structural issues (physical space, available resources, state regulations) may make it difficult, if not impossible, to simply install a clinical process without changes.

Recognizing this, the collaborative agreed at the outset that Providence and Tuality would each decide whether or how to adopt each of the new clinical processes. For example, some of them called for tasks to be performed by an advanced registered nurse practitioner who had earned at least a master's degree. Because that role did not exist in either organization at the time, Tuality and Providence had to adjust the value streams to have other personnel perform those tasks. In the end, Tuality chose to adopt some form of all the value streams. Providence adopted four but decided that its programs for upper respiratory illness, diabetes, and screening were robust and would be kept; it was still committed, however, to achieving HMC goals for all three.

Proposed changes to any of the Virginia Mason value streams were vetted at meetings of Intel's global medical director, Donald C. Fisher, MD; Providence's and Tuality's medical directors; and the physician leader. The directors evaluated all the changes by testing and monitoring the results and then reconvened to reflect on how each health system could improve.

5 Prioritize on the basis of impact and difficulty

Intel combed through Cigna's claims data and chose which medical conditions to focus on initially—those whose improvement would most benefit its employees, their dependents, and the company. About two years into the effort, the medical directors at Providence and Tuality selected additional conditions. The group used four criteria to establish priorities:

Expenditures and impact on patients. Intel focused on types of care on which it spent a lot of money and treated the most patients—both Intel's employees and the community at large. Although the treatment costs for certain conditions are relatively low, they typically result in greater total expenditures because they occur so frequently. Therefore, team members considered frequency as well as cost in setting priorities.

Level of complication and risk. Intel chose to start with less complicated and less risky conditions to make it easier for Providence and Tuality to put the new clinical processes in place. For example, because of their complexity and the intense emotions that patients and their families typically experience, the collaborative's steering committee opted not to tackle pregnancy or cancer while in learning mode. In addition, Intel knew from experience that tackling the most complicated challenges first—something teams are often tempted to do because the potential payoff is the highest—increases the likelihood that a program will bog down or fail.

Ease of standardization. Intel wanted processes that could be standardized easily across multiple care-delivery systems. So it initially chose value streams that Virginia Mason had already developed and successfully implemented in several health care sites.

Benefit to the health systems. Although Intel set the initial priorities, it recognized that all the stakeholders needed to benefit from implementation of the value stream. Certain "production" costs for the two health systems would be reduced by eliminating unnecessary procedures (such as MRI scans), optimizing staff (for example, using clinical professionals other than physicians to diagnose and treat uncomplicated conditions), and reengineering

Building a Collaborative

The Healthcare Marketplace Collaborative was organized and staffed as an important business enterprise with a regular operating rhythm, not as an "extracurricular" activity.

TEAM	MEMBERS	FREQUENCY	RESPONSIBILITY
CORE OPERATING TEAM	**PROGRAM MANAGERS, LEAN EXPERTS, CLINICIANS,** and the **PHYSICIAN LEADER**	WEEKLY	**OVERSEE THE DESIGN AND IMPLEMENTATION OF VALUE STREAMS,** manage integration among the teams, identify issues such as variations in practices and data collection problems, and determine possible solutions.
MEDICAL TEAM	**MEDICAL DIRECTORS** from Intel and the two health systems, the **PHYSICIAN LEADER,** and **PROGRAM MANAGERS**	MONTHLY	**REVIEW AND MODIFY THE CLINICAL VALUE STREAMS** to accommodate local needs, evaluate results of various approaches, and approve the final value streams. Cultivate buy-in from skeptical clinicians and foster a patient-centric, data-driven culture.
STEERING COMMITTEE	**EXECUTIVE SPONSORS, MEDICAL DIRECTORS,** and the **PHYSICIAN LEADER**	QUARTERLY	**SET THE INITIATIVE'S STRATEGIC DIRECTION**, determine how many and what type of conditions should be tackled, and monitor progress.
ALL-HANDS TEAM	**ALL KEY PLAYERS**; other stakeholders such as **CLINICIANS** and **IT STAFF** from the health systems	ANNUALLY	**CONDUCT ANNUAL PLANNING** and align strategic direction.

What did it take to staff the HMC initiative? Here's how the resource allocation broke down.

COMPANY	MEMBERS OF THE HMC	COMMITMENT (% OF TIME PER PERSON)
INTEL	**EXECUTIVE SPONSORS** VP of human resources, VP of manufacturing	10%
	MEDICAL DIRECTOR	20%
	PROGRAM MANAGER midlevel manager with experience in leading lean projects and managing initiatives across organizations	50%
	OPERATIONS FACILITATORS 2 to 3 senior individual contributors skilled in group facilitation and long-range planning	30%
	LEAN EXPERTS 2 to 4 people certified in lean methodologies	50% to 75%
	ADMINISTRATIVE ASSISTANT	15%
	HMC CHAMPIONS 2 senior VPs	1%
	DATA SPECIALIST	20%
PROVIDENCE AND TUALITY	**EXECUTIVE SPONSORS** Providence's chief strategy officer and Tuality's CEO	10% to 15%
	MEDICAL DIRECTORS	20%
	PROGRAM/OPERATIONS MANAGERS	40%
	CLINICIANS	50%
PUBLIC EMPLOYERS	**EXECUTIVE SPONSOR** administrator of the boards	3% to 5%
VIRGINIA MASON	**PHYSICIAN LEADER**	5%
CIGNA	**EXECUTIVE SPONSOR** regional medical executive	5%
	DATA ANALYST	5%

administrative processes. Revenue would grow as a result of increasing patient throughput—for example, by offering patients with uncomplicated conditions rapid access to treatment and by providing patients with complicated conditions rapid access to specialists (whose schedules were no longer filled by patients with uncomplicated conditions). The benefits of increased volume and reduced costs would more than offset any reduction in revenue associated with eliminating unnecessary care. Indeed, the health care providers would most likely increase their market share as better outcomes and lower costs translated into a stronger financial position.

Uncomplicated back pain was selected as the first value stream to improve because it was high on Intel's list in terms of frequency and total cost; Virginia Mason had used this lean process to treat thousands of back patients since 2005 and had solid experience standardizing the clinical process at multiple sites; and Providence and Tuality treated a high number of patients with the condition. (See the exhibit "Two Approaches to Treating Back Pain" for more on the redesigned value stream.)

6 Choose simple metrics and goals

U.S. health care providers measure more than 100 indicators of the quality of their clinical processes—such as the rate of ventilator-associated pneumonia, the percentage of patients whose prophylactic antibiotics are discontinued within 24 hours of surgery, and so on—which they report to public- and private-sector bodies. Although they are all valid quality indicators, few are useful in an employer-driven initiative like the HMC. The collaborative needed a set of simple, standard metrics to measure progress; it chose five that had been adopted by the Seattle collaborative and addressed the aim of better, faster, and more-affordable care. And it set audacious goals for each.

The goal was to actually *reduce* costs, not just slow the rate of increase.

Better care. The HMC used two metrics for this goal. One gauged medical quality: whether or not patients received evidence-based care. The other tracked patient satisfaction: the proportion of patients who responded "probably" or "definitely" to the survey question "Based on today's visit, would you refer a friend to our medical clinic?" The goal for both measures was 100%.

Faster care. The HMC choose two metrics here: same-day access to care and return to function (how many days before patients could resume their normal daily routines). The goal was that 85% of patients who called Monday through Friday could get an appointment with an appropriate provider within one business day of their call. For the return-to-function metric, the team members from Intel, the medical directors from the two health systems, and the physician leader determined the targets for each value stream. The goal was for 90% of patients to meet or beat the target.

More-affordable care. The first metric for affordable care was the total cost to employer and patient of treating a condition—in other words, the fees paid to providers. (Historically, this has been hard to calculate in the United States because most providers charge for each item or service, not for the full treatment of the condition.) The collaborative compared costs from when the need for care arose and when the problem was resolved using both the new approach and the one typically used in the health system. The goal was to actually *reduce* costs (no numerical target was set), not just slow the rate of increase.

Although not calculated in dollar figures, the return-to-function metric also was considered in gauging progress on more-affordable care. The cost of lost productivity often is much greater than the cost of care—and is something that health systems in the United States typically don't consider.

There were inevitably differences of opinion about how to implement value streams, and using common measures allowed the health systems to test approaches in parallel and easily compare the results, accelerating decisions. For example, Virginia Mason's process called for a physician and a physical therapist to jointly evaluate whether a patient whose lower back pain seems to be uncomplicated might have something more serious. Specialist physicians at both Providence and Tuality believed that the therapist alone would suffice. So the two systems tested the approach for three months—Tuality with a physician and Providence without. Recovery rates and satisfaction levels were essentially the same, so both health systems decided that physician involvement was unnecessary.

7 Use one improvement methodology

Getting all the members of a collaborative to agree to use the same improvement methodology is essential. The good news is that virtually any quality improvement approach can be applied,

Measuring Results

To measure progress, the HMC chose five metrics that addressed the aim of better, faster, and more affordable care and set audacious goals: (1) 85% of patients who called for an appointment could get one within one business day; (2) 100% of patients would refer a friend to the clinic; (3) 100% them would receive treatment in accordance with validated research; (4) 90% would meet targets for number of days to resume normal daily routines; and (5) costs of treating a condition would be lower for the new process versus the established one.

SUCCESS MEASURES	LOWER BACK PAIN	SHOULDER, KNEE, AND HIP PAIN	HEADACHE	BREAST PROBLEMS	UPPER RESPIRATORY ILLNESS	DIABETES	SCREENING
SAME-DAY ACCESS	93%	86%	100%	26%	100%	100%	100%
PATIENT SATISFACTION	98%	98%	92%	94%	100%	96%	96%
EVIDENCE-BASED MEDICINE	92%	81%	N/A	100%	N/A	N/A	N/A
RAPID RETURN TO FUNCTION	99%	97%	N/A	42%	N/A	N/A	N/A
SAVINGS IN DIRECT COSTS	23.5%	37.7%	49.1%	N/A	N/A	N/A	N/A
INITIATED	2010	2010	2011	2012	2012	2013	2012
DURATION	35 MOS	35 MOS	24 MOS	38 MOS	18 MOS	10 MOS	14 MOS
NO. OF PATIENTS	499	343	657	86	111	47	151

NOTE THE SIX VALUE STREAMS WERE UNCOMPLICATED BACK PAIN; UNCOMPLICATED SHOULDER, KNEE, AND HIP PAIN; UNCOMPLICATED HEADACHES (MIGRAINES); BREAST PROBLEMS (LUMPS, PAIN, REDNESS, DISCHARGE); UNCOMPLICATED UPPER RESPIRATORY ILLNESS; DIABETES; SCREENING FOR INFLUENZA AND PNEUMONIA IMMUNIZATIONS AND TO DETECT ILLNESSES SUCH AS DIABETES, HIGH BLOOD PRESSURE, AND COLON AND BREAST CANCER.

including varieties of the Toyota Production System, Six Sigma, and the Model for Improvement (created by Associates in Process Improvement and used by the Institute for Healthcare Improvement). Intel's Rapid Integrated Lean, or RIL, approach had many benefits, especially its pace: It was designed to deliver exceptional results in three weeks. It does this by focusing individuals, teams, or managers on standardizing work that is under their control and by concentrating them on problems where they can make the most impact. Intel loaned the HMC several of its lean experts and trained 48 people at Providence and Tuality in the technique. In exchange, Intel required that both providers share results with everyone in the collaborative.

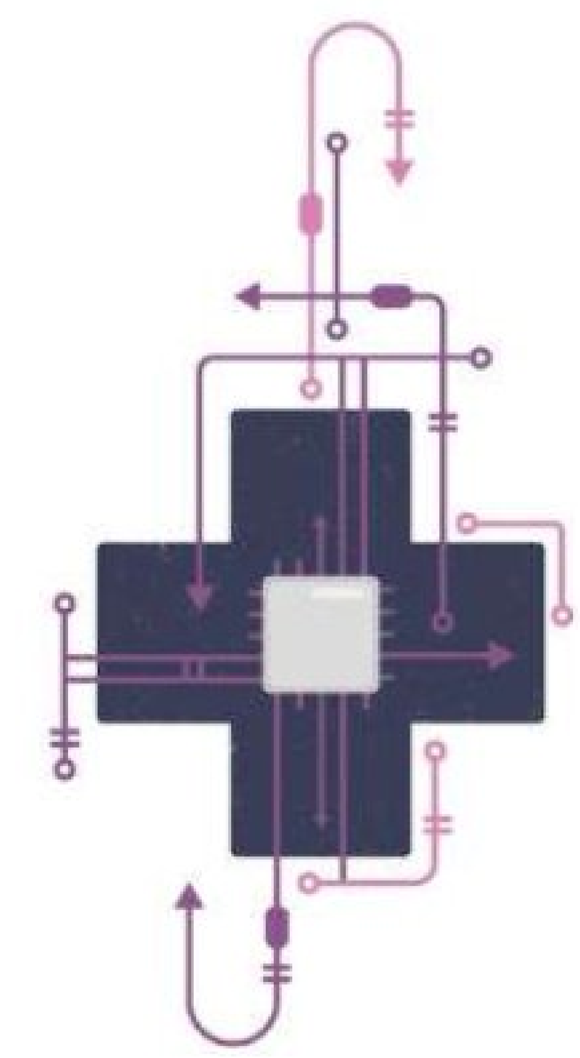
In using RIL to tailor and implement the Virginia Mason processes, a core HMC operating team and specialist clinicians from the two health systems mapped out each value stream on a wall for everyone to see. People from Providence and Tuality provided input on how the workflow would fit into each of the organizations. They highlighted differences in practice and explained why each was needed. The medical directors then agreed on which changes to test.

As the work progressed, the core operating team tested pieces of the value stream (including proposed variations), observed them in action, gleaned insights, and tried again—continually learning and sharing best practices. All changes to the existing workflow were tested in small experiments and then gradually scaled up—an approach that helped get buy-in from people in the health systems. Every week the core operating team met and used Post-it notes to document what had been accomplished and what hadn't, what could be done differently, and what barriers had been encountered. It typically took 10 to 14 weeks to design and test a clinical value stream and get it ready to be implemented more broadly. Value streams for administrative processes took three to five weeks.

In addition to serving as a tracking mechanism, the visual representation of the work was a team-building exercise. Everyone learned how to work together and how efforts were progressing across all players in the system.

8 Fix the business side

Administrative costs consume an enormous chunk of the money that goes to health care—more than 25% of U.S. hospitals' expenditures, according to a 2014 analysis by David Himmelstein and colleagues published in *Health Affairs*. So any serious effort to make health care more affordable has to tackle not only the



Two Approaches to Treating Back Pain

Evidence shows that most patients with uncomplicated lower back pain can be treated effectively with physical therapy. Yet most health care providers routinely require more-elaborate processes that waste time and money.

clinical side but also the business side. In addition, administrative processes such as booking appointments and billing have a significant impact on the patient experience.

The HMC used RIL to remove waste and non-value-adding activities from Providence's and Tuality's business operations, including billing, inventory management, checking in patients, processes for getting patients into rooms to be treated, and cleaning. As of March 2014, a total of 48 business processes had been improved at the two systems, generating an estimated $2.6 million in annual savings. Since then, both have continued their improvement efforts.

Understanding the Challenges

Naturally, the Healthcare Marketplace Collaborative encountered challenges. As the anchor of the initiative, Intel brought the group together, implemented RIL, and drove players to abide by the process. Sometimes people at the other member organizations resented being told what to do, so Intel had to be careful not to push too hard.

Persuading clinicians in the health care systems to accept standard clinical processes wasn't always easy. At Intel, if a manufacturing process was deemed an improvement or a best practice, it was documented and then implemented at all the company's factories. There were specific methods and procedures for putting new process steps in place. This was not the case at the health systems. Not all clinicians, even within a specialty, practiced the same way; standard protocols often hadn't been instituted. Some medical leaders of clinics and individual care providers didn't like being told what was best for their patients. The collaborative had to find a balance between allowing highly trained clinicians to use their judgment in unique cases and creating standard approaches for treating the vast majority of patients. In addition, the health systems differed in their willingness to make changes that would reduce office visits with a physician and, as a result, their reimbursements.

The medical directors on the HMC team played an instrumental role in overcoming such resistance. Launching value-stream efforts at Providence and Tuality clinics and then demonstrating the results also proved effective in getting people at other sites on board. Ultimately, embedding protocols proven to provide the best care in an electronic-medical-record system will help clinicians stick with them. Virginia Mason already does this. For example, its clinicians cannot order an MRI for lower back pain unless they identify a medical indication for it in the EMR system or phone a designated expert.

Persuading patients to abide by the new process also requires a concerted effort. For instance, the health systems couldn't force patients with uncomplicated back pain to go directly to a clinic and not see their primary care physicians first. Intel and the two state agencies understood this and used a number of means to publicize the streamlined services and encourage people to use them. Still, it takes time to change mindsets.

Sometimes the health systems lacked sufficient staff to implement a new value stream smoothly. For instance, staff turnover and difficulty lining up surgeons and radiologists explain why same-day access for the breast problems value stream was so low. Viewing those poor results as an improvement opportunity, Tuality decided to dedicate another surgeon to the breast problems value stream.

Another big challenge was getting data. In a number of cases, the health systems lacked the resources to track metrics; in others, it was difficult to track particular kinds of patients, such as unemployed Medicare patients. Cigna provided the cost data, but there was a frustrating lag of several months because the insurer had to wait for claims to be submitted, approved, and paid. In other industries, gathering cost data takes minutes or even seconds. (These slow data turns—the norm in the health care industry—are a major barrier to rapid improvements in clinical processes.) For some value streams, the HMC couldn't get meaningful cost data because it had such information only for Intel employees and the number treated by the new value stream was too small to draw statistically valid conclusions. Because of the challenges in getting useful data, it's wise to bring a data analysis engineer on board early in the development stage of a value stream.

Finally, agreeing on a uniform set of medical classification codes was difficult. More than 16,000 codes for diagnoses and procedures are used for billing and reimbursement in the United States. Back pain, for example, has many possible codes, and preferences may differ by provider. The medical directors ultimately decided to use the codes in Virginia Mason's handbooks to conduct cost analyses. But differences between the codes used for existing clinical processes and those used for the new ones made it difficult, if not impossible, to compare results. For the other metrics, the HMC did not use control groups to measure the degree of improvement. Instead, it created extremely ambitious goals and tried, where it could, to use them to gauge progress.

THE HEALTHCARE Marketplace Collaborative ended in June 2014, after the improvement process had been established at both health systems and Intel was no longer needed to drive the effort. While results of the HMC experiment were hardly perfect, and should be viewed as coming from a challenging work in progress rather than from an ideal end state, they proved that an employer can engage all the players in a market to accelerate health care reform. HMC's focus on patient-centered care produced solid cost savings and, more important, behavioral changes grounded in evidence-based medicine, measures, results, and patient satisfaction.

We encourage employers to take the lead in securing better health for local populations and lowering costs for employees and companies alike.

Intel is now applying elements of the HMC approach to purchasing health care services in Oregon and New Mexico and plans to do so elsewhere as well.

The Bree Collaborative, in Washington State, in which Bob Mecklenburg is involved, is taking the Portland approach to the next level. It incorporates goals and metrics like those used in Portland in employers' contracts with participating health systems, but it involves more employers and health systems, is tackling more-complicated conditions, and has created or is creating a standard bundle of all the services that patients with a given condition require through recovery. Each employer negotiates a fixed price for each bundle, which also includes a warranty against hospital readmissions for avoidable complications. The initiative has already created bundles for joint replacements and lumbar fusion and expects to complete one for coronary artery bypass grafting in the summer of 2015.

We encourage employers to use their purchasing power to drive the transformation of health care in their regions. That means taking the lead in securing better health for local populations, improving their experiences of care, and lowering costs for employees and companies. Employers should choose plans and providers on the basis of their willingness to join them in the effort. Ultimately, companies in such initiatives should report the results of health systems' efforts to make care better, faster, and more affordable and encourage employees to use the information to select providers.

We urge care providers to join collaboratives in their regions and develop business models in which better outcomes and lower costs translate into improved financial performance. Providers should build new skills to standardize clinical and business processes and strive to integrate all aspects of care, including behavioral or mental health and social services. They should learn to be transparent about prices and outcomes to help employees choose the best providers and to help employers teach their employees that more care is not necessarily better care.

Health plans should develop business models that allow them to succeed in an environment in which health care costs and premiums are decreasing. They should identify high-performing providers of care or those on a positive trajectory. They should make information on providers' prices and outcomes rapidly available to employers, employees, and their families in a useful form. They should lend their power and insight to efforts to change the payment system so that it is no longer an obstacle to improving outcomes and lowering costs.

In virtually all regions, at least some employers, providers, and health plans will be able to transcend narrow self-interest and cooperate to develop new business models that result in the best health outcomes for individuals at lowest cost. We enthusiastically invite them to join us on the journey.

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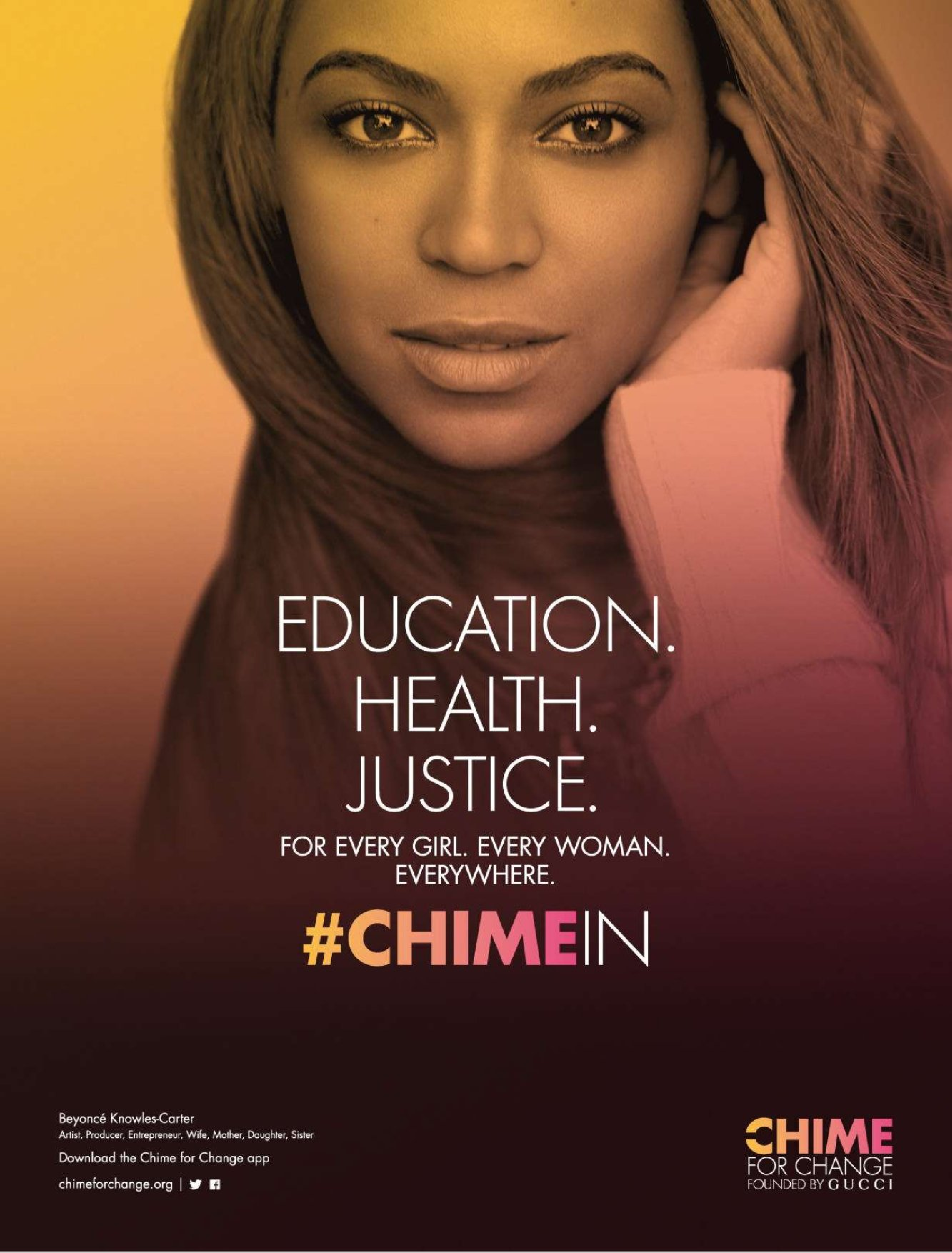
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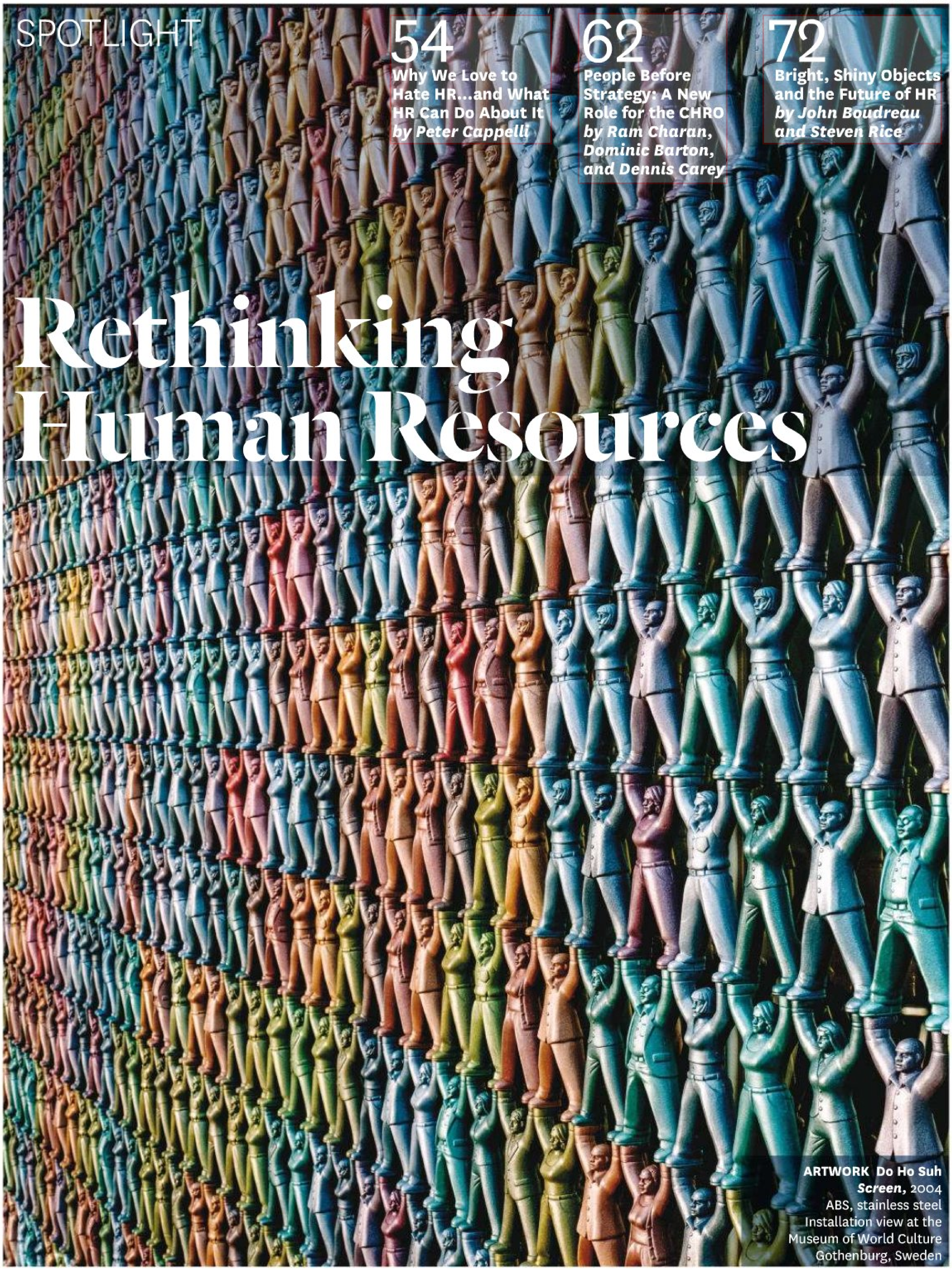
Rethinking Human Resources



ARTWORK **Do Ho Suh**
Screen, 2004
ABS, stainless steel
Installation view at the Museum of World Culture
Gothenburg, Sweden

SPOTLIGHT

ARTWORK Do Ho Suh, *Floor,* 1997–2000, PVC figures, glass plates, phenolic sheets, polyurethane resin; modules 100 x 100 x 8 cm
Installation view at Lehmann Maupin Gallery, New York

Why We Love to Hate HR ...and What HR Can Do About It

by Peter Cappelli

Peter Cappelli is a professor of management at the Wharton School and the author of several books, including *Will College Pay Off? A Guide to the Most Important Financial Decision You'll Ever Make* (PublicAffairs, 2015).

Recent complaints about the HR function have touched a nerve in a large, sympathetic audience, particularly in the United States. The most vocal critics say that HR managers focus too much on "administrivia" and lack vision and strategic insight.

These feelings aren't new. They've erupted now and in the past because we don't like being told how to behave—and no other group in organizational life, not even finance, bosses us around as systematically as HR does. We get defensive when we're instructed to change how we interact with people, especially those who report to us, because that goes right to the core of who we are. What's more, HR makes us perform tasks we dislike, such as documenting problems with employees. And it prevents us from doing what we want, such as hiring someone we "just know" is a good fit. Its directives affect every person in the organization, right up to the top, every single day.

The complaints also have a cyclical quality—they're driven largely by the business context. Usually when companies are struggling with labor issues, HR is seen as a valued leadership partner. When things are going more smoothly all around, managers tend to think, "What's HR *doing* for us, anyway?"

This doesn't mean that HR is above reproach. Quite the contrary: It has plenty of room to improve, and this is a moment of enormous opportunity. Little has been done in the past few decades to examine the value of widely used practices that are central to how companies operate. By separating the effective from the worthless, HR leaders can secure huge payoffs for their organizations. But it's important to understand HR's tumultuous history with business leaders and the economy before turning our attention to what the function should be doing now and in the future.

The "Personnel" Pendulum

How top executives feel about HR pretty reliably reflects what's going on in the U.S. economy. When the economy is down and the labor market is slack, they see HR as a nuisance. But sentiments change when labor tightens up and HR practices become essential to companies' immediate success.

Think back to the Great Depression. People would put up with nearly anything to stay employed. Line managers complained that personnel departments were getting in the way of better performance, which they thought could be achieved with the "drive" system: threatening workers and sometimes even hitting them if they failed to measure up.

Similarly, business leaders didn't put a lot of stock in HR during the 2001 and 2008 recessions, because employees—keenly aware of how replaceable they were—stayed put and more or less behaved themselves. Because companies had a large pool of job seekers to draw from, wages stayed flat and productivity rose. More employees were working harder for the sake of security. And that remains true in our "jobless recovery" from the latest financial crisis. Although 83% of people in a Salary.com survey said they would look for a new job in 2014, the number who are actually quitting has not yet spiked. So it's still easy for leaders to push back on all those annoying HR policies. They seem superfluous.

Consider, in contrast, times when labor wasn't so plentiful. In the 1920s—when the economy was booming, and keeping workers was both hard to do and crucial to business—personnel departments started to make supervisors treat their employees well. And after World War II, U.S. industry suffered a talent shortage unlike anything since. Many of the men (it was always men) who might have gone into business had fought instead. It didn't help matters that talent development had received little or no attention during the Depression. The postwar question "What happens if the boss gets hit by a bus?" pointed to a huge concern. About one-third of executives died in office—many of them from heart attacks—and no one was around to take their place. A lot of small companies went out of business, and many big ones had to be sold.

Idea in Brief

THE PROBLEM
When talent is in short supply, business leaders see HR as a valuable strategic partner. But when the labor market loosens up, HR suddenly seems like a nuisance, because we don't like being told how to behave—and we see no immediate benefit to complying.

THE OPPORTUNITY
Instead of sitting tight until the next market shift changes leaders' perception, HR managers should set the talent agenda now. They have the required perspective and expertise.

THE SOLUTION
HR managers can score big wins for their companies by rethinking programs that have been around since the 1950s, making a business case for the initiatives that matter, and cutting loose pet programs that lack impact.

In that leadership void, modern HR was born, ushering in practices such as coaching, developmental assignments, job rotation, 360-degree feedback, assessment centers, high-potential tracks, and succession plans. They sound routine now, but they were revolutionary then. And they arose from an urgent need to develop and retain talent in the 1950s.

In that "gray flannel suit" era, 90% of positions (and virtually all those in the top ranks) were filled from within—and 96% of large companies dedicated an entire department to planning for workforce needs. Those numbers reflect an intense commitment to development, which paid large dividends. HR was a powerful function, voted the most glamorous area in business by executives.

Things have changed quite a bit. Only a third or so of today's hires are internal. Companies engage executive search firms to fill most senior-level vacancies. One in four CEOs comes from the outside. And companies spend less time and effort than they used to mapping out the talent they'll need in the years to come: By the mid-2000s only a third were doing *any* planning in this area.

What happened? The economic slowdown of the 1970s practically eliminated labor shortages, and business leaders began dismantling those postwar programs designed to identify and develop good managers and workers. Corporations that held on to them, such as GE, were the exception. New companies, particularly in tech, could hire all the executives they needed when—thanks to layoffs and stalled advancement—people left the great organizations. Microsoft became the largest company in the world in terms of market capitalization, with virtually no investment in developing management skills. Others followed its example. As one CEO said to me at the time, "Why should I train people when my competitors are willing to do it for me?"

In the "gray flannel suit" era, 90% of positions were filled from within—and 96% of large companies had an entire department to do workforce planning.

Meanwhile, supervisors spent less and less time on their direct reports. They had too many people under them to manage everyone carefully, and other tasks were given higher priority. In his book *The Leadership Factor,* the Harvard Business School professor John Kotter reported on this phenomenon at a leading New York bank in the early 1980s. Junior managers complained that their people-management tasks were distracting them from their more important roles as individual contributors, so the bank's leaders allowed them to devote less energy to evaluation and coaching.

Thus employees weren't getting the investment and attention they needed to grow. Even HR's brief resurgence during the dot-com boom—corporate recruiters, rather than IT workers, had the hottest job in the United States then, according to the Bureau of Labor Statistics—was limited to hiring and retention.

At the same time, more and more tasks that had traditionally been performed by HR (from hiring to development to compensation decisions) were pushed onto line managers, on top of their other work. And that's been the case ever since. HR is now in the position of trying to get those beleaguered managers to follow procedures and practices without having any direct power over them. This is euphemistically called "managing with ambiguous authority," but to those on the receiving end, it feels like nagging and meddling.

I recently participated in a debate of HR leaders staged by Will Peachey, the head of HR transformation for Capgemini. He kicked it off with a provocative question: Is HR as a function doing more harm than good by prompting line managers to take their responsibilities as supervisors more seriously? The position that carried the day was that things would be much worse for employees without HR's involvement. But there was also a palpable sense that in many organizations HR is simply slapping bandages on problems that will persist until top executives make talent issues a clear priority for managers.

What HR Should Be Doing Now

As the economy continues to recover, businesses may very well wait for labor to become scarce again before looking to HR for meaningful support. But HR can speed things up by assuming the reins now. It has the expertise to help companies get ahead of the market shift that we should all see coming. Here are the basic but powerful steps HR leaders can take:

Set the agenda. Like any other function, HR must show why the issues it addresses matter to the business and that it has sensible ways to manage them. A few years ago the head of HR at a leading corporation—someone who had survived lots of restructurings—was asked about the key to his success. He said, "I do whatever the CEO wants." Though doing things the boss *doesn't* want is certainly a career-limiting strategy, too many HR managers wait to be told which issues to tackle. If a company starts a wellness program after the chief executive has a heart attack, or launches a women's initiative after his daughter takes a job in the business, you can be sure that the HR team is not leading the charge.

CEOs and other operating executives are rarely experts on workplace issues. They often have no relevant experience, now that fewer of them are coming up through training programs and rotational assignments in which they could have learned effective people-management practices from knowledgeable peers. So the HR team can show these executives what they should care about and why. That means articulating a point of view on every people-related topic relevant to the business. For instance:

- **Layoffs.** According to a report published near the beginning of the 2008 recession, only about a third of HR departments said they were consulted on company decisions about which people to let go. That's a stunning lack of influence in an area where HR has the most expertise of any function.
- **Recruiting.** HR understands that structured interviews help identify the best candidates. Yet many organizations allow managers with no training in interviewing to go with their gut in asking questions and deciding whom to hire—which increases the risk of litigation as well as the cost of poor hires.
- **Flexible work arrangements.** Line managers who want to retain control often resist flextime and working from home. But HR leaders know that these arrangements can be highly effective.
- **Performance management.** Forced ranking—imposed by top executives who thought supervisors weren't tough enough in their evaluations—was the rage about a decade ago. Now most companies

HR's Activities Closely Track the Labor Market

SOURCE BUREAU OF LABOR STATISTICS

(including GE, where the practice became famous) are stepping away from it as they realize what HR has long known: Supervisors need the training, the time, and the incentives to have serious conversations with subordinates about performance and growth.

HR should be in front of every one of these issues, saying, "Here's how we should be managing this task, and here's the evidence behind that view."

Focus on issues that matter in the here and now. Many U.S. businesses still follow the talent-management playbook written in the 1950s. For example, even though elaborate succession plans are rarely used, companies keep creating them. Instead of copying what large corporations did decades ago, HR should craft company-specific (and industry-specific) policies that respond to today's challenges.

If you're wondering why that's not obvious, think of the simmering debate within HR about whether it should be a profession like accounting, with universal practices. This view has been championed by the Society for Human Resource Management and driven by its very successful certification programs, which teach and then document knowledge in designing compensation systems and other specialties.

Detailed knowledge of practices is essential, but it's more important to understand *what works when and where.* For example, rather than just knowing how to put a broad-based stock option plan in place, one ought to understand its pluses and minuses in various circumstances. Such plans add volatility to compensation that can be difficult for the business to control, so they may not be the top choice in an economy that's already unstable or even one that's in recovery but subject to unpredictable swings. And they are effective only when employees feel that they have sufficient autonomy and authority to influence stock performance.

To appreciate the importance of context, consider what's happening in consulting and tech firms, where developing skills and human capital is crucial to success. PwC and Juniper Networks have already abandoned traditional performance appraisals—perhaps the most reviled standard practice in all of management—and moved toward a model of ongoing conversation designed to improve skills and results. (See "Bright, Shiny Objects and the Future of HR," on page 72.) Microsoft and Deloitte are moving in a similar direction. Concerned about retaining key talent, Deloitte broke up the traditional promotion ladder, providing a more open and flexible framework for career advancement that accommodates both employee interests and changing business demands. (See "Reinventing Performance Management," HBR, April 2015.) And Infosys, in India, has figured out how to use the classroom to deliver the kind of contextual knowledge people previously assumed had to be

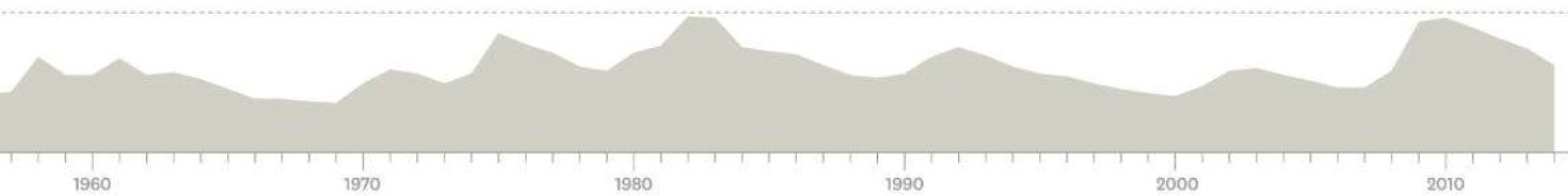
1970s
As the economy slowed, labor was once again plentiful. Business leaders started undoing all those postwar programs designed to attract and develop talent.

EARLY 1980s
The U.S. went into a deep recession, and workers clung to their jobs. Rather than invest in HR, companies pushed hiring and development tasks onto line managers, who had neither the time nor the training to do them properly.

LATE 1990s
During the dot-com boom, companies competed fiercely for "employer of choice" status to meet their soaring talent needs. So HR enjoyed a brief heyday, focusing primarily on hiring and retention.

2001
When the dot-com bubble burst and the economy tanked, business leaders felt little urgency to attract talent. Productivity rose, wages stayed flat, and HR lost the influence it had enjoyed during the boom.

2015
With the effects of the Great Recession of 2008 still lingering, most people with jobs aren't jumping ship yet, so executives feel no urgent need for HR programs. HR must make a case for them.



acquired on the job. The company teaches managers how to do business in other cultures and in particular industries—for instance, how to tailor their IT services to chemical companies in Germany.

All this is a matter of looking more closely at the environment in which the organization operates. It's about continually identifying new challenges and designing tools to meet them.

Acquire business knowledge. HR has (and should have) deep knowledge about workplace issues. But it should also bring first-rate analytic minds into the function to help companies make sense of all their employee data and get the most from their human capital.

In a recent survey by Deloitte, HR leaders said they felt least prepared in the area of analytics—but some are doing exciting work on that front. Not surprisingly, Microsoft and Google mine their own data to predict good hires, and IBM uses its enormous employee database to create project teams more effectively. But companies outside the tech sector, too, are bringing analytics into HR. Cigna uses sophisticated data to minimize its own health care costs and identify its best performers. Managers of Cornerstone OnDemand (formerly Evolv) and other providers of call center software are parsing simple jobs in a hundred ways to predict and then improve performance.

In many businesses, CIOs and their teams are the ones wrestling with big data to solve classic HR problems, such as how to find the best candidates and which practices increase productivity. If HR is to set the agenda on people management, it must either staff up to handle those analyses itself or partner with people in the company who can do the work. Otherwise, the answers to fundamental HR questions will come from elsewhere in the business, and HR might as well pack it in.

Highlight financial benefits. During the tight labor market of the late 1990s, an HBR article described how the HR team at Sears, Roebuck had demonstrated that improved employee attitudes led to a better customer experience and, in turn, to higher store profits. (See "Employee-Customer-Profit Chain at Sears," January–February 1998.) Few HR departments since have felt compelled to make the case that any of their practices could drive profits. Many don't calculate ROI, even though other functions have been expected to do so for at least a generation. That just feeds into business leaders' view of HR as a cost center where the goal is always to cut, cut, cut.

Why HR Is Still Hot Everywhere but in the U.S.

Back in the 1950s, HR controlled the promotions and career of every manager at every level. For precisely that reason, William H. Whyte wrote in *The Organization Man,* it was the most glamorous job in business. The only other time that was true in the United States was in the late 1990s, when the labor market tightened up again and companies vied to become the "employer of choice."

HR hasn't fallen out of favor in other countries, however. In Japan it is still the preferred track to the C-suite. And in India, my studies with colleagues suggest, it's arguably the most powerful of all the functions. Indeed, across Southeast Asia, top executives are investing in the training and development of employees and more-sophisticated systems, especially for hiring. Even in Europe, which has a talent glut, HR appears to be growing in influence as companies recognize the importance of organizational culture, knowledge management, and so forth. The U.S. is the outlier.

The main reason HR is more vital elsewhere is that organizational power goes to the group that deals with the biggest problems—an idea dating back at least to the great economist Alfred Marshall. Businesses in the rest of the world have to deal with aggressive government regulation of the workplace, strong unions, political support for workers' interests, and often a real shortage of people who can even be trained for key jobs. Among developed countries the U.S. has the most favorable environment for employers—and the least incentive to make changes.

Ideology plays a role as well, though. The leaders who ran U.S. corporations after World War II had broad training in and appreciation for management and used a governance model based on balancing the interests of stakeholders, who included employees. Those leaders have been replaced by people disproportionately from financial backgrounds, whose model of governance—maximizing shareholder value—awards no special role to the interests of employees.

No doubt most HR departments were initially caught off guard by questions about whether practices such as expat and rotational assignments actually pay off. The information they gathered tended to focus on individual outcomes, such as job satisfaction; they didn't feel equipped to estimate financial returns. But that excuse no longer holds. The enterprise resource planning systems of most organizations contain copious data on turnover, productivity, and other factors that suggest which talent development programs merit investment.

Take IBM's recent decision to retrain IT consultants whose skills were obsolete. The company said it would provide on-site training during working hours one day a week for anyone who wanted to participate, but employees would share the costs by forgoing pay for the days they participated. With that requirement baked in, it was relatively easy to make a financial case for offering the program: The savings in hiring would be more than twice the costs of the training.

Quantifying costs and benefits in this way turns talent decisions into *business* decisions.

Walk away from the time wasters. HR invests heavily in many programs that lack impact. Consider the current preoccupation with generational differences. There's little compelling evidence that they even exist: Young employees today appear to be remarkably like young employees decades ago, and they've always been a challenge to older managers. Their supervisors aren't having any unusual problems with them now. Nevertheless, many HR departments spend a lot of energy worrying about how Millennials want to work. Given all the other things to worry about, it shouldn't be a priority to learn how to manage one subset of subordinates differently. Everyone wrestles with engagement and satisfaction; Millennials aren't alone in that. But even if they *were* unique in their preferences, HR couldn't make managers tailor the supervision of them—it doesn't have the authority.

The same is true for diversity programs. Employment law prohibits diversity mandates in hiring and promotion practices, so companies try to change line managers' attitudes and priorities instead. But such efforts are effective only if top executives lead them, transforming the culture. Otherwise HR is just a cheerleader for an initiative it can neither enforce nor measure; its leaders will end up pleading with line managers to take on yet another set of tasks, burning up more social capital in the process.

Companies seldom have long-term plans with straightforward talent requirements. Instead they generate projects and initiatives to address successive needs.

The Way Forward

One of traditional HR's biggest difficulties has been supporting business strategy, because it's such a moving target these days. Companies seldom have long-term plans with straightforward talent requirements. Instead they generate streams of projects and initiatives to address successive needs.

But HR is by nature a long-term play. Developing talent, heading off problems with regulations and turnover, building corporate culture, and addressing morale problems all take time. Often, leadership teams and priorities change before such initiatives have paid off. And when companies don't meet their performance goals for the quarter, those programs are among the first to go.

How can HR bring the long view back into organizations? By reconciling it with the immediate pressures that businesses face, which those one-at-a-time projects are designed to address. Even when company leaders say, "We will do this without our own employees, by outsourcing or engaging contractors," HR folks should be involved, because they're best able to assess whether those engagements will succeed. (After all, outsourcing is just paying to use another company's human capital and becoming reliant on it.) But meanwhile, HR should also keep stepping back to study those initiatives in the aggregate: What emerging needs do they point to? How do those needs map to the organization's talent pipeline and practices? Which capabilities need shoring up? How are things likely to change in the marketplace, and what will be needed then? Why don't we have the ability to handle those tasks internally? That's the kind of analytic counsel the "new HR" should provide. Then its job is to help organizations act on the insights.

Consider the recent decision at Comcast to bring world-class IT capabilities in-house, which will allow the company to develop its own software for managing and delivering online entertainment. The HR challenge there is clear: attracting and retaining the best talent in Philadelphia, which is not known as an IT center. But with HR's guidance, the company is addressing that in creative ways, such as building and supporting an IT start-up community and targeting IT students and recent graduates raised in Philadelphia for internships and jobs. This big bet on the future rests on HR's ability to pull all that off.

Tech companies such as Google, Microsoft, and Apple are now on the front lines of HR innovation, largely because they have an acute need for specialized talent. Human capital is practically their only major asset; talent is in short supply; and competitors are eager to lure employees away. There's been some creative HR thinking in financial services as well, to predict and ward off unethical behavior. JPMorgan, for instance, is using an algorithm to identify employees who are likely to break the rules.

No crisis or scandal is necessary for HR to transform its practices, though. Nor should the function focus solely on innovations in hiring. Discretionary effort—by employees who are engaged and willing to give their best—is at the heart of organizational success, and managing and developing people is the way to drive and sustain that effort. So the time is ripe for reimagining human capital much more broadly. Business leaders will see that—if HR makes a compelling, evidence-based case for what matters, and jettisons what doesn't.

HBR Reprint R1507C

SPOTLIGHT

ARTWORK Do Ho Suh, *Cause and Effect*, 2009
Acrylic, stainless steel, aluminum frame
Installed at HITE Collection, Seoul

People Before Strategy:

A New Role for the CHRO

by Ram Charan, Dominic Barton, and Dennis Carey

CEOS KNOW THAT they depend on their company's human resources to achieve success. Businesses don't create value; people do. But if you peel back the layers at the vast majority of companies, you find CEOs who are distanced from and often dissatisfied with their chief human resources officers (CHROs) and the HR function in general. Research by McKinsey and the Conference Board consistently finds that CEOs worldwide see human capital as a top challenge, and they rank HR as only the eighth or ninth most important function in a company. That has to change.

It's time for HR to make the same leap that the finance function has made in recent decades and become a true partner to the CEO. Just as the CFO helps the CEO lead the business by raising and allocating financial resources, the CHRO should help the CEO by building and assigning talent, especially key people, and working to unleash the organization's energy. Managing human capital must be accorded the same priority that managing financial capital came to have in the 1980s, when the era of the "super CFO" and serious competitive restructuring began.

CEOs might complain that their CHROs are too bogged down in administrative tasks or that they don't understand the business. But let's be clear: It is up to the CEO to elevate HR and to bridge any gaps that prevent the CHRO from becoming a strategic partner. After all, it was CEOs who boosted the finance function beyond simple accounting. They were also responsible for creating the marketing function from what had been strictly sales.

Elevating HR requires totally redefining the work content of the chief human resources officer—in essence, forging a new contract with this leader—and adopting a new mechanism we call the G3—a core group comprising the CEO, the CFO, and the CHRO. The result will be a CHRO who is as much a value adder as the CFO. Rather than being seen as a supporting player brought in to implement decisions that have already been made, the CHRO will have a central part in corporate decision making and will be properly prepared for that role.

These changes will drive important shifts in career paths for HR executives—and for other leaders across the company. Moreover, the business will benefit from better management of not just its financial resources but also its human ones. We say this with confidence, based on our experience with companies such as General Electric, BlackRock, Tata Communications, and Marsh, all of which act on their commitment to the people side of their businesses.

The CEO's New Contract with the CHRO

A CFO's job is partly defined by the investment community, the board, outside auditors, and regulators. Not so for the CHRO role—that's defined solely by the CEO. The chief executive must have a clear view of the tremendous contribution the CHRO could be making and spell out those expectations in clear, specific language. Putting things in writing ensures that the CEO and CHRO have a shared understanding of appropriate actions and desirable outputs.

To start redefining the job, the CEO should confer with his or her team and key board members, particularly the board's compensation committee (more aptly called the talent and compensation committee), and ask what they expect in an ideal CHRO. Beyond handling the usual HR responsibilities—overseeing employee satisfaction, workforce engagement, benefits and compensation, diversity, and the like—what should an exemplary CHRO do?

Here are three activities we think are critical: predicting outcomes, diagnosing problems, and prescribing actions on the people side that will add value to the business. Some of these things may seem like the usual charter for a CHRO, but they are largely missing in practice, to the disappointment of most CEOs.

Predicting outcomes. CEOs and CFOs normally put together a three-year plan and a one-year budget. The CHRO should be able to assess the chances of meeting the business goals using his knowledge of the people side. How likely is it, for example, that a key group or leader will make timely changes in tune with rapid shifts in the external environment, or that team members will be able to coordinate their efforts? CHROs should raise such questions and offer their views.

Because a company's performance depends largely on the fit between people and jobs, the CHRO can be of enormous help by crystallizing what a particular job requires and realistically assessing whether the assigned person meets those requirements. Jobs that are high leverage require extra attention. Many HR processes tend to treat all employees the same way, but in our observation, 2% of the people in a business drive 98% of the impact. Although coaching can be helpful, particularly when it focuses on one or two things that are preventing individuals from reaching their potential, it has its limits. Nothing overcomes a poor fit. A wide gap between a leader's talents and the job requirements creates problems for the leader, her boss, her peers, and her reports. So before severe damage is done, the CHRO should take the initiative to identify gaps in behavior or skills, especially among those 2% and as job requirements change.

The CHRO, with the CFO, should also consider whether the key performance indicators, talent assignments, and budgets are the right ones to deliver desired outcomes. If necessary, the pair should develop new metrics. Financial information is the most common basis for incentivizing and assessing performance, because it is easy to measure, but the CHRO can propose alternatives. People should be paid according to how much value they contribute to the company—some combination of the importance of the job and how they handle it. Finance and HR should work together to define ahead of time the value that is expected, using qualitative as well as quantitative factors. Imagine the leaders of those functions discussing a business unit manager and triangulating with the CEO and the group executive to better understand what the manager needs to do to outperform the competition in the heat of battle. For example, to move faster into digitization, will he have to reconstitute the team or reallocate funds? Predicting success means weighing how

Idea in Brief

THE PROBLEM
CEOs consistently rank human capital as a top challenge, but they typically undervalue their chief human resources officer and view HR as less important than other functions.

THE SOLUTION
The chief human resources officer must become a true strategic partner to the CEO.

THE APPROACH
The CEO must rewrite the CHRO's job description and create a core decision-making body comprising the CEO, CFO, and CHRO.

well-attuned the manager is to outside pressures and opportunities, how resilient he would be if the economy went south, and how quickly he could scale up into digitization. The specific metrics would be designed accordingly.

As another example, a top marketing manager might have to build capability for using predictive data in advertising. The CFO and CHRO should recognize that if the manager fails to steep herself in the fundamentals of data analytics and is slow to hire people with that expertise, new competitors could come in and destroy value for the company. Metrics should reflect how quickly the marketing head acts to reorient her department. One set of metrics would focus on the recruiting plan: What steps must the marketing manager take by when? These become milestones to be met at particular points in time. Another set of metrics might focus on budget allocations: Once the new people are hired and assimilated, is the manager reallocating the marketing budget? And is that money in fact helping to increase revenue, margins, market share in selected segments, or brand recognition? Such improvements are measurable, though with a time lag.

The CHRO should also be able to make meaningful predictions about the competition. Just as every army general learns about his counterpart on the enemy side, the CHRO should be armed with information about competitors and how their key decision makers and executors stack up against those at the CHRO's organization. Predictions should include the likely impact of any changes related to human resources at rival companies—such as modifications to their incentive systems, an increase in turnover, or new expertise they are hiring—and what those changes might signify about their market moves. In 2014, for instance, Apple began to hire medical technology people—an early warning sign that it might make a heavy push to use its watch and perhaps other Apple devices for medical purposes. Such activity could have implications for a health care business, a medical device manufacturer, or a clinic. Similarly, a competitor's organizational restructuring and reassignment of leaders might indicate a sharper focus on product lines that could give your company a tougher run.

Intelligence about competitors is often available through headhunters, the press, employees hired from other companies, suppliers, or customers' customers. Even anecdotal information, such as "The marketing VP is a numbers guy, not a people guy," or "She's a cost cutter and can't grow the business," or "The head of their new division comes from a high-growth company," can improve the power of prediction. For example, Motorola might have been able to anticipate the iPhone if the company's CHRO had alerted the CEO when Apple began trying to recruit Motorola's technical people.

The CHRO should make comparisons unit by unit, team by team, and leader by leader, looking not only at established competitors but also at nontraditional ones that could enter the market. Is the person who was promoted to run hair care at X company more experienced and higher-energy than our new division head? Does the development team in charge of wireless sensors at Y company collaborate better than we do? The answers to such questions will help predict outcomes that will show up as numbers on a financial statement sometime in the future.

Diagnosing problems. The CHRO is in a position to pinpoint precisely why an organization might not be performing well or meeting its goals. CEOs must learn to seek such analysis from their CHROs instead of defaulting to consultants.

The CHRO should work with the CEO and CFO to examine the causes of misses, because most problems are people problems. The idea is to look beyond obvious external factors, such as falling interest rates or shifting currency valuations, and to link the numbers with insights into the company's social system—how people work together. A correct diagnosis will suggest the right remedy and avoid any knee-jerk replacements of people who made good decisions but were dealt a bad hand.

If the economy slumped and performance lagged compared to the previous year, the question should be, How did the leader react? Did he get caught like a deer in the headlights or go on the offensive? How fast did he move, relative to the competition and the external change? This is where the CHRO can help make the critical distinction between a leader's misstep and any fundamental unsuitability for the job. Here too the CHRO will learn new things about the leader, such as how resilient he is—information that will be useful in considering future assignments.

But focusing on individual leaders is only half the equation. The CHRO should also be expert at diagnosing how the various parts of the social system are working, systematically looking for activities that are causing bottlenecks or unnecessary friction. When one CEO was reviewing the numbers for an important product line, he saw a decline in market share and profits for the third year in a row. The medical diagnostic product that the group was counting on to reverse the trend was still not ready to launch. As he and his CHRO dug in, they discovered that the marketing team in Milwaukee and the R&D team in France had not agreed on the specifications. On the spot, they arranged a series of face-to-face meetings to resolve the disconnect.

There is great value in having the CHRO diagnose problems and put issues on the table, but such openness is often missing. Behaviors such as withholding information, failing to express disagreement but refusing to take action, and undermining peers often go unnoticed. Some CEOs look the other way rather than tackle conflicts among their direct reports, draining energy and making the whole organization indecisive. Take, for example, problems that arise when collaboration across silos doesn't happen. In such situations, no amount of cost cutting, budget shifting, or admonition will stem the deterioration. Thus CHROs who bring dysfunctional relationships to the surface are worth their weight in gold.

At the same time, the CHRO should watch for employees who are energy creators and develop them. Whether or not they are directly charged with producing results, these are the people who get to the heart of issues, reframe ideas, create informal bonds that encourage collaboration, and in general make the organization healthier and more productive. They may be the hidden power behind the group's value creation.

Prescribing actions to add value. Agile companies know they must move capital to where the opportunities are and not succumb to the all-too-typical imperatives of budgeting inertia ("You get the same funding as last year, plus or minus 5%"). When McKinsey looked at capital allocation patterns in more than 1,600 U.S. companies over 15 years, it found that aggressive reallocators—companies that shifted more than 56% of capital across businesses during that time—had 30% higher total shareholder returns than companies that shifted far less.

Companies should be similarly flexible with their human capital, and CHROs should be prepared to recommend actions that will unlock or create value. These might include recognizing someone's hidden talent and adding that individual to the list of high potentials, moving someone from one position to another to ignite growth in a new market, or bringing in someone from the outside to develop capability in a new technology. Although capital reallocation is important, the reassignment of people along with capital reallocation is what really boosts companies.

Responding to the external environment today sometimes requires leaders with capabilities that weren't previously cultivated, such as knowledge of algorithms, or psychological comfort with digitization and rapid change. The company might have such talent buried at low levels. To have impact, those individuals might need to be lifted three organizational levels at once rather than moved incrementally up existing career ladders. The CHRO should be searching for people who could be future value creators and then thinking imaginatively about how to release their talent. Judging people must be a special skill of the CHRO, just as the CFO has a knack for making inferences from numbers.

Dow Chemical found that aggressively hiring entrepreneurial millennials was the fastest way to create more "short-cycle innovation" alongside the company's traditional long-cycle R&D processes. The share of employees under age 30 went from 9% in 2004 to 15% in 2014. To benefit from this new talent, the company also revamped its career paths to move the 20- and 30-somethings into bigger jobs relatively quickly, and it invited them to global leadership meetings relatively early.

Another way to unlock value is to recommend mechanisms to help an individual bridge a gap or enhance her capacity. These might include moving her to a different job, establishing a council to advise her, or assigning someone to help shore up a particular skill. For example, to build the technology expertise of the small start-ups he funded, the famed venture capitalist John Doerr used his huge relationship network to connect the people running those businesses with top scientists at Bell Labs. In the same vein, CHROs could make better use of their networks with other CHROs to connect people with others who could build their capacity.

The CHRO might also recommend splitting a division into subgroups to unleash growth and develop more P&L leaders. He might suggest particular skills to look for when hiring a leader to run a country unit or big division. Other prescriptions might focus on improving the social engine—the quality of relationships, the level of trust and collaboration, and decisiveness. The CHRO could, for instance, work with business divisions to conduct reviews once a month rather than annually, because reducing the time lag between actions and feedback increases motivation and improves operations.

What not to do. In addition to spelling out clearly what is expected in the way of making predictions, diagnosing problems, and prescribing beneficial actions, the CHRO's new contract should define what she is *not* required to do. This helps provide focus and free time so that she can engage at a higher level. For example, the transactional and administrative work of HR, including managing benefits, could be cordoned off and reassigned, as some companies have begun to do. One option is to give those responsibilities to the CFO. At Netflix, traditional HR processes and routines are organized under the finance function, while HR serves only as a talent scout and coach (see the "Further Reading" list). Another model we see emerging is to create a shared service function that combines the back-office activities of HR, finance, and IT. This function may or may not report to the CFO.

Compensation has traditionally been the purview of CHROs, but it may be hard for them to appreciate the specific issues business leaders face, just as it is hard for the CFO to understand the nuances of

Companies should be flexible with their human capital, and CHROs should recommend actions that will unlock or create value. The reassignment of people along with capital reallocation is what really boosts companies.

the social engine. Because compensation has such an enormous impact on behavior and on the speed and agility of the corporation, the best solution is for the CEO and CFO to also get involved. While the CHRO can be the lead dog, compensation decisions should be made jointly by the three—and, given the increasingly active role of institutional investors, with the board's engagement.

The CHRO's fit. With a new contract in hand, the chief executive should assess how well the CHRO meets the job specifications now and where he needs to be in three years. Most CHROs have come up through the HR pipeline. While some have had line jobs, most have not; Korn Ferry research indicates that only 40 of the CHROs at *Fortune* 100 companies had significant work experience outside HR before they came to lead that function. This might leave a gap in terms of predicting, diagnosing, and prescribing actions that will improve business performance. However, inclusion in broader discussions will expand a CHRO's understanding of the business. CEOs should give their CHRO a chance to grow into the newly defined role, and they should assess progress quarter by quarter.

Measuring the performance of the CHRO has long been problematic. HR leaders are usually judged on accomplishments such as installing a new process under budget, recruiting a targeted number of people from the right places, or improving retention or employee engagement. Yet such efforts are not directly tied to value creation. In keeping with recasting HR as a value creator rather than a cost center, performance should be measured by outputs that are more closely linked to revenue, profit margin, brand recognition, or market share. And the closer the linkage, the better.

A CHRO can add value by, for example, moving a key person from one boss to another and improving his performance; arranging for coaching that strengthens a crucial skill; bringing a person from the outside into a pivotal position; putting two or three people together to create a new business or initiative to grow the top or bottom line; reassigning a division manager because she will not be able to meet the challenge two years out; or discovering and smoothing friction where collaboration is required. Such actions are observable, verifiable, and closely related to the company's performance and numbers.

Here's a case in point: When a promising young leader was put in charge of three divisions of a large company, replacing an executive vice president with long tenure, the divisions took off. The new EVP, who was growth-oriented and digitally savvy, seized on commonalities among the three businesses in technology and production and nearly halved the product development cycle time. In three years the divisions overtook the competition to become number one.

Creating a G3

To make the CHRO a true partner, the CEO should create a triumvirate at the top of the corporation that includes both the CFO and the CHRO. Forming such a team is the single best way to link financial numbers with the people who produce them. It also signals to the organization that you are lifting HR into the inner sanctum and that the CHRO's contribution will be analogous to the CFO's. Although some companies may want the CHRO to be part of an expanded group that includes, say, a chief technology officer or chief risk officer, the G3, as we call it, is the core group that should steer the company, and it should meet apart from everyone else. The G3 will shape the destiny of the business by looking forward and at the big picture while others bury their heads in operations, and it will ensure that the company stays on the rails by homing in on any problems in execution. It is the G3 that makes the connection between the organization and business results.

At Marsh, a global leader in insurance brokerage and risk management, CEO Peter Zaffino often has one-on-one discussions with his CFO, Courtney Leimkuhler, and his CHRO, Mary Anne Elliott. In April 2015 he held a meeting with both of them to assess the alignment of the organization with desired business outcomes. The G3 began this meeting by selecting a business in the portfolio and drawing a vertical line down the middle of a blank page on a flip chart. The right side was for the business performance (Leimkuhler's expertise); the left side for organizational design issues (Elliott's expertise). A horizontal line created boxes for the answers to two simple questions: What is going well? What is not going well?

"Peter could have filled in the entire two-by-two chart on his own," Elliott says, "but doing it together really added value." Zaffino adds, "The whole meeting took about 15 minutes. We found the exercise to be very worthwhile. We already run the business with disciplined processes. We conduct deep dives into the organization's financial performance through quarterly operational reviews, and we conduct quarterly talent reviews, where we focus on the human capital side. So you might not think we'd

The CEO should create a triumvirate at the top of the corporation that includes both the CFO and the CHRO. Forming such a team is the single best way to link financial numbers with the people who produce them.

want to introduce another process to evaluate how we are managing the business. But this G3 process provided us with a terrific lens into the business without adding bureaucracy."

Working together to synthesize disparate data points into one flip chart helped the team identify items on the organizational side that would predict business performance in the next four to eight quarters. Significant value came from the dialogue as connections emerged naturally. Zaffino says, "We constantly drill down deep to understand why a business is performing the way it is. In those instances, we are drilling vertically, not horizontally, when there could be some items identified on the organizational side that are actually driving the performance." Zaffino cited the implementation of a new sales plan, which HR was working on, as one example. His concern was making sure business results were aligned with remuneration "so we didn't have sales compensation becoming disconnected from the overall financial result of the business," he explains. "We also didn't want to drive top-line growth without knowing how to invest back in the business and increase profitability." The CHRO was thinking it through from her perspective: Is this sales plan motivating the right behaviors so that it moves business performance to the "going well" category?

Seeing the interconnections also helped the trio identify what mattered most. "It's easy enough to list everything we want to do better," Leimkuhler says, "but it's hard to know where to start. When you understand which things on the organizational side are really advancing business performance, it makes it easier to prioritize." For example, managing the transition of regional business leaders was a big issue for HR—one that, because of its difficulty, would have been easy to push off. Seeing the extent to which inaction could be holding back business performance created a greater sense of urgency.

"In the HR world, we talk about understanding and integrating with the business," Elliott notes. "G3 meetings are a pragmatic activity. When you're sitting with the CEO and CFO, there's no place for academic HR. It's all about understanding what the organization needs to do to drive business performance and how to align those key variables."

"There's something to be said for peeling off into a smaller group," Leimkuhler adds. "It would be unwieldy to have this discussion with the full executive committee, which at Marsh consists of 10 executives. In any case, it's not one or the other; it's additive." Says Zaffino, "This was a streamlined way to get a holistic view of the business. Each of us left the first G3 meeting feeling comfortable that the organization and the business were aligned and that we have a very good handle on the business."

Vinod Kumar, CEO of Tata Communications, also uses an informal G3 mechanism. Kumar's company supplies communication, computing, and collaboration infrastructure to large global companies, including many telephone and mobile operators. In 2012 there were price drops of 15% to 20%, and disruptive technologies were par for the course. To keep pace, Tata Communications had to transform its business very quickly, which meant building critical new capabilities by hiring from the outside, at least in the short term—an effort that would hardly help the company deal with rising costs. Something had to give, and Kumar enlisted then-CFO Sanjay Baweja and CHRO Aadesh Goyal to help chart a path forward while taking into account both financial and talent considerations.

Frequent discussions among the G3 led to a consensus: Tata Communications would restructure roles that had become redundant or were out of sync with the company's new direction, and it would move jobs to the right geographical locations. These actions would reduce staffing costs by 7%. The company would use the savings to build the necessary capabilities, mainly by making new hires, especially in sales, marketing, and technology.

The G3 next went to work on changes that would occur over a longer time. Tata Communications launched a companywide program in late 2013 aimed at continuously improving productivity. The initial objective was to reduce the cost base by $100 million, but the overall intention was to seed a new culture. The G3 began by creating a cross-functional team that employees joined part-time. Ultimately more than 500 people participated, working on ideas in 50 categories and achieving even more cost reductions than originally targeted. In short, the project was a big success, and it continues to produce results.

Dialogue—both institutionalized and informal—between the CHRO, the CFO, and the CEO is now a way of life at Tata Communications. In time, as CHRO Goyal's grasp of the business became evident, Kumar made a bold move: He gave Goyal the additional responsibility of managing one of the

FURTHER READING

For more innovative thinking about the human resources function, see these articles at **HBR.org**.

"Building a Game-Changing Talent Strategy"
Douglas A. Ready, Linda A. Hill, and Robert J. Thomas

"How Netflix Reinvented HR"
Patty McCord

"It's Time to Split HR"
Ram Charan

company's high-growth subsidiaries and made him part of the Innovation Council, which identifies opportunities to invest in and incubate new businesses.

Regular G3 Meetings

If a G3 is to be effective, the CEO has to ensure that the triumvirate meets on a regular basis.

Weekly temperature taking. The CEO, CFO, and CHRO should get together once a week to discuss any early warning signals they are picking up internally or externally about the condition of the social engine. Each of them will see things through a different lens, and pooling their thoughts will yield a more accurate picture. The three don't have to be together physically—they can arrange a conference call or video chat—but meeting frequently is important. After about six weeks, and with discipline, such sessions could be finished in 15 to 20 minutes.

The CEO has to set the tone for these reviews, ensuring that the discussion is balanced and that intellectual honesty and integrity are absolute. It's a given that both the CFO and the CHRO must be politically neutral to build trust, and they must never sacrifice their integrity to be the CEO's henchmen. They must be willing to speak up and tell it like it is. Over time, each G3 member will have a better understanding of the others' cognitive lenses, discussions will be more fluid, and all three will learn a lot about the intricacies of the business. They will also become more comfortable correcting one another's biases, more skilled at reading people, and more likely to get the right people in the right jobs.

Looking forward monthly. The G3 should spend a couple of hours every month looking four and eight quarters ahead with these questions in mind: What people issues would prevent us from meeting our goals? Is there a problem with an individual? With collaboration? Is a senior team member unable to see how the competition is moving? Is somebody likely to leave us?

Companies do operational reviews, which are backward-looking, at least quarterly. The objective here is to be predictive and diagnostic, looking forward not just at the numbers but also at the people side, because most failures and missed opportunities are people-related. There may be organizational issues, energy drains, or conflicts among silos, particularly in the top two layers. Conflicts are inherent in matrix organizations; the G3 needs to know where they exist, whether they could affect progress on a new initiative, and how the leaders in charge are handling them. Probing such matters is not micromanagement or a witch hunt. It's a means of finding the real causes of both good and poor performance and taking corrective action promptly or preemptively.

Planning three years out. It is common practice to plan where the company needs to be in three years and to decide what new projects to fund and where to invest capital. Often missing from that process is exploration of the people questions: Will we have employees with the right skills, training, and temperament to achieve the targets? Will our people have the flexibility to adapt to changing circumstances? In most strategic planning, there is zero consideration of the critical players in the organization—or those working for competitors.

Discussion of people should come before discussion of strategy. (This is a practice that General Electric is known for.) What are employees' capabilities, what help might they need, and are they the very best? The CEO and the CHRO of one company decided that for every high-leverage position that opened, they should have five candidates—three from inside, two from outside. Talent should always be viewed in a broad context. Consider who is excelling, being let go, or being lured away, along with any other information that could affect your competitiveness or your rivals'.

New HR Leadership Channels

Some CEOs might be holding back on elevating their CHROs because they lack confidence in the HR leader's business judgment and people acumen. There's a fear that HR chiefs aren't prepared to discuss issues beyond hiring, firing, payroll, benefits, and the like. That reservation must be met head-on by providing rich opportunities for CHROs to learn. Give them more exposure to the business side through meetings of the G3, and provide some coaching. If knowledge or skills gaps persist, ask the CHRO how she might fill them. Some CHROs will rise to the occasion. Others won't measure up, and the supply of suitable replacements might be scarce at first. (The same issue applied in the 1980s to finding the right CFO types from the ranks of accounting.)

An enduring solution is to create new career paths for HR leaders to cultivate business smarts and for business leaders to cultivate people smarts. Every entry-level leader, whether in HR or some other job, should get rigorous training in judging, recruiting, and coaching people. And those who begin their careers in HR leadership should go through rigorous training in business analysis, along the lines of what McKinsey requires for all its new recruits. There should be no straight-line leadership promotions up the functional HR silo. Aspiring CHROs should have line jobs along the way, where they have to manage people and budgets.

All leaders headed for top jobs should alternate between positions in HR and in the rest of the business. Make it a requirement for people in the top three layers of the company to have successfully worked as an HR leader, and the function will soon become a talent magnet. Be sure that it isn't just ticket punching. Those who have no feel for the people side are unlikely to succeed for long in high-level jobs.

The Transition to the New HR

Any CEO who is sold on the idea that people are the ultimate source of sustainable competitive differentiation must take the rejuvenation and elevation of the HR function very seriously. Creating a mechanism that knits the CFO and the CHRO together will improve the business and expand the CEO's personal capability. It won't happen overnight—three years seems to us the minimum time required to achieve a shift of this magnitude. Stating the new expectations for the CHRO and the human resources function is a good place to begin. Creating ways to blend business and people acumen should follow. And redesigning career tracks and talent reviews will take the company further still. But none of this will happen unless the CEO personally embraces the challenge, makes a three-year commitment, and starts executing.

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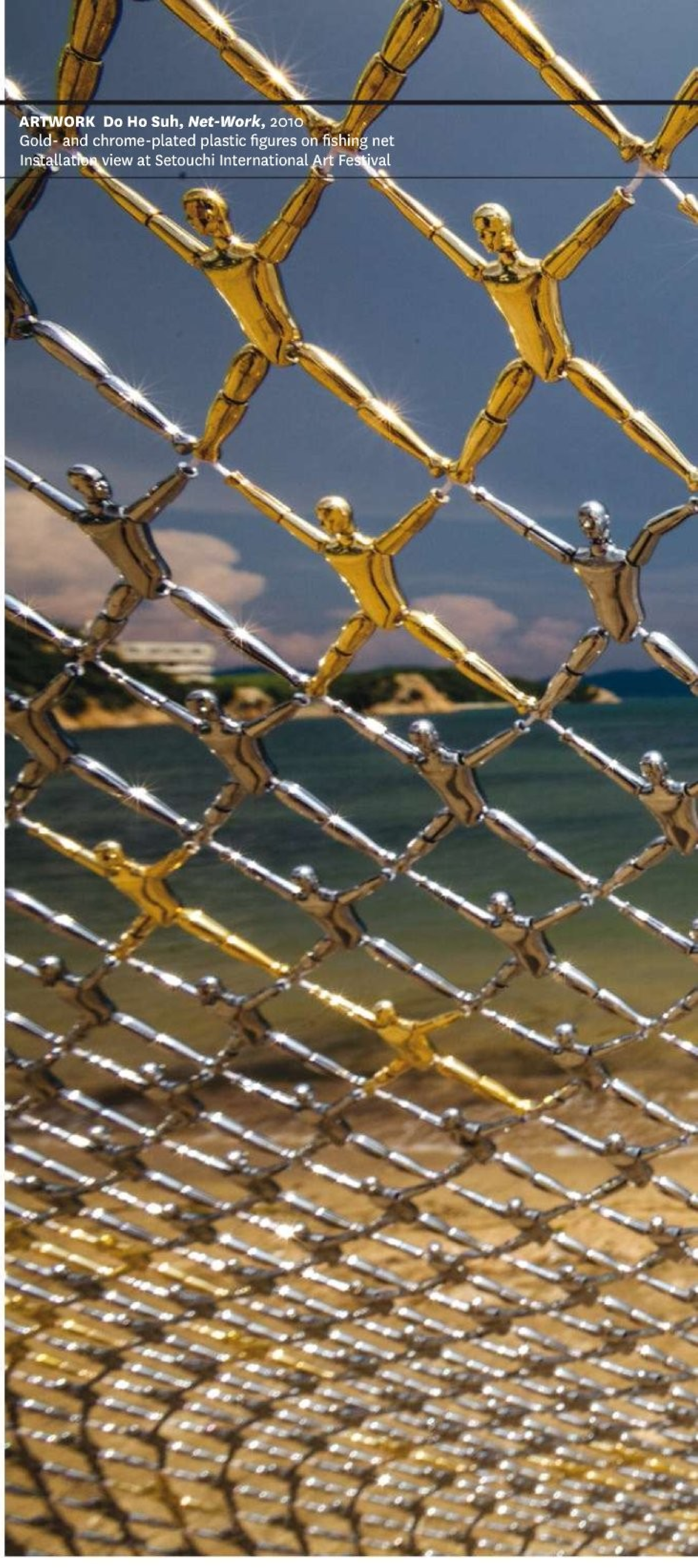
SUSAN CAMILLERI KONAR

"And I'm proud to say that we've adopted not only a paperless environment but a peopleless one too."

SPOTLIGHT



ARTWORK Do Ho Suh, *Net-Work*, 2010
Gold- and chrome-plated plastic figures on fishing net
Installation view at Setouchi International Art Festival

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Bright, Shiny Objects and the Future of HR

How Juniper Networks tests and integrates the most valuable new approaches

by John Boudreau and Steven Rice

MANY OF US have had the experience of listening to a talk and suddenly making a connection between the speaker's big idea and a challenge we face at work. To listen to David Rock, of the NeuroLeadership Institute, for example, is to have one's eyes opened to recent neuroscience research. One discovery Rock shares is that when people realize they are being compared with others, a "threat response" in their brains sends cortisol levels skyrocketing and makes it hard for them to take in other information. If you oversee your company's annual performance review process and it centers on the delivery of a single number derived from a stack-ranking exercise, this insight could be a lightbulb going on.

Or maybe you're listening to Rob Cross, of the University of Virginia, revealing that your company runs according to a hidden structure that looks nothing like its official org chart. Informal networks matter much more than hierarchies. Whatever the source, you find yourself doing what so many HR leaders have done before. You grab that bright, shiny object and take it home, in the form of pages of excitedly scrawled notes and an intense resolve to get your team working on it.

Is this a bad thing? We're inclined to say that the opposite reaction—sitting with arms crossed, impervious to any provocative ideas—would be far worse. But such enthusiasm does present challenges. Applying any big new idea will change how some aspect of HR is managed, and that aspect is connected to all the others in a larger system.

In this article we will describe how Juniper Networks, a Silicon Valley–based innovator of high-performance networking technology, tackles those challenges. Over the past six years the company's HR team has adopted an approach whereby it can tap into the latest research and thinking and apply it in unexpected contexts. It's a loose, four-part process, which we'll outline below. But first we want to share a valuable lesson we've learned about cultivating such constant evolution and innovation. Before Juniper could figure out which solutions were right—much less how to apply them—it had to adopt a certain mindset.

To reinvent its business strategy and grow, Juniper would have to innovate. So HR needed to figure out how its initiatives and activities could yield a talent pool that was better prepared and empowered to do so.

Fall in Love with the Problem, Not the Solution

As leaders, we have ready access to potentially powerful, game-changing ideas. It's easy—and tempting—to chase after a new practice, a new expert, or new research that seems to provide some relief or a solution to a problem. What's harder, but far more valuable, is to fall in love with the problem. Then you aren't quite so eager to embrace the first possible solution and move on. You spend some time letting the challenge soak in, studying it from various angles, and understanding it more deeply. Rather than hastening to narrow the scope of your decision and the options under consideration, you remain receptive to additional, possibly better ones. For example, Juniper's David Rock moment didn't end with a workshop or a separate initiative. Brain science fueled the company's understanding of an important problem—one tied to values and talent.

In 2009 Juniper's top managers had called for a renewed focus on values and culture as a differentiator. They sought advice from Ann Rhoades, who had done much work along these lines at Southwest Airlines and then at JetBlue. (She later wrote about her work with Juniper in *Built on Values: Creating an Enviable Culture That Outperforms the Competition.*) One outgrowth of that effort was a program of "trio tours"—a total of 75 sessions with three senior executives at various company locations to connect with local talent in thoughtful discussions of Juniper's culture.

During one session in Bangalore, a young engineer decided to speak his mind. The topic he put on the table was the company's use of forced performance rankings. He felt that it was demoralizing and effectively pitted colleagues against one another in a zero-sum game. How did that jibe with Juniper's espoused values of authenticity and trust? How did it support a culture of innovation? Unquestionably, his bluntness was challenging. But he raised a problem worth digging into: How *should* a company do performance management if it really believes in its talent and wants to raise everyone's game? And why would a company that seeks to differentiate itself

Idea in Brief

THE CHALLENGE
HR leaders tend to reach for the shiny objects of their trade—cool new research and insights about talent management and leadership. How can they choose the best of these and then integrate them into coherent systems?

THE EXEMPLAR
Juniper Networks' resolve to be "different by design" has four basic elements. Its HR team works to understand the big picture of the business, seize on the most valuable ideas, apply them in context, and manage their impact.

THE LESSON
Any business that competes on innovation knows the value of talent—and should have an HR function that can keep its edge.

through talent use the same performance evaluation tool everyone else does?

This was the problem Juniper was considering when neuroscience started to edge its way into the business world. Rock's research clarified why forced rankings were undermining the desired culture of trust, collaboration, and risk taking. It provided another angle for exploring the complexities of culture, values, and talent systems.

In 2011 Juniper became one of the first global companies to abolish forced rankings. Rather than spreading people across a bell curve, it now seeks simply to have what it calls Best Talent. It has replaced annual reviews with frequent "conversation days" for the purpose of discussing areas for improvement, goals, and career aspirations. Today more than 97% of its employees are considered Best Talent, and Juniper's talent management efforts focus on putting the right capabilities in the right places to achieve its business goals. The Bangalore engineer was absolutely right, but his insight required more than a rush to a solution. The problem had to be viewed differently.

Juniper's leaders avoid knee-jerk reactions and instead hold out for bigger ideas and underlying principles. They home in on what's *pivotal*—where change will have the greatest impact. They hired Chris Ernst, David Gonzalez, and Courtney Harrison, of the Center for Creative Leadership, and built an HR team committed to radically rethinking HR. The team's members collectively immerse themselves in challenges—even those that don't appear to be HR problems or that seem too big to solve.

Falling in love with the problem rather than the solution makes it possible to avoid shiny-object syndrome, unconnected programs, and random HR innovation. Within that overall mindset, we believe, the right approach consists of a four-part process.

Get the Big Picture

How do HR leaders decide which few, pivotal solutions to adopt and then successfully integrate them into the organization? First, they need a reliable way to discern the big picture—the conditions and business imperatives that create the context for their choices.

Six years ago that big picture was coming into focus at Juniper after something of an identity crisis. As a start-up, the company had revolutionized the computer network industry with the M40 router, which played an essential role in scaling the internet to where it is today. Juniper grew rapidly, expanded its offerings, and was flush with success. Even so, it struggled with being "stuck in the middle"—tiny in comparison with its closest competitor, but bigger and more diversified than the single-solution niche players. It couldn't compete with a rival that was able to throw 10 times as much money, time, and personnel at any problem. And unlike the smaller companies, Juniper had already banked on offering end-to-end solutions. To reinvent its business strategy and grow, it would have to innovate. So HR needed to figure out how its initiatives and activities could yield a talent pool that was better prepared and empowered to do so. That meant innovation within the function as well.

A great example is the initiative Juniper undertook a few years later to refresh its understanding of the big picture. It sounded like madness to some at the time, but the HR team resolved to have one-on-one conversations with every senior leader of the company (a total of 150 executives), including the chairman, and with

100 other managers around the world. The conversations would include questions such as What are the key external environmental challenges currently facing Juniper? How are they affecting you and your team specifically? What excites you most about Juniper's business strategy and its execution? What concerns you most? Of course, the risk was that HR would hear about a lot of people issues for which it had no ready solutions.

Uncomfortable truths did surface. Juniper had too many silos and too many priorities. It was top-heavy and conflict avoidant. It made the work overly complex where it should have been operating more interdependently to provide solutions for customers.

That initiative paid off in ways that go well beyond leadership development and performance management. The findings inspired Juniper to rip out business units, break down P&Ls, and integrate in ways it had never done before. Now it has the simplest operating model in its history. Across the company, six people can get together and make any decision. Product lines have been streamlined too. Previously, for instance, numerous resources were tied to multiple routers, switches, and security products. Now a common resource strategy spans the product road map, saving the company millions of dollars and untold headaches.

2 Spot the Valuable Insight

Deep understanding of the business allows HR leaders to pursue the second part of the process: Seek out—and take in—the latest and greatest management ideas and connect them to what is pivotal in the organization. Tying together values, performance assessment, and neuroscience is one example in Juniper's experience. Another is improving customer service by analyzing an organizational network—and this effort put HR directly into the operations of the business.

A series of communication problems with a key customer had resulted in missteps and quality concerns. The obvious, traditional solution might have been to focus on the salespeople who met the customer. Instead the HR team reflected on an intriguing line of research: the idea that organizations are networks, not just hierarchies and business units. That exposed the problem as a lack of sufficient collaboration across units and functions. It wouldn't be effective to encourage everyone in the organization to be slightly more collaborative; collaboration had to be seriously enhanced in the few spots where it would make a crucial difference.

Rob Cross was recruited to conduct an organizational network analysis. He and the HR team began by looking for employees who were involved in any way with the customer account. They spoke with a few dozen key people and identified 344 such employees. "Impossible," said the EVP sponsoring the project. "There cannot be 344 people working on a single account."

So the team did a formal network analysis, after which it told the executive he was partly right: The account didn't have 344 people working on it—it had *920*. In other words, almost 10% of Juniper's employees had some involvement in getting the job done well for that big customer. It's no wonder that lines were getting crossed. The network analysis brought hard (albeit uncomfortable) evidence to support an observation often made by Juniper's founder, Pradeep Sindhu: "Silos rob networks of their inherent value."

Since then Juniper has learned to think about natural organizational networks as crucial components of how it works. But it's what the company does with a network analysis that makes a difference. Later, for example, with a different account team, it went beyond simply describing the informal network to learning how to optimize it. HR served as an embedded adviser to the account team, conducting weekly sessions to systematically apply the network analysis findings and concepts in team planning, development, and information sharing. The team began to operate across the internal network, bringing in expertise faster, clarifying decision rights, and eliminating power or information bottlenecks. The account relationship went from being closely held by a few to involving open communication among functions and levels in both organizations. The customer is now Juniper's largest in the Europe, Middle East, and Africa region, delivering 135% of expected revenue in 2014 and with stellar customer service results.

This sounds like a story in which a new idea was spotted and introduced to an organization. Its more subtle lesson is that although a new concept may be broadly useful, it will get the most traction if you think beyond its obvious appeal. Understand the research. Look at the evidence. Then dig more. You'll better see how to translate the idea to your context.

Apply with Care

Next comes sensitively integrating the insight with other initiatives already under way. Most important here is that major HR innovations must be *purpose built.* Juniper has explicitly moved away from a "best practice" approach. Instead it strips a promising practice down to its kernel of insight and then expands that insight into work experiences that are right for the company's unique climate, brand, and business objectives. This allows and requires the application to have impact *in connection* with other components, leading to a greater payoff.

Prototyping the application of an idea in some fertile area of the organization is a valuable way of working out the necessary synergies. It also offers proof of concept through experience. You can't just tell people about a great idea and expect them to pick it up and run with it; they need to see and experience its value. HR plays a big part in creating such experiences. One example of how Juniper put its own stamp on a research idea lies in the area of boundary-spanning leadership.

Rooted in research from the Center for Creative Leadership, the concept of boundary spanning—which reframes common barriers (horizontal, vertical, stakeholder, demographic, geographic) as places for opportunity and innovation—was introduced at Juniper by Chris Ernst. However, the ability to lead and collaborate across boundaries doesn't come naturally in today's siloed and internally competitive organizations.

To more deeply explore the implications of boundary spanning, Juniper decided to bring together 85 people from engineering, sales, and operations who had differing roles, levels, locations, and backgrounds. The focal point for the gathering was a Juniper Innovation Challenge: The participants would spend three days collaborating in San Francisco with the explicit goal of hatching new product ideas. But the company had another agenda, which it made no attempt to hide: These people would be immersed in an experience that might reveal how boundary-spanning leadership connects to the problem Juniper loves most—the need for breakthrough innovation.

That purpose-built network and energizing experience changed the thinking of a small cross-section of Juniper employees about their ability to innovate. Out of it came a product that was prototyped within six months and is today being tested in production environments in more than half a dozen large companies. Of course not every HR initiative or project will lead to a clear and tangible business win *and* a proof-of-concept experience. But that Innovation Challenge showed how valuable it is to put early applications of a new idea in service to already recognized priorities and try them out on a manageable scale that will generate learning quickly.

Ultimately, the broader dissemination of any concept will call for integration. The amalgam of ideas to which you commit must have integrity as a system, with no elements working at cross-purposes and everything guided by the same sensibility and vision. If the ideas you've introduced are well integrated, you'll know—because they will begin to connect and amplify one another in unforeseen ways.

When Rami Rahim was named CEO, late in 2014, he set the expectation in his first 30 days that the Juniper Way (the company's values and related behaviors) would return to the front seat. The concepts of informal networks and boundary spanning had already taken hold, so rather than relaunching the Juniper Way top-down, the company turned to a subset of "connectors"—informal influencers—who'd been discovered through organizational network analysis. Rahim asked them to work together to redefine the values in simple language and in terms of observable behaviors and then develop that understanding across the company. HR's collection of applied ideas revealed itself in that moment as a well-integrated system.

Aim for Business Impact

The similarity of HR metrics between organizations with very different strategies is amazing—especially when you consider how powerfully the choice of what to measure can drive behaviors. In our view, if you intentionally rethink your HR function, you will also need to rethink how you measure progress and impact.

In all its measurement efforts, HR must ensure that it keeps people's focus on what is most pivotal for the business. Assessing pivotal impact is a critical step toward further progress. Measurement becomes a forward-looking learning and improvement process rather than a backward-looking declaration of triumph or failure. Metrics and signals along the way tell you what's working and what isn't, where to recalibrate or ask more questions. You need the mindset—and the stomach—for experimentation, revision, and occasional missteps.

If your new initiatives are well applied, they may suggest and enable important new metrics. For example, after Juniper's network and boundary-spanning efforts had identified the nearly 5% of employees who operate as connectors, the company had the basis for an important new metric: Those people are flagged on the dashboard, so any attrition in the group will spark an investigation of the cause.

Understanding progress may also mean looking at available data through a different lens. Pay attention to business measures such as time-to-revenue of new products, cycle times, product introductions, and quality metrics. Factor them into your talent processes, compensation systems, or learning objectives—and interpret them through your big themes or pivot points. At Juniper, the level of participation in the 401(k) plan can be seen as a proxy for how people feel about the company—an indicator of culture and values. For HR, the fact that 87% of employees now participate in the plan—one of the highest participation rates among high-tech companies—is a signal that people are committed to future growth and believe that they and their colleagues can make it happen.

The precise ROI of an important new idea in HR is impossible to measure. That doesn't mean that HR can't make its case, or that you can't observe the idea's impact. You can map the logical connections between an effective HR initiative and desired business outcomes. Focus on what can be measured along that path, and extrapolate where you can't measure precisely. That's exactly what every other management discipline does.

Juniper has undergone significant changes and challenges—including three CEOs in three years. In 2014 it sent out an employee survey designed around three key questions: Do you know our strategy? Do you understand your role in executing that strategy? Do you feel inspired and accountable to help the company achieve it? None of those questions got even 50% affirmative responses, so the company created a road show for executives to share the granular details of its strategy with teams around the world. Then the connectors were empowered to engage their peers in small-group strategy conversations across the company. Four months after the initial survey, the results of a second survey put all three indicators above 80%.

Different by Design

Developing a reputation as an innovative HR organization requires walking a fine line. You are not an R&D facility or a university; you do not employ a large cadre of social science researchers and data scientists. Your ideas for innovation will often arise from popular talks and articles. Embrace too many of those, however, or apply them too superficially, and you'll develop a reputation for fad surfing. Dig beneath the surface to the fundamental scientific research and insights, and you can set the stage for true impact.

Failing to innovate is not an option, so it's important to have a specific approach for responsibly bringing new ideas to the organization. Juniper's method—getting the big picture, seizing on insights, applying them wisely, and ensuring their impact—may be useful to you. It has enabled this company to move from one-off programs and unconnected experiments to a system that is always evolving in exciting and consistently business-aligned ways.

There's nothing wrong with being attracted to the bright, shiny objects of a thriving thought leadership industry. They offer new solutions and, at the least, inspire you to revisit your assumptions. The key is to maintain your long-term love affair with the problems you need to solve and the business you are here to serve. You'll know you've struck the right balance when your HR programs start to look less and less like your competitors' and contribute more and more to your competitive distinction—when every year makes you more different by design.

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Data-Driven HR: The CHRO Challenge

Today's business environment confronts executives with a demand for rapid-fire decisions. Talent needs can change from quarter to quarter, and the market for knowledge workers is hypercompetitive. As the global markets expand, the ability to get the right people in the right place at the right time can give companies a competitive advantage.

All of these pressures are reshaping the expectations that the Chief HR Officer (CHRO) become a key player in business strategy. CEOs want HR to make, execute, and measure the success of talent management based on business outcomes and make fast, accurate workforce planning a strategic asset.

But new research by Harvard Business Review Analytic Services found a large gap between what CEOs want from the CHRO and the analytic capabilities needed to deliver it. Only a third of the companies surveyed said their CHROs use an accurate and complete view of workforce costs to evaluate decisions or use analytics to manage and predict workforce needs.

That lag is caused both by expectations and lack of skills, the survey found. Business leaders are split over HR's role: Many CHROs are still charged with focusing on the traditional management benefits, compensation, and compliance. Lack of analytical skills is a major obstacle. And the survey found that while most executives said they want strategic, data-driven, and analytical HR, many admit their companies have done nothing to give CHROs the right tools and skills. Less than 30 percent of those companies surveyed had allocated HR budget for analytics software/solutions.

These deficiencies can be costly. Even a small error in predicting workforce needs can lead to overstaffing, cost overruns, and then layoffs, or leave a company far short of the talent it needs to seize market opportunities.

Visier is the innovation leader in Workforce Intelligence, providing cloud solutions that enable CHROs and the teams they lead to maximize their business outcomes through their people. A growing number of the world's best brands are using Visier solutions to:

- Shape their workforce to meet business priorities
- Hire, develop, and retain more top performers for critical roles
- Connect talent and financial requirements
- See, predict, and optimize all their workforce costs

78% of business executives agree that a CHRO should be able to talk about human capital in business terms.

69% of business executives want CHROs to use analytics when making workforce decisions.

33% of companies currently use analytics to make real-time decisions and predictions about their workforce.

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BREAKTHROUGH PRODUCT
Designed for the rough roads and lower incomes of the developing world, this wheelchair is generating buzz in the United States.

Amos Winter is the Robert N. Noyce Career Development Assistant Professor and the director of the Global Engineering and Research Laboratory in the department of mechanical engineering at the Massachusetts Institute of Technology.

Vijay Govindarajan is the Coxe Distinguished Professor at Tuck School of Business at Dartmouth and a Marvin Bower Fellow at Harvard Business School. He is the lead author of *Reverse Innovation* (Harvard Business Review Press, 2012).

BRUCE PETERSON

engineering reverse innovations

Principles for creating successful products for emerging markets

by Amos Winter and Vijay Govindarajan

SLOWLY BUT STEADILY, IT'S DAWNING ON WESTERN MULTINATIONALS THAT IT MAY BE A GOOD IDEA TO DESIGN PRODUCTS AND SERVICES IN DEVELOPING ECONOMIES AND, AFTER ADDING SOME GLOBAL TWEAKS, EXPORT THEM TO DEVELOPED COUNTRIES.

This process, called "reverse innovation" because it's the opposite of the traditional approach of creating products for advanced economies first, allows companies to enjoy the best of both worlds. It was first described six years ago in an HBR article cowritten by one of the authors of this article, Vijay Govindarajan. (See "How GE Is Disrupting Itself," October 2009.)

But despite the inexorable logic of reverse innovation, only a few multinationals—notably Coca-Cola, GE, Harmon, Microsoft, Nestlé, PepsiCo, Procter & Gamble, Renault, and Levi Strauss—have succeeded in crafting products in emerging markets and selling them worldwide. Even emerging giants—such as Jain Irrigation, Mahindra & Mahindra, and the Tata Group—have found it tough to create offerings that catch on in both kinds of markets.

For three years now we've been studying this challenge, analyzing more than 35 reverse innovation projects started by multinationals. Our research suggests that the problem stems from a failure to grasp the unique economic, social, and technical contexts of emerging markets. At most Western companies, product developers, who spend a lifetime creating offerings for people similar to themselves, lack a visceral understanding of emerging market consumers, whose spending habits, use of technologies, and perceptions of status are very different. Executives have trouble figuring out how to overcome the constraints of emerging markets—or take advantage of the freedoms they offer. Unable to find the way forward, they tend to fall into one or more mental traps that prevent them from successfully developing reverse innovations.

Our study also shows that executives can avoid these traps by adhering to certain design principles, which together provide a road map for reverse innovation. We distilled them partly from our work with multinationals and partly from the firsthand experiences of a team of MIT engineers led by this article's other author, Amos Winter. His team spent six years designing an off-road wheelchair for people in developing countries, which is now manufactured in

Idea in Brief

THE PROBLEM
Multinational companies are starting to realize that developing new products in and for emerging markets will allow them to outperform local rivals and undercut them on price—and even disrupt Western markets. However, most struggle to create those products and then sell them in the developed world.

THE ANALYSIS
A three-year study suggests that Western companies often fail to grasp the economic, social, and technical contexts of emerging markets. Most Western product engineers find it tough to overcome these markets' constraints and leverage their flexibility. They tend to fall into one or more traps that thwart their innovation efforts.

THE TAKEAWAYS
Companies can avoid these traps if they:
1 Define the problem independent of solutions.
2 Create the optimal solution using the design flexibility available.
3 Understand the technical landscape behind the problem.
4 Test products with as many stakeholders as possible.
5 Use constraints to create global winners.

India. Called the Leveraged Freedom Chair (LFC), it is 80% faster and 40% more efficient to propel than a conventional wheelchair, and it sells for approximately $250—on par with other developing world wheelchairs. The technologies that generate its high performance and low cost have been incorporated into a Western version, the GRIT Freedom Chair, which was modified with consumer feedback and sells in the United States for $3,295—less than half the price of competing products.

As we will show in the following pages, the reverse innovation process succeeds when engineering creatively intersects with strategy. Companies can capture business opportunities only when they design appropriate products or services and understand the business case for them. That's why it took two academics—one teaching mechanical engineering, and the other strategy—to come up with the principles that must guide the creation of reverse innovations.

Five Traps—and How to Avoid Them

For every product, multinational companies typically produce three variations: a top-of-the-line offering, which provides the best performance at a premium price; a "better" version, which delivers 80% of that performance at 80% of the price; and a "good" variant, which provides 70% and costs 70% as much. To break into emerging markets, where consumers have very high expectations but much smaller pocketbooks, multinationals usually follow a design philosophy that minimizes the up-front risks: They value-engineer the "good" product, watering it down to a "fair" one that offers 50% of the performance at 50% of the price.

This rarely works. In developing countries, not only do "fair" (or "good enough") products prove too expensive for the middle class, but the upmarket consumers—who can afford them—will prefer the top-of-the-line versions. Meanwhile, because of economies of scale and the globalization of supply chains, local companies are now bringing out high-value products, at relatively cheap prices, more quickly than they used to. Consequently, most multinationals capture only small slivers of the local market.

To win over consumers in developing countries, multinationals' products and services must match or beat the performance of existing ones but at a lower cost. In other words, they must provide 100% of the performance at 10% of the price, as product developers wryly put it. Only through the creation of such disruptive products and technologies can companies both outperform local rivals and undercut them on price. But the traps we mentioned earlier prevent companies from meeting this challenge. To escape those traps, they must follow five design principles.

TRAP 1: Trying to match market segments to existing products. Current offerings and processes cast a long shadow when multinationals start creating products for developing countries. At first it appears to be quicker, cheaper, and less risky to adapt an existing product than to develop one from scratch. The idea that time-tested products, with modifications, won't appeal to lower-income customers is difficult to digest. Designers struggle to get away from existing technologies.

The U.S. tractor-manufacturer John Deere, a seasoned global player, encountered this problem in India. There Deere initially sold tractors it had carefully modified for emerging markets. But its small tractors had a wide turning radius, because they had been designed for America's large farms. Indian holdings are very small and close to one another, so farmers there prefer tractors that can make narrow turns. Only after John Deere designed ab initio a tractor for the local market did it taste success in India.

DESIGN PRINCIPLE 1: Define the problem independent of solutions. Casting off preconceived solutions before you set down to define problems will help your company avoid the first trap—and spot opportunities outside its existing product portfolio. Consider the problem of irrigating farms in emerging markets. Farmers will argue for the expansion of the power grid so that they can use electricity to run water pumps and irrigate fields. However, farmers need water, not electricity, and the real requirement is getting water to crops—not power to pumps. If they isolate the problem, engineers may find that creating ponds near fields or using solar-powered pumps is more cost-effective and environmentally appropriate than expanding the power grid.

When defining problems, executives must keep their eyes and ears open for behavior that may signal needs that customers haven't articulated. In 2002, Commonwealth Telecommunications Organisation researchers reported that in East Africa, people were transferring airtime to family and friends in villages, who were then using or reselling it. Doing so allowed workers in cities to get money to people back home without making long and unsafe journeys with large amounts of cash. It indicated a latent demand for money remittance services. That's how M-Pesa, the successful mobile money-transfer service, was born.

It's good to study the global market in-depth before kicking off the design process. For example, when the MIT team analyzed the wheelchair market, it learned that of the 40 million people with disabilities who didn't have wheelchairs, 70% lived in rural areas where rough roads and muddy paths were often the only links to education, employment, markets, and the community. Environmental conditions were harsh; traditional wheelchairs broke down quickly as a result and were difficult to repair. Because of their poverty, most people got wheelchairs free or at subsidized prices from NGOs, religious organizations, or government agencies. Those suppliers were willing to pay \$250 to \$350 for a wheelchair—an important price constraint.

No wheelchair user specified the mobility solution he or she desired; the team had to figure out the needs of the market by watching and listening. For inspiration, it drew on the numerous complaints it heard: Wheelchairs were tough to push on village roads; manually powered tricycles were too big to use indoors; imported wheelchairs couldn't be repaired in villages; the commute to an office was often more than a mile, so it was tiring. And so on.

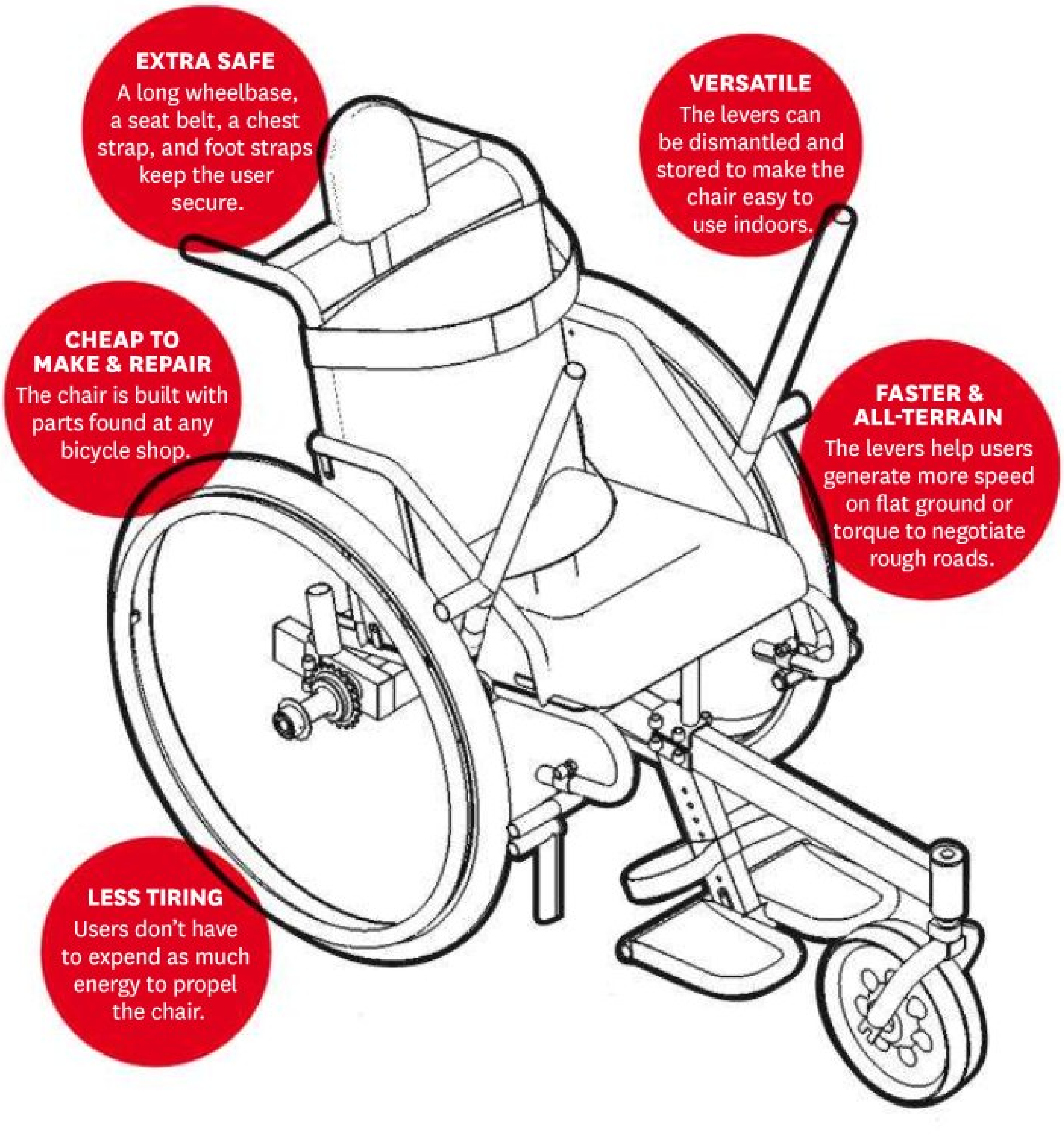
The team's assessment of consumer needs generated four core design requirements:

1. A price of approximately \$250
2. A travel range of three miles a day over varied terrain
3. Indoor usability and maneuverability
4. Easy, low-cost maintenance and local repair

Those criteria conveyed little about what form the wheelchair would have to take. However, had the team missed one of them, imposed an existing solution, or made its own assumptions, it probably would have failed.

TRAP 2: Trying to reduce the price by eliminating features. Many multinationals think this is the way to make products affordable for consumers in emerging markets. People in developing countries are willing to accept lower quality and products based on sunset technologies, runs the argument.

Key Advantages of the LEVERAGED FREEDOM CHAIR



GRIT/ASME DEMAND

This approach often leads to poor decisions and bad product designs.

For example, when one of the Big Three automobile makers decided to enter India in the mid-1990s, it charged its product developers in Detroit with coming up with a suitable model. The designers took an existing midprice car and eliminated what they felt were unnecessary features for India, including power windows in the rear doors. The new model's price was within the reach of Indians at the top of the pyramid—who hire chauffeurs. Thus the chauffeurs got power windows up front while the owners had to hand-crank the rear windows, greatly reducing customer satisfaction.

DESIGN PRINCIPLE 2: Create an optimal solution, not a watered-down one, using the design freedoms available in emerging markets. Though emerging markets have many constraints, they offer intrinsic design freedoms as well. These freedoms take various forms: In Egypt high irradiance makes solar power attractive in areas with unreliable power; in India low labor costs and high material costs make manual fabrication cost-effective. Even behavioral differences broaden companies' options: Some African consumers prioritize the purchase of TV sets over roofs, suggesting that companies must appeal to users' wants as well as their needs.

Carefully considering design freedoms helped the MIT team achieve many objectives. For instance, wheelchairs that use a mechanical system of multiple gears, just as geared bicycles do, were available in the developing world, but they were very expensive, and few could afford them. Compelled to devise an alternative, the engineers homed in on people's ability to make a broad range of arm movements as something they could use in the drivetrain to make the chair go faster or slower. While that ability isn't specific to emerging markets, the engineers wouldn't have thought of using it if they weren't trying to achieve high performance at a low price—a requirement specific to emerging markets.

The MIT team designed the LFC with two long levers that are pushed to propel the chair; users change speed by shifting the position of their hands on the levers. To go up a hill, users grab high on the levers and gain more leverage; in "low gear" the levers provide 50% more torque than pushing the rims of the chair does. On a flat road, they grab low and push through a larger angle to move faster, generating speeds that are 75% faster than a standard wheelchair's. To brake, users pull back on the levers.

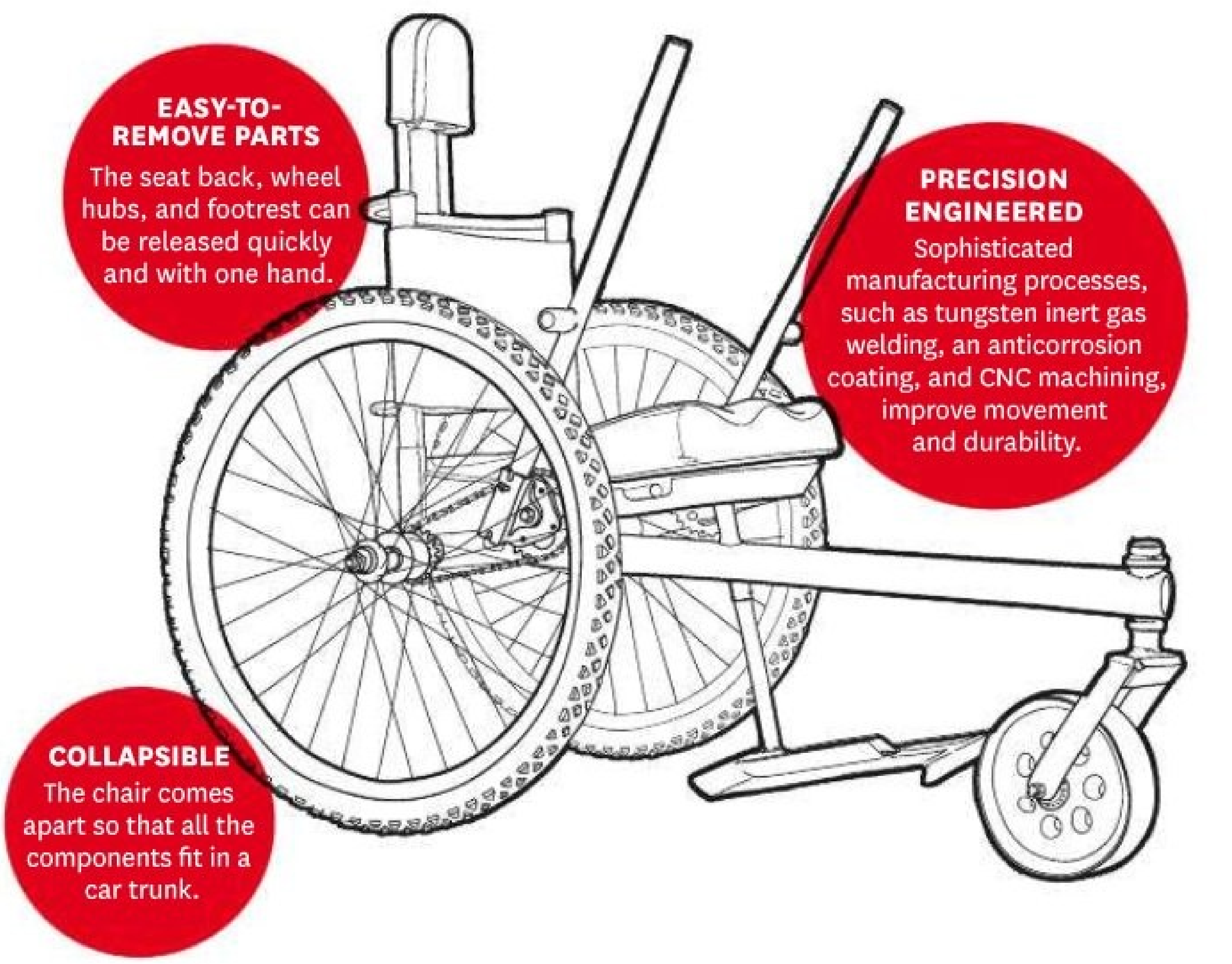
By making the users the machines' most complex part—they are both the power source and the gearbox—the team could fabricate the drivetrain from a simple, single-speed assembly of bicycle parts. In fact, the ability to use bicycle parts was another freedom the team could exploit. People in developing countries use bicycles extensively, and repair shops that stock spare parts are almost everywhere. Incorporating bicycle parts into the drivetrain made the LFC low cost, sustainable, and easy to repair, especially in remote villages.

TRAP 3: Forgetting to think through all the technical requirements of emerging markets. When designing offerings for the developing world, engineers assume they're dealing with the same technical landscape that they are in the developed world. But while the laws of science may be the same everywhere, the technical infrastructure is very different in emerging markets. Engineers must understand the technical factors behind problems there—the physics, the chemistry, the energetics, the ecology, and so on—and conduct rigorous analyses to determine the viability of possible solutions.

Thorough calculations will allow engineers to validate or refute assumptions about the market. Consider the PlayPump, designed for Africa, which pumps water from the ground into a tower by harnessing the energy of village children pushing a merry-go-round. Having children do something useful for the community while playing is a win-win by any yardstick. Moreover, a first-order engineering analysis suggested that the technological assumptions were logical.

TO WIN OVER EMERGING MARKET CONSUMERS, PRODUCTS MUST PROVIDE 100% OF THE PERFORMANCE AT 10% OF THE PRICE.

U.S.-Focused Upgrades to the GRIT FREEDOM CHAIR



GRIT/NATHAN COOKE

Let's assume that in a 1,000-strong village, each person needs three liters of drinking water a day, the village has a tower that can hold 3,000 liters, and it's 10 meters high. Using high school physics, one can calculate that 25 children, playing for 10 minutes each, could theoretically fill the tower.

But further analysis alters the picture. After all, children spin merry-go-rounds so that they can ride them until they're dizzy, and if all the energy from their pushing goes to pumping water, the merry-go-round will stop as soon as they stop pushing. That's no fun! If we assume that half their energy goes into spinning and half into pumping, the energy requirement doubles; 50 children must use the PlayPump for 10 minutes each daily to keep the tower full.

If the water comes from a well 10 meters deep, double the energy will be necessary and 100 children must use the merry-go-round. Accounting for inefficiencies, the number could go to 200. What happens when it's too hot, wet, or cold, and children don't want to play on the PlayPump? How will the village get its water then? If the makers of the PlayPump had included all those factors in their calculations, they would have realized it wasn't a technically viable solution. Despite receiving the World Bank Development Marketplace award in 2000 and donor pledges of $16.4 million in 2006, PlayPumps International had stopped installing new units by 2010. The PlayPump sounded like a good idea, but a village water system needs reliable power—and ensuring that isn't child's play.

DESIGN PRINCIPLE 3: Analyze the technical landscape behind the consumer problem. Underlying technical relationships may look markedly different in developing countries. For example, urban Indian homes receive water from pressurized municipal supply systems, just like those found in the United States, which ensure that if there is a leak, water goes out but contaminants can't get in. However, most Indian households use booster pumps to suck water from the municipal pipes to rooftop tanks. This suction pulls contaminants from the ground into the pipes, creating a mechanism for contamination that is not common in the United States.

Social and economic factors often drive the technical requirements for products. For instance, if a company wants to sell inexpensive tractors to low-income farmers, it must make them light; material costs determine much of a tractor's price. Engineers then must check how lowering the weight would affect the machine's performance, particularly traction and pulling force. The latter is important; in emerging markets, farmers use tractors not only to farm but for odd jobs, such as transporting people.

By studying the technical landscape, engineers can identify pain points as well as creative paths around them. Understanding the requirements for energy, force, heat transfer, and so on will illuminate novel ways of satisfying them. As noted earlier, the LFC is human powered, which eliminates the costs of a motor and an energy source. However, the design team had to figure out how users' upper body strength could provide propulsion. It did so by calculating the power and force that people could produce with their arms and the amounts needed on various kinds of terrain. Finally, the designers worked out the optimal length of the two levers so that users could travel at peak efficiency across normal terrain and have enough strength to propel their way out of trouble in harsh conditions such as mud or sand.

TRAP 4: Neglecting stakeholders. Many multinationals seem to think that all they need to do to educate product designers about consumers' needs and desires is to parachute them into an emerging market for a few days; drive them around a couple of cities, villages, and slums; and allow them to observe the locals. Those perceptions will be enough to develop products that people will purchase, they assume. But nothing could be further from the truth.

DESIGN PRINCIPLE 4: Test products with as many stakeholders as possible. Companies would do well to map out the entire chain of stakeholders who will determine a product's success, at the beginning of the design process. In addition to asking who the end user will be and what he or she needs, companies must consider who will make the product, distribute it, sell it, pay for it, repair it, and dispose of it. This will help in developing not just the product but also a scalable business model.

It's best to adopt the attitude that you're designing with, not for, stakeholders. If treated as equals, they're more likely to participate in the process and provide honest feedback. When you're designing a prosthetic limb, for instance, collaborate with amputees, the clinics that provide the prostheses, and the organizations that pay for them. If you're able-bodied, it doesn't matter how many doctoral degrees you've earned; you still don't know what it's like to live with a prosthetic device in a developing country.

The MIT team formed partnerships with wheelchair builders and users throughout the developing world. Those stakeholders, who provided insights on how to make the wheelchair better, easier to manufacture, more robust, and cheaper, came up with ideas for several features. The team gathered further feedback through field trials in East Africa, Guatemala, and India, conducted in conjunction with local wheelchair manufacturing and supply organizations. The tests had a huge impact, resulting in several design modifications.

Although the first prototype performed well on rough terrain in East Africa, it didn't do so well indoors. It was too wide to go through a standard doorway, which the MIT designers hadn't noticed, and it was 20 pounds heavier than rival products were. For the next iteration, tested in Guatemala, the engineers reduced the chair's width by shaping the seat closer to the user's hips, bringing the wheels closer to the frame, and using narrower tires. By conducting a structural analysis, optimizing the strength-to-weight ratio of the frame, and reducing materials wherever possible, the team also decreased the LFC's weight by 20 pounds. That version performed well indoors, but several users felt they might fall out when traversing rough terrain. So the team included foot, waist, and chest straps to secure the user to the seat in tests in India. Users rated the third version at par with conventional wheelchairs indoors and far superior outdoors.

No matter how thorough engineers are, users expose design flaws that only they can notice. For instance, of the seven major improvements users suggested, only eliminating the LFC's excess weight had been evident to the MIT team before the East African trial. It's critical to test prototypes in the field with potential users and design solutions with organizations that will disseminate the product. Remember, design is iterative; you can't get it right the first time, so be prepared to test many prototypes.

TRAP 5: Refusing to believe that products designed for emerging markets could have global appeal. Western companies tend to assume that consumers in developed markets, who are brand-conscious and performance-sensitive, will never want products from emerging markets, even if their prices are lower. Executives also worry that even if those products did catch on, they could be dangerous, cannibalizing higher-priced, higher-margin offerings.

DESIGN PRINCIPLE 5: Use emerging market constraints to create global winners. Before designing solutions, companies should identify the inherent constraints that will operate on the new product or service—such as low average consumer income, poor infrastructure, and limited natural resources. This list will dictate the requirements—like price, durability, and materials—that new designs must meet.

MANY MULTINATIONALS THINK ALL THEY NEED TO DO IS PARACHUTE PRODUCT DESIGNERS INTO AN EMERGING MARKET FOR A FEW DAYS AND HAVE THEM OBSERVE THE LOCALS.

The constraints of developing countries usually force technological breakthroughs that help innovations crack global markets. The new products become platforms on which companies can add features and capabilities that will delight many tiers of consumers across the world. One example is the Logan, a car Renault designed specifically for Eastern European customers, who are price-sensitive and demand value. Launched in Romania in 2004, the Logan cost only $6,500 but offered greater size and trunk space, higher ground clearance, and more reliability than rival products. To ensure a low price, Renault used fewer parts than usual in the vehicle and manufactured it in Romania, where labor costs are relatively low.

Two years later, Renault decided to make the Logan attractive to consumers in developed markets, by adding more safety features and greater cosmetic appeal, including metallic colors. In France it sold the Logan for as much as $9,400. In Germany sales of the Logan jumped from 6,000 units to 85,000 units over a three-year period. By 2013 sales in Western Europe had reached 430,000 units—a 19% increase over 2012. Thus, while the constraints in Eastern Europe forced Renault to create a new auto design, the result was a product that delivered high value at low cost to consumers in Western Europe as well.

Something similar is happening with the LFC: Wheelchair users in the United States and Europe have noticed the media buzz about the product and want to buy it. The MIT team worked with Continuum, a Boston-based design studio, to conduct a study of what a U.S. version of the LFC could look like. The designers also tested the LFC with potential customers in the West to identify features to add. The GRIT Freedom Chair, as the developed world model is called, was designed to fit into car trunks in the United States. It also has quick-release wheels that users can remove with one hand and is made from bicycle parts available in the United States.

Although commercial production of the Freedom Chair began only in May 2015, it's on its way to success in the developed world. The venture the MIT team founded to make the chairs, Global Research Innovation and Technology, was one of four start-ups that received a diamond award at MassChallenge, the world's largest start-up competition, three years ago. In 2014, GRIT ran a Kickstarter campaign to launch the Freedom Chair, meeting its funding goal in only five days.

How the Principles Pay Off

Few companies have avoided the traps we've described as well as the global shaving products giant Gillette did when designing an offering for India. As recently as a decade ago, Gillette made most of its money in that country by catering to top-of-the-pyramid consumers with pricey products. In 2005, Procter & Gamble acquired Gillette and immediately saw an opportunity to expand market share in the country.

Prodded by its new parent, which had been in India since the early 1990s, Gillette decided to develop a product for the 400 million middle-income Indians who shave primarily with double-edge razors. It began by exploring consumer requirements. After mapping out the value chain, from steel suppliers to end users, a cross-functional team conducted ethnographic research, spending over 3,000 hours with 1,000 would-be consumers.

Gillette learned that the needs of Indian shavers differ from those of their developed world counterparts in four ways:

Affordability. The price would be a critical constraint, since Gillette's main competitor, the double-edge razor, costs just Re 1 (less than 2 cents).

Safety. Consumers in this market segment sit on the floor in the dark early-morning hours and, using a small amount of still water, wield a mirror in one hand and a razor in the other. Shaving often results in nicks and cuts, because double-edge razors don't have a protective layer between the blade and the skin.

THE CONSTRAINTS OF DEVELOPING COUNTRIES USUALLY FORCE TECHNOLOGICAL BREAKTHROUGHS THAT HELP INNOVATIONS CRACK GLOBAL MARKETS.

Even so, when Gillette's product designers watched Indian men shaving, most of the men did not cut themselves. Their response was simple: "We are experts; we don't cut ourselves." However, the team concluded that shaving requires concentration; Indian shavers could not relax or talk during the process for fear of injuring themselves. Gillette had identified a latent need: Most shavers were keen to relieve the tension by using a safer razor and blade.

Ease of use. Indian men have heavier beards and thicker facial hair than most American men do, and shave less frequently, so they have to tackle longer hairs. They also like to use a lot of shaving cream. All of that leads their razors to clog up quickly. With little running water at their disposal, Indian men need razors that they can easily rinse.

Close shaves. Gillette rightly assumed that Indian men want close shaves, as men across the world do, but the difference is that they do not place a premium on time. They spend up to 30 minutes shaving, whereas U.S. men spend five to seven minutes.

To come up with a competitive product, Gillette had to relearn the science of shaving with a single blade. It found that multiple passes of a single-blade razor can achieve a close shave because of the viscoelastic nature of hair. As a blade cuts strands of hair, it also pulls them out a little from the skin. The hairs don't spring back at once; the follicles act like the mechanisms that close a screen door slowly. Because the hairs continue to protrude, the next pass of the blade can cut them a little shorter. And so on.

This process helped Gillette hit upon a valuable design freedom: It could use only a single blade in its new razor, which drastically lowered the production cost. The new razor would also need 80% fewer parts than other razors did, greatly reducing manufacturing complexity.

Gillette's engineers then had to figure out how to flatten the skin before cutting the hairs to ensure a close shave without injury. They also had to understand the mechanics of flushing out the razor by swishing it in a cup of water. Finally, they had to balance competing requirements: Small teeth at the cartridge's front were necessary to flatten the skin before it made contact with the blade, while the rear had to have an unobstructed pass-through to allow hair and shaving cream to wash out easily.

Rethinking the razor from the ground up, the Gillette team also designed a unique pivoting head. That helped the user maneuver around the curves of the face and neck, particularly under the chin—an area difficult to shave. Seeing that Indians gripped razors in numerous ways, Gillette created a bulging handle and textured it to prevent slippage.

Gillette didn't stop at designing a product specifically for India; it also built a new business model to support it. To reduce production and transportation costs, it manufactures the product at several locations. And because India's distribution infrastructure consists of millions of mom-and-pop retailers, the team designed packaging that consumers could easily spot in any store.

Over time the American company did well in this Indian segment—mainly because it didn't set out to make the cheapest razor; it strove to make a product with superior value at an ultralow cost. The Gillette Guard razor costs Rs 15 (around 25 cents)—3% as much as the company's Mach3 razor and 2% as much as its Fusion Power razor—and each refill blade costs Rs 5 (8 cents). Introduced in 2010, the innovative product has quickly gained market share: Two out of three razors sold in India today are Gillette Guards. Although Gillette has not sold the Guard outside India yet, it embodies the promise of a successful reverse innovation.

THOUGH MOST Western companies know that the business world has changed dramatically in the past 15 years, they still don't realize that its center of gravity has pretty much shifted to emerging markets. China, India, Brazil, Russia, and Mexico are all likely to be among the world's 12 largest economies by 2030, and any company that wants to remain a market leader will have to focus on consumers there. Chief executives have no choice but to start investing in the infrastructure, processes, and people needed to develop products in emerging markets. Doing so will also allow multinationals to benefit from the "frugal engineering" (as Renault's CEO Carlos Ghosn labeled it) that's possible there. Because of abundant skilled talent—especially engineers—and relatively low salaries in those countries, the costs of creating products there are often lower than in developed nations. But no amount of investment will result in portfolios of successful new products and services if companies don't follow the design principles that govern the development of reverse innovations.

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HOW TO NEGOTIATE WITH POWERFUL SUPPLIERS

by Petros Paranikas, Grace Puma Whiteford, Bob Tevelson, and Dan Belz

Petros Paranikas is a partner and managing director at the Boston Consulting Group. **Grace Puma Whiteford** is a senior vice president and the chief procurement officer at PepsiCo. **Bob Tevelson** is a senior partner and managing director at BCG, and **Dan Belz** is a principal there.

THE VOORHEES

IN MANY INDUSTRIES THE BALANCE OF POWER HAS DRAMATICALLY SHIFTED FROM BUYERS TO SUPPLIERS.

A classic example comes from the railway industry. In 1900 North America had 35 suppliers of cast rail wheels; railway builders could pick and choose among them. A century later no one looking to build a railroad had this luxury, as only two suppliers remained. Today there is just one, which means that railroad builders have no choice but to accept the supplier's price.

The shift has come about for various reasons, any or all of which may be in play in a given industry. In some cases suppliers have eliminated their competitors by driving down costs or developing disruptive technologies. In others, fast-growing demand for inputs has outstripped supply to such a degree that suppliers have been able to charge what they want. In still others, buyers have consolidated demand and forced suppliers' prices down so far that many suppliers exited the market, giving the remaining few more clout.

Whatever the reason, companies that have gotten into a weak position with suppliers need to approach the situation strategically. They can no longer rely on hard negotiations through their procurement offices. To help with the strategic reappraisal, we've developed an analytic framework with four steps, in order of ascending risk. Companies should start by assessing whether they could help the supplier realize value in other contexts. If not, they should consider whether they could change how they buy. They should then look at either acquiring an existing supplier or creating a new one. If all else fails, they must consider playing hardball, which can have a lasting impact on the relationship and is a last resort.

Let's look at each step in detail.

Idea in Brief

THE PROBLEM
The balance of power in an industry can dramatically shift from buyers to suppliers.

THE CHALLENGE
Companies that have gotten into a weak position with suppliers need to strategically redefine the relationship, tackling the problem as an enterprisewide challenge.

THE SOLUTION
Four approaches:
- Bring new value to the supplier.
- Change how you buy.
- Create a new supplier.
- Play hardball.

#1 Bring New Value to Your Supplier

This is the easiest way to redefine your relationship with a powerful supplier. It can rebalance the power equation and turn a purely commercial transaction into a strategic partnership. You can provide new value in several ways. For example:

Be a gateway to new markets. The quickest and least expensive way to redress a power imbalance is to offer the supplier a market opportunity that is too good to pass up in exchange for price concessions. Finding the right carrot can take some digging. Here's a case in point: A beverage company was facing annual price hikes from a beverage-packaging supplier. It seemed to have no way out; the supplier had patented its manufacturing process, *and* its pricing was lower than that of other sources.

But as it happened, the buyer was about to enter two large developing markets in which the supplier had tried but failed to gain traction. The procurement manager realized that the company could give the supplier's products a foothold in those markets. She and her team put their heads together with the marketing team and presented the supplier with an offer that was hard to refuse: In exchange for a 10% price reduction globally, the company would use the supplier's cans in the new markets.

Reduce the supplier's risks. If a company is well placed to help a supplier reduce its price risks, it can demand some concessions in return. For instance, a large chemical company was working with a single, recalcitrant supplier. To produce titanium dioxide it required feedstock manufactured to tight specifications, and only that supplier could meet its needs. When the chemical company tried to increase its order, the supplier claimed to have limited capacity and demanded a price premium.

Given the cyclical nature of the industry, the company surmised that the supplier would jump at the chance to lock in a long-term contract—a commitment other customers lacked the financial strength to make. Procurement worked closely with a team from finance, which created detailed models to determine a price range that would let the supplier generate returns of 15% on invested capital. The supplier agreed to a multiyear contract with prices that would not fluctuate more than 10% annually, and the chemical company got a 10% discount from the original quote.

#2 Change How You Buy

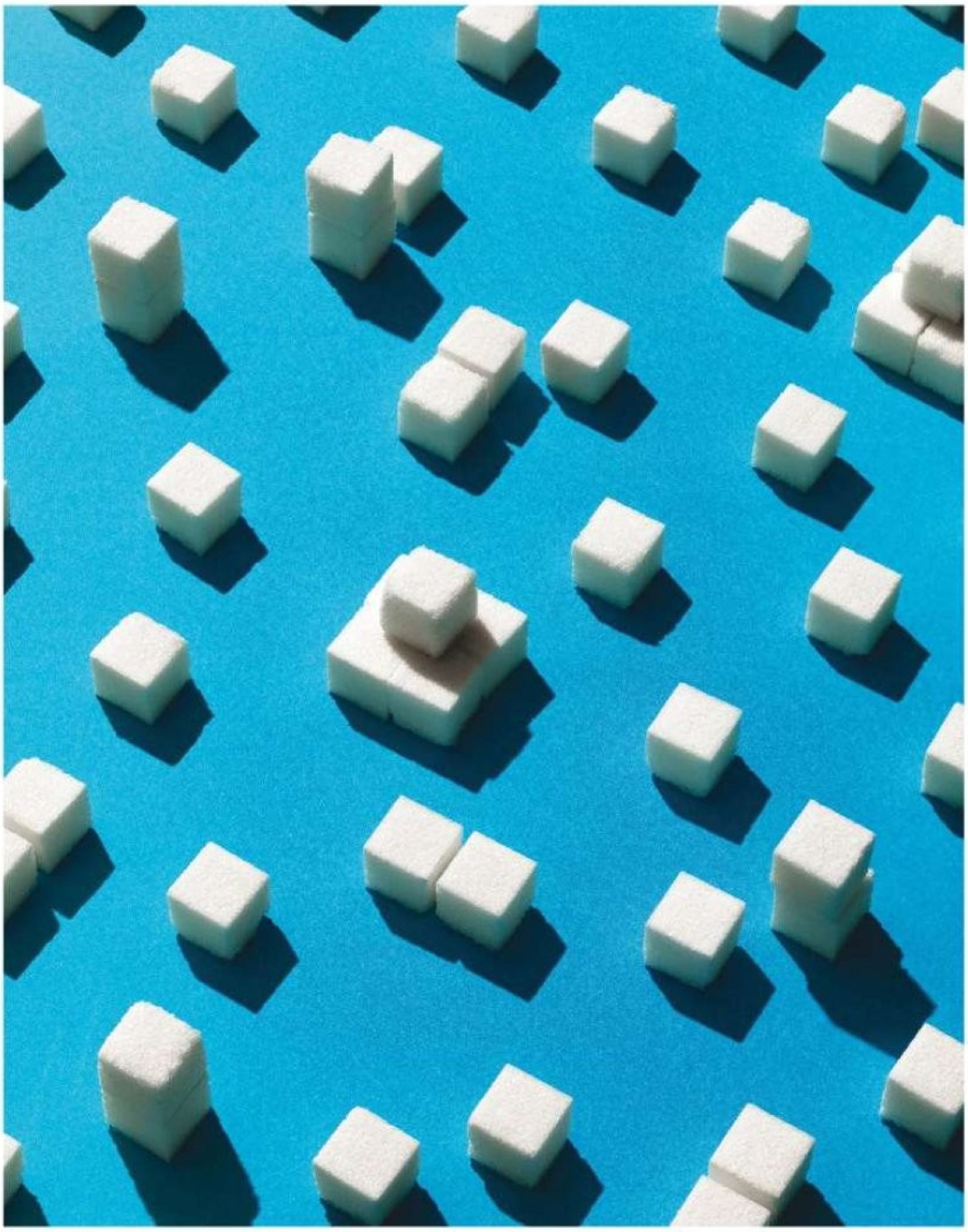
If no opportunities exist to help the supplier create new value, your next best alternative is to change your pattern of demand. Because this strategy can have implications for other parts of your organization, it requires close collaboration with any functions that could be affected. A company can change its demand patterns in three ways, all of which may require intensive data collection and analysis.

Consolidate purchase orders. This is the least-risky option and the easiest one to implement. It may involve little more than acting on an internal audit of procurement data.

At one aircraft manufacturer, various business units were independently purchasing components from a large supplier, which was doubling or tripling the prices it had originally quoted. The supplier was reaping gross margins of about 20%, whereas the aircraft manufacturer's were only 10%. And deliveries were unreliable, which drove up the manufacturer's overall costs. Individually the business units lacked the power to force a change in behavior. But the unit CEOs got together, consolidated their spending data, and went to the supplier's top executive with a threat to suspend all purchases unless changes were made. The supplier became far more responsive, cutting prices so that its margins were also about 10% and improving the timeliness of deliveries.

Small companies that don't order through multiple units can form purchase consortiums with other firms in their industry. In 2008 an oligopoly of four suppliers controlled the ATM market in one European country. To counterbalance the group's power, four banks created a purchasing consortium for ATM parts and maintenance, ultimately cutting their ATM costs by 25%. To succeed, consortiums must align their members' interests and have the right governance in place. To avoid raising antitrust issues, they should not be too powerful themselves, which means that this approach is best suited to relatively fragmented, competitive industries.

Rethink purchasing bundles. If a company cannot create large purchasing bundles within product categories or geographies, it should consider purchasing across them. One telecom company dealing with a powerful supplier for a particular component gained price concessions by pointing out that it also bought other components from that supplier—ones it could easily obtain elsewhere. Similarly, a global chemical manufacturer accustomed to buying a key ingredient from two suppliers, one in the United States and one in Europe (and each with a monopoly in its region), announced that it was considering consolidating to a single supplier and began a qualification process to choose which one. By awarding a single global contract, it would have given the winner a toehold in the loser's monopoly territory. Faced with the threat of competition, each supplier agreed to a 10% discount.



At other times the right strategy is to pick apart your existing bundles; this may enable you to create competition among suppliers where none previously existed. When a consumer goods company decided to renegotiate its contract with a powerful information provider that offered an integrated global product and services package, the procurement team quickly realized that it needed to differentiate between data (for which the supplier held a monopoly in some geographies) and analytic services (for which the market was generally competitive). It also decided to negotiate at a country level—enabling suppliers that could cover some but not all geographies to participate. As a result it obtained savings of 10% on data and 20% on analytics.

Decrease purchase volume. The third way to alter demand is to shift volume away from a powerful supplier, ideally by switching to a substitute or lower-cost product. The mere threat of this can increase the supplier's openness to negotiation—but the buyer's organization needs to stand behind its negotiation team and be willing to revisit what it purchases. Determined to reduce IT costs, one retailer we advised determined that most of its staff members did not need to create documents—they needed only to read them. It was able to eliminate 75% of its office software licenses, replacing them with a lower-cost, read-only alternative.

#3 Create a New Supplier

If options for changing your company's demand profile aren't available, you should next explore creating a completely new supply source. Like the first two strategies, this ultimately shifts demand away from powerful suppliers, but it tackles the other side of the equation. It is most likely to be necessary in industries where price negotiations have gone so far as to drive most suppliers out of business, effectively giving the survivors a monopoly. Of course, such drastic action risks alienating your supplier completely and may change your company's business model. It will also alter the competitive dynamics and perhaps even the structure of your supplier's industry and your own. For these reasons it is a risky proposition, but if well executed, it can transform your prospects. There are essentially two options:

Bring in a supplier from an adjacent market. The easiest way to create a new supplier is to bring in a competitor from an adjacent geography or industry, one that might not otherwise have entered the market. One major airline reduced its food costs and improved quality by enticing a European catering company to enter the U.S. airline-catering market, which had been controlled by two well-entrenched suppliers that were reluctant to lower prices. The new entrant had an innovative, off-premises production model that enabled it to offer higher-quality food at significantly lower prices in exchange for longer-term contracts.

Because the airline would need to give the new supplier a multiyear agreement, the procurement team shared its plans with the airline's chief operating officer, its head of airport operations, and its head of catering. After aligning these key functions on the strategy, the airline announced that it had awarded its contract at a major U.S. hub to the new entrant. After losing that share of business, one of the established suppliers replaced its management team and took a more collaborative approach with the airline.

Vertically integrate. If no plausible new suppliers are to hand, consider making yourself the new supplier by investing in the requisite assets and capabilities, possibly in a strategic partnership or joint venture with a company that has some of those assets and capabilities. If you're lucky, a credible threat to take this action will be sufficient to shift the balance of power, as was the case with a paper company that relied on a regulated utility for electricity.

Unable to secure a better rate from the utility, the company began planning to build its own power

Gaining the Upper Hand

When negotiating with powerful suppliers, you have four basic strategies to choose from. In general, it's best to pick the least-risky option that's feasible for your organization. Consider each strategy in order of ascending risk and ask yourself the two questions to the right. Only if you answer no to both should you consider a riskier course of action.

LEVEL OF RISK	STRATEGY	QUESTIONS
LOW	BRING NEW VALUE TO THE SUPPLIER	CAN WE HELP THE SUPPLIER ENTER NEW MARKETS OR INDUSTRIES? CAN WE HELP IT REDUCE ITS BUSINESS RISK?
	CHANGE HOW WE BUY	CAN WE GAIN LEVERAGE BY CONSOLIDATING ORDERS OR BY BUNDLING OR UNBUNDLING PRODUCT OR SERVICE PACKAGES? DO WE REALLY NEED EVERYTHING WE'RE BUYING?
	CREATE A NEW SUPPLIER	ARE THERE POTENTIAL ENTRANTS IN ADJACENT MARKETS? CAN WE VERTICALLY INTEGRATE TO BECOME OUR OWN SUPPLIER?
HIGH	PLAY HARDBALL	CAN WE AFFORD TO WITHHOLD OR CANCEL ORDERS? DO WE HAVE GROUNDS FOR LITIGATION?

IF ALL ELSE FAILS, CANCELING YOUR ORDERS, SUSPENDING FUTURE BUSINESS, OR THREATENING LITIGATION MAY BE THE ONLY ANSWER.

plant—and it made sure the utility knew about its plans. It spent nine months finding a location, securing pipeline capacity, getting permits, and partnering with a dryer company that wanted to use the steam that the plant would generate. The strategy worked—the utility agreed to reduce its rates by 40% to prevent the company from building the plant. The danger with this approach, of course, is that your threat to vertically integrate may be called. So before embarking on this option, make sure that the new venture could deliver value that exceeds the investment costs and compensates for the added management attention and the hidden risks and challenges that might arise.

#4 Play Hardball

If everything else fails, canceling all your orders, excluding the supplier from future business, or threatening litigation—or some combination of those actions—may be the only answer, short of going out of business. These are truly tactics of last resort.

A global financial services firm had its back against the wall because it had to reduce costs by $3 billion. To cut IT infrastructure costs, it asked its major hardware supplier for a 10% price decrease. When the supplier refused, the firm's chief information officer contacted the supplier's CEO to say that all the supplier's projects in the company were suspended, effective immediately. Within an hour the supplier was deactivated in the payment system, and the procurement, IT, and development teams were notified that they were no longer to work with it. Faced with the costly loss of existing and upcoming projects, the supplier quickly agreed to the price cut.

Then there's litigation. In the early 2000s a security company that provided cash transportation services to banks decided to increase its rates by 40%. Because it controlled 70% of the market, its customers had few alternatives. But one bank that faced significant margin pressures wasn't ready to accept the price hike. To better understand what was driving the increase, it asked to review the security company's financial statements, which revealed only a 10% cost increase—nothing that would justify the drastic hike.

The bank took a two-pronged approach. Its chief operating officer met with the COO of the security company to explain that the increase was unacceptable and would undermine their relationship. And the procurement team threatened to join forces with other financial institutions and bring the matter to the attention of the national authorities in charge of restricting monopolies. The security company backed down and instituted a price increase more in line with its cost increase.

AS WE'VE SHOWN, companies negotiating with powerful suppliers have plenty of ways to redefine the relationship. Whichever option they choose, they need a clear understanding of the problem, an ability to work on it across functions, a willingness to think outside the box, and strong analytical capabilities that can reveal the enterprisewide picture and generate useful insights. It's also important that senior executives commit to strategic rather than tactical moves. With these elements in place, what had seemed an impossible negotiating task becomes one that is merely challenging.

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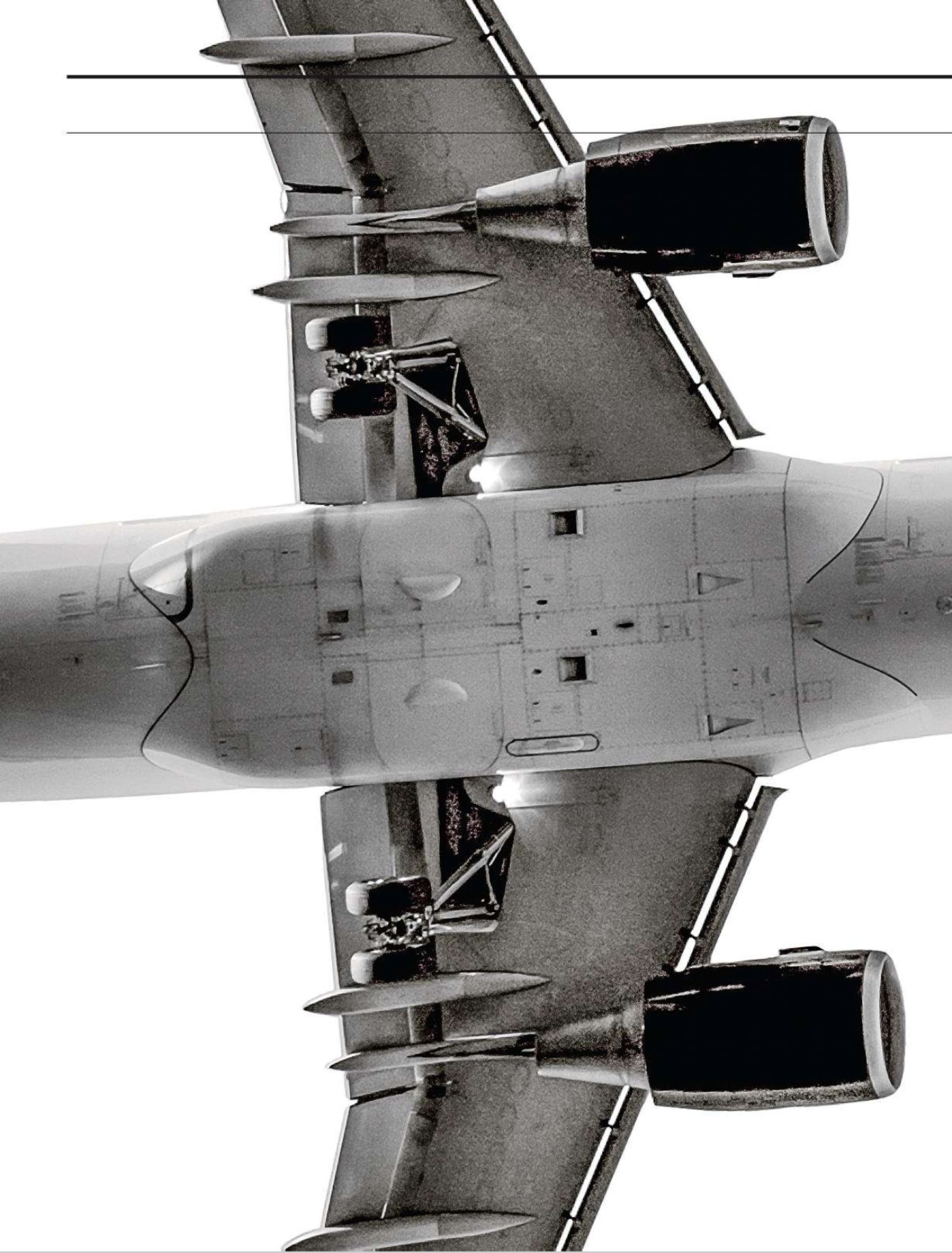

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BREAK YOUR INDUSTRY'S BOTTLENECKS

WHERE TO FIND THE BIG CHANGES THAT WILL TRANSFORM YOUR BUSINESS

by Barrett Ersek,
Eileen Weisenbach Keller, and John Mullins

If you want to create a successful business, you have to do more than win your share of customers or control costs—you have to break the rules and overturn the received wisdom about how things work.

Consider the airline industry. High-priced landing fees are just a cost of doing business, right? Ryanair didn't think so. It turned Europe's unused World War II landing strips into very low cost airports. To be a cell phone service provider, you need to invest in towers, networks, billing systems, and more, don't you? India's Airtel said no and leased virtually everything it needed from others. In sharply lowering its costs and improving its working capital model, Airtel was able to offer India's impoverished consumers cell phone service at a dramatically reduced price.

So how can companies figure out what rules to break? Over the past five years, we have worked with more than 50 small and midsize companies that have managed to set "business as usual" to one side and solve big structural problems endemic to their industries, not just problems they alone face. In breaking those bottlenecks, they significantly reduced their costs—in some cases eliminating entire cost categories—or boosted demand levels, and sometimes both.

On the basis of our research and our work with these companies, we found that just about every "not business as usual" innovation was effective because it broke one of five types of bottlenecks: (1) an outdated purchase or usage experience, (2) a superfluous major expense category, (3) significant financial risks for customers, (4) disengaged or demotivated employees, and (5) detrimental side effects of the product or service. In the following pages, we'll discuss each of these bottlenecks and how to break them by describing the experiences of five companies.

Bonobos
Retailoring the Customer Experience

In many cases a bottleneck begins life as a seemingly unavoidable and, from the customer's perspective, unpleasant or frustrating way of doing business. But very often companies can use advances in technology to eliminate the outdated practice and bust the bottleneck.

TRY BEFORE YOU BUY ONLINE

"We thought we could do away with the whole idea of a 'shopping experience,' since most men aren't interested."

ANDY DUNN, BONOBOS FOUNDER (*FINANCIAL TIMES*, 2009)

Until quite recently, buying clothes was an experience that hadn't changed in over a century. Most people went to shops where they tried to find a pair of trousers, say, that they liked and that fit. The process often involved visiting multiple shops and trying on clothes at each one. Rich people had the option of having trousers made for them,

Idea in Brief

THE CHALLENGE
To create a really successful business, you have to turn conventional business wisdom on its head. But how do you know which rules to break?

THE APPROACH
Smart companies solve big structural problems endemic to their industries. In breaking those bottlenecks, they significantly reduce their costs.

THE STRATEGIES
Companies can break bottlenecks in five key ways:

- Update the customer experience
- Eliminate superfluous expense categories
- Neutralize customers' financial risk
- Re-engage employees
- Mitigate environmental or ethical side effects

but that was expensive, labor-intensive, and almost as time-consuming.

Entrepreneur Andy Dunn saw an opportunity to remove the frustration through an online shopping solution, especially for men. Launched in 2007, retailer Bonobos, named after the great ape species, initially provided better-fitting jeans and trousers targeted to younger consumers (who were more willing to try online solutions) at a moderate price. In 2011, following four years of rapid growth, Dunn identified yet another customer experience bottleneck. Many men were reluctant to order pants online, having learned from lifelong brick-and-mortar experience that pants often don't fit. "No sense in ordering if I'll just have to return them," they concluded.

This insight led to a new concept, the Guideshop. Now with 17 locations in major cities from New York to San Francisco, Guideshop showcases its merchandise in small spaces that hold a full array of sizes and styles for trying on but offer nothing for sale on-site. Thus it eliminates the supply chain requirements that brick-and-mortar retailers face while addressing the "try before you buy" challenge that plagues online retailers. Guideshops have no inventory to manage, racks to stock, or cash registers to staff. Customers make an appointment, and when they visit they are treated to personalized, private service; typically there are no more than two or three customers in the store at a time, each with his own guide. No products are purchased at the stores. Instead, a guide aids the customer in placing an online order, and retains the customer's information to streamline future purchases and service.

Industries with long-standing customer experience formats are quite likely to have bottlenecks. Customers become used to formats and don't question them—and if they don't complain, it's unlikely that incumbent companies will recognize a problem. Innovators should look for some aspect of the customer experience that discourages demand for all firms in your industry (like having to stand at a curb to hail a taxi, which Uber eliminates). Map the customer buying experience in a flow chart, step by step, and then ask, "Can we eliminate one or more of the steps?" Steps that are often repeated (like going from store to store in search of trousers that fit) are particularly fruitful candidates for elimination.

Redbox
Axing the Cost Category

Many industry bottlenecks develop because companies don't question whether customers really want all the features of a particular product or service. What happens is that a first mover achieves success with a particular offering, and its model gets established as the way to do business. The customer is happy because the advantages outweigh any disadvantages, the industry accepts the cost of the entire offering, and a bottleneck is born.

Companies that take a second look at their industry's cost structure will often find ways to gain advantage. Redbox, the automated video rental company, is a case in point. In the late 1990s, Blockbuster adopted a revenue-sharing model with movie companies that allowed it to open stores all over the world with large selections of videos. Competitors soon followed suit. And because going to a video store was the only way customers could rent the films they wanted to see, people flocked to the stores. No one questioned the assumption that this was the best way to provide the offering.

But in 2002, the new-venture unit of fast-food giant McDonald's was looking for ideas that could drive additional traffic to the company's restaurants. "They were also looking for a worldwide product outside of the food sector," McDonald's venture team leader at the time, Gregg Kaplan, told *Self-Service World* magazine in 2007.

A concept for renting DVDs from a vending machine looked promising. Kaplan and his team began experimenting with location, pricing, and DVD selection, eventually settling on a robotic kiosk to be located outside McDonald's stores. The no-membership-fee format priced DVD rentals at a dollar a day, far below the then-prevalent pricing at Blockbuster and others.

Why could Redbox rent DVDs for less than the industry leaders? It was easy, really. Redbox required no on-site staff (payroll expense, gone) and virtually no location costs (rent, utilities, and more, gone, too). Its kiosks cost only $15,000 and took up just 12 square feet, compared with a couple of thousand or more square feet for a typical Blockbuster store.

Redbox, with Kaplan as its CEO, grew at an astonishing pace, becoming the fifth-largest movie rental company in the United States by the end of 2007. By 2009, its more than 15,000 locations had taken 19% of the market, leaving 36% for rent-by-mail operators like Netflix and 45% for traditional stores. In July 2013, Redbox rented its three billionth disc, from an assortment that by then incorporated movies and video games. It reckoned that some 68% of the American population lived within a five-minute drive of a Redbox kiosk.

To tackle the cost bottleneck, first comb through your industry's financial statements. Focus on any large cost category that's common to all firms and consider ways to make a dent in it or eliminate it entirely. Pose some what-if questions: If we're not going to use physical stores to rent videos, how will we reach our customers? What will our customers be losing and gaining as a consequence? To get ideas, look at other industries that sell products in different ways. Vending kiosks were not new, but using them to rent and return items was.

Hyundai
Eliminating Customer Risk

In many industries, customers routinely take on significant financial risks when buying a product. Most people, for example, can't afford to buy a car outright and have to take out a loan to finance the deal. But this exposes them to risk, because in order to make the payments, they need to have a steady income for many years. In a strong economy, people feel confident in their ability to make payments and

CONQUER FEAR

"The idea of giving people the option to give the car back if they were struggling... seemed a great way to make customers comfortable and increase our market share in an economy like this."

JOEL EWANICK, FORMER VP OF MARKETING, HYUNDAI MOTOR AMERICA (*ADVERTISING AGE*, 2009)

are happy to bear the risk. But what if they lose that confidence, as they did in the Great Recession?

By the fourth quarter of 2008, the U.S. auto industry was in a tailspin. Industry sales were down by 35%; Hyundai sales had fallen even more. "This is a recession of fear," Joel Ewanick, then-VP of marketing at Hyundai Motor America, told *Advertising Age*. So the company came up with an innovation that removed fear from the equation.

On February 1, 2009, Hyundai offered consumers a unique deal, in an ad aired during the Super Bowl. "Finance or lease any new Hyundai, and if you lose your income in the next year, you can return it with no impact on your credit." The carmaker then aired the ad nine times during the Academy Awards (spots given up by the financially ailing General Motors) the following month. The buyback guarantee brought sales increases of 8% in 2009 and 24% in 2010. Better yet, Hyundai had to buy back only 350 cars.

If you are in an industry whose products or services represent a major financial commitment for your customers, ask whether you are better positioned than they are to bear that risk. In Hyundai's case, the consequences of taking back a car were less severe to the company than the consequences of defaulting on a loan were to an individual—who would not only lose a means of transport but also would take a hit on his or her credit rating. Of course, a new pricing model is relatively easy for competitors to copy, so the advantage is not that sustainable. But it may allow enough time for your product to prove its merits with users who might not otherwise have considered it.

Appletree Answers
Motivating the Workforce

Some industry bottlenecks stem from unquestioned assumptions about how to manage and motivate employees. In late 2008, Appletree Answers, a provider of call center services, had a 110% employee turnover

Busting Your Industry's Bottlenecks

Industry bottlenecks typically fall into five categories. To identify whether your industry has a bottleneck that you can exploit, ask yourself the key questions below and look to other industries for fresh insights. For example, Redbox identified the retail store as a major industry expense and realized that if soft drinks could be sold through vending machines, videos could be rented that way too.

SOURCE OF BOTTLENECK	WHAT TO ASK	EXAMPLES
An outdated customer experience	Has the customer experience in your industry remained unchanged for a long time? Are new technologies challenging it? Are there repeated steps that could be eliminated?	**BONOBOS/GUIDESHOP** To address the frustration of having to visit multiple stores to find clothes that fit, Guideshop offered a new service: personalized appointments for fittings, followed by online-ordering assistance. **APPLE ITUNES** Customers didn't like having to buy a whole CD when they wanted just one track, so iTunes offered single MP3 files online.
Superfluous expense categories	What large categories of expense are common in your industry? Is it possible to reduce or eliminate any?	**REDBOX** By eliminating the payroll and location expenses of operating brick-and-mortar retail stores, Redbox's automated vending kiosks transformed the video rental business. **PAPA MURPHY'S PIZZA** Rather than absorb the operating expense of pizza ovens, why not sell pizzas that customers take home and bake themselves?
Customer-borne risk	Does buying your product require customers to assume significant risk? If your company were to assume that risk, would it change customers' purchase decisions?	**HYUNDAI** In the 2008 recession, customers hesitated to make large purchases because they feared that their uncertain financial situation would make it too risky, so the carmaker promised buyers that they could return the car if they lost their job. **GOOGLE ADWORDS** Marketers have long struggled with the infamous advertising problem: Half the budget is wasted, but which half? So Google decided to charge a fee only when an ad is clicked on.
Disengaged employees	Do you have a high employee turnover rate? Do you strive to understand your employees' desires and constraints as well as you do your customers'?	**APPLETREE ANSWERS** In an effort to fight the high employee turnover endemic to the call center business, the company boosted employee motivation with a program that granted people's dreams. **ZAPPOS** It's not easy to win repeat customers when competitors are a click away, so Zappos trained its employees to engage emotionally with customers rather than demanding that they churn through multiple calls per hour.
Negative externalities	Does your product cause adverse side effects that people care about? Will customers pay a premium to reduce them?	**PATAGONIA** Environmental damage and negative health impacts from suppliers' farming practices were unacceptable to Patagonia's founder—and to many customers. So the company sources only organic cotton and brands its products accordingly. **VIRGIN ATLANTIC** A public commitment to fighting pollution from fossil-fuel use led Virgin Atlantic to invest in the development of alternative fuels.

rate. Although that was low by industry standards, CEO John Ratliff estimated that at a cost of $5,000 per turnover, Appletree had a $2.2 million problem—a huge burden for a company generating revenue of just $16 million a year.

Ratliff's team came up with 50 ideas about how to reduce employee turnover. The one the group settled on was Dream On, a concept borrowed from the Make-A-Wish Foundation. Frontline employees were invited to submit "dreams" to the executive team, with the promise that some would be chosen and fulfilled.

But four weeks after announcing the Dream On initiative in their numerous call centers, not a single request had been submitted. Ratliff and his team members were stumped, but they soon discovered that the employees didn't believe the executive team was serious. "They didn't want to look stupid in front of their peers," Ratliff told one of us (Ersek). "They didn't think it was real."

Two weeks later, after more outreach efforts, Ratliff finally had his first submission. It was from an employee going through a divorce. "She had been kicked out of the house with her two kids, and they were living in a car," said Ratliff. This employee's dream was an apartment in which to raise her children. "We were all over it!" Appletree paid her first and last months' rent and security deposit for the apartment, and purchased more than $1,000 worth of furniture. The company even promised her landlord that if the employee were to fall behind in payments, Appletree would help. Ratliff vividly remembers what happened next. "She wasn't obligated to announce what the dream was. It's totally confidential. But she said, 'Not talk about it? I'll tell anyone who listens that it's the greatest thing that ever happened to me.'"

Dream On quickly spread, and Ratliff was soon receiving dozens of dream requests. Over a period of four years, at a total cost of about $400,000, the company granted some 275 of them. Appletree Answers was included on *Inc.* magazine's list of the fastest-growing U.S. companies for seven consecutive years, and staff turnover decreased from 110% in 2008 to 30% in 2012. A more engaged staff led to decreased customer attrition and made a positive impact on gross margin, which increased from 47% in 2008 to 60% in 2012.

Companies are often very good at developing creative ways to engage with and delight their customers. They tend to be less willing to experiment with new ways of motivating their employees. Salaries, bonuses, and occasionally recognition and prizes are the tools of choice. But by focusing on better hiring and retention, companies can transform the economics of its business just as surely as it can by improving sales. Appletree's $400,000 investment in employee satisfaction and loyalty really paid off. Identifying such bottlenecks involves better understanding the tough problems employees face at work and home—problems that are typically very different from those of top managers.

Patagonia
Saving the Planet

Many industries create products that generate side effects (what economists call "negative externalities") that are not felt directly by the consumer. Farmers may use fertilizer that damages the water table, for example, but until the chemical compromises the water they will actually use or consume, it is very easy for them to ignore that effect. Many industries matured at a time when pollution and other side effects went relatively unnoticed or were routinely ignored, and managers and customers in those industries continue to overlook the possibility of creating value by eliminating them. When such change does occur, it's often driven by the passion of an individual or by necessity.

DO NO HARM
"Build the best product, cause no unnecessary harm, use business to inspire and implement solutions to the environmental crisis."
PATAGONIA'S MISSION STATEMENT

Yvon Chouinard, founder of the apparel company Patagonia, is one such individual. He believes he can build a profitable business while being a good steward of the environment—and that in doing so he can influence other companies to be more environmentally conscientious as well.

Historically, increasing demand for cotton apparel had motivated farmers to use chemical pesticides and fertilizers to speed growth of crops and increase yield. The result has been a larger and better-priced supply of cotton and consequently more output of cotton apparel at cheaper prices. The unintended consequence, or negative externality, has been the deterioration of soil and water and health threats to those who live or work nearby.

Patagonia found an alternative approach in the Texas Organic Cotton Marketing Cooperative. Chouinard saw the potential benefit of a product that did not involve the use of damaging chemicals. By using organic fabrics, Patagonia could provide a superior, highly differentiated product that would appeal to a growing segment of the market. In 1994, he mandated that Patagonia use only organic cotton, and he began building a sound business model around the use of higher-quality, more environmentally conscious materials. Sales of its cotton clothing quickly jumped by 25%, despite the higher cost.

This and other environmentally oriented initiatives have struck a chord with Patagonia's fiercely loyal consumers, enabling the company to grow at a rapid pace, more than tripling its revenue from 2001 to 2013.

Eliminating harmful side effects from a product can be a powerful source of competitive advantage if enough customers are willing to switch to the new offering. The success of ethical labeling—on products such as dolphin-safe tuna—testifies to growing consumer awareness of negative environmental and social externalities.

Although these concerns are most pressing in consumer products markets, they are becoming increasingly important in business-to-business environments, too. The scope for gaining competitive advantage by changing a product's composition or by creating a cleaner supply chain will continue to grow. What's more, we've observed that pro-environmental strategies, like Patagonia's, are seldom widely copied. Any T-shirt maker could switch to organic cotton, of course. But most have not, which enables Patagonia to enjoy a clear competitive differentiator, better gross margins, and a sustainable advantage in serving a market segment it loves. Isn't that what most companies hope to achieve?

OF COURSE, identifying your industry's bottlenecks—let alone fixing them—isn't easy. It's particularly hard for market leaders, who are often heavily invested in the status quo. Those companies compete by being better at what everyone is currently doing—their goal is incrementally improvement. They're less likely to step back and pose existential questions of the sort we've discussed here.

This is not to say that change can't come from within an industry. Innovators like John Ratliff of Appletree Answers and CEO Michael O'Leary of Ryanair call on personal experiences that reveal the waste, inconvenience, risk, employee disengagement, or environmental and social degradation their industry is causing. Why not ask questions today rather than wait for that experience to hit?

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HARLEY SCHWADRON

Sony Pictures CEO Michael Lynton

"They Burned the House Down"

MICHAEL LYNTON'S "BLACK SWAN" materialized late last year, when someone—the U.S. government says it was North Korea—pulled off the most devastating hack in corporate history. Lynton, the CEO of Sony Pictures Entertainment, had to look on as highly confidential company information—salary details, private e-mails (some of them harshly critical of top Hollywood talent), unreleased movies—was leaked for all the world to see. For good measure, the hackers wiped out huge amounts of data on the company's servers.

The attack pushed a reluctant Lynton to the forefront of U.S. foreign relations when the hackers threatened retaliation if *The Interview,* a Sony Pictures comedy set in North Korea that includes the assassination of Kim Jong-un, was released. Fearing reprisals, many theaters declined to screen the film, and Sony had to look for alternative distribution. President Barack Obama weighed in, chastising Sony for what he viewed as caving to Pyongyang's pressure. The R-rated bro film had suddenly become a First Amendment icon.

How does an institution make it through all that? How does it sustain its culture, and retain its talent, as each salacious, embarrassing, top-secret bit of information spills out into public? I visited Lynton in his sumptuous office at Sony Pictures' fabled art deco complex in Culver City, California, to talk about the experience. He seemed unguarded and optimistic, freely acknowledging the difficulties Sony faced in the weeks after the attack, yet sounding hopeful that the company had made it through intact.

Attacks like this may well be the new normal. Lynton says he can only hope that his company's nightmare will serve as a wake-up call for other U.S. businesses. —*Adi Ignatius*

HBR: Let's go back to the end of last year. Sony had just been hacked. What were your first thoughts?
Lynton: I was on my way to work. It was about 8:00 in the morning, and our CFO called to say that we had been breached. By the time I got to the office, the whole studio was off-line.

And that was just the beginning. Yes. We received a series of threatening messages warning of a data dump of the information the hackers had stolen, and then the disclosures began. Soon we were dealing with a few things at once. We were trying to keep the business operating. We were dealing with employees who feared their information would be made public. We were dealing with the press, which was publishing some of the e-mails. And then we had the FBI coming in to do forensic analysis.

You were known as a CEO who tended to delegate. Did that change? Yes, my role changed radically and quickly. The crisis required me to be very hands-on. We set up a command central to ensure that all decisions were made with my understanding and knowledge and approval. That basically became a full-time job, which meant everybody else had to operate the business—which they did, very successfully.

What went into setting up the command central? The first thing was to establish a means of communication in the absence of e-mail. We were basically analog for a while. We had phones, and that was it. So we set up texting trees and then turned to our employee notification system. That meant we could centrally text our employee population, which we did frequently.

Was this just for crisis-related communications, or to sustain business as usual? It was for business as usual, making sure people could communicate with one another about the stuff we do on a daily basis—making movies, making television shows, ensuring that everything gets distributed. Then we needed to create a temporary e-mail system. And we had to set up systems to make payroll, pay vendors, and so on. Making payroll alone was a monumental task: The finance department hauled old machines out of the basement to cut checks.

It sounds like a nightmare. I can't imagine seeing all my personal information suddenly made public. Well, that was just part of it. The bigger challenge was that the folks who did this didn't just steal practically everything from the house; they burned the house down. They took our data. Then they wiped stuff off our computers. And then they destroyed our servers and our computers.

So they had it, and you didn't. Correct. We had backup, but we couldn't access it until we had computers, servers, and systems that would allow us to do so. So you have these very public e-mails out there, some of which are salacious. And then you have the challenge of operating the business when the networked services you've relied on are unavailable.

Containing the Damage

What did your employees need most from you at that point? They needed reassurance. They were concerned that their personal information was out there and available, and we had to explain exactly what we were doing to protect them. Some were afraid that the company might go under as a result of all this.

EMILY SHUR

Nightmarish Days: A Timeline of the 2014 Sony Hack

NOVEMBER 24
When Sony Pictures Entertainment (SPE) employees log on to their computers, they see a skeleton and the words "Hacked by the #GOP" (Guardians of Peace). The hackers steal confidential business information, including employee data and private e-mails, and movies, including *Annie* and other unreleased films.

NOVEMBER 25
SPE's top two executives, Michael Lynton and Amy Pascal, first communicate with employees to commend their hard work while the company strives to resolve the system disruption.

DECEMBER 2
Lynton and Pascal e-mail employees acknowledging that a brazen attack has occurred and stating that SPE is working closely with law enforcement officials.

DECEMBER 5
Certain SPE employees receive an e-mail from someone claiming to be a GOP member, demanding that they disassociate themselves from Sony, and threatening, "If you don't, not only you but your family will be in danger."

DECEMBER 6
Lynton forwards an e-mail from the cybersecurity expert Kevin Mandia to all employees to explain the nature of the attack: "This was an unparalleled and well-planned crime, carried out by an organized group, for which neither SPE nor other companies could have been fully prepared."

DECEMBER 7
The Korean Central News Agency describes the attack as a "righteous deed" but dismisses reports of North Korean involvement as a "wild rumor."

DECEMBER 8
The GOP posts a message demanding that the studio "stop immediately showing the movie of terrorism which can break the regional peace and cause the War" and linking to sensitive information stolen from SPE.

DECEMBER 11
Pascal issues an apology after her personal e-mails are made public.

Sony stages a quiet Los Angeles premiere for *The Interview.*

DECEMBER 14
David Boies, outside counsel for SPE, writes to journalists reminding them that the leaked material is "stolen information" and calls on media outlets not to read or publish any SPE documents in their possession.

DECEMBER 15
Lynton calls an "all hands" meeting to tell employees they "should not be worried about the future of this studio."

DECEMBER 15–16
Two separate class-action lawsuits are filed on behalf of former and current employees alleging that Sony did not do enough to safeguard their private information.

DECEMBER 16
The GOP posts a 9/11-type threat against moviegoers who try to see *The Interview* when it's released on Christmas Day. Major theater chains start to cancel screenings.

DECEMBER 17
SPE decides not to move forward with the movie's planned nationwide theatrical release the following week.

Lynton and SPE executives begin reaching out to potential digital distribution partners, including Google.

DECEMBER 19
The FBI publicly states that North Korea was behind the attack. President Obama, too, attributes the attack to North Korea.

Obama calls canceling the theatrical release "a mistake" and adds, "They should have called me."

DECEMBER 22
North Korea experiences a 10-hour internet outage; connectivity problems continue for days.

DECEMBER 23
SPE announces that *The Interview* will have a limited theatrical release on Christmas Day.

DECEMBER 24
The Interview is released on Google Play, YouTube Movies, Microsoft's Xbox Video, and a dedicated site run by the studio through Kernel and Stripe.

JANUARY 20
SPE announces that *The Interview* was rented or bought online and through cable, satellite, and telecom providers more than 5.8 million times, for a total of some $40 million in consumer sales, and that the movie has made $6 million in box office receipts through its limited theatrical release.

FEBRUARY 4
SPE says the hack cost $15 million through the end of 2014.

FEBRUARY 5
Pascal resigns.

How did you reach out to them? We held big town hall meetings, with 3,000 to 4,000 people at a time, to talk about what was happening. And we held small forums, where we brought together groups of 50 to 80 and listened to their concerns. I usually ate by myself in the cafeteria and made sure people could just come up and speak with me. Physical presence was very important. I left in the middle of all this to go to Japan for about a day and a half, because I had to make a board presentation on our budget. When I got back, our head of HR, George Rose, said, "Why have you been gone so long?" And I said, "George, I've been gone *36 hours*." Time felt very compressed, because things were happening so quickly.

Were your employees also angry? Some were, yes. And once they heard that the U.S. government thought the hack was done by North Korea, some were angry that we were releasing *The Interview*. When you take a job in a movie studio, this is not what you think you're signing up for.

How did you cope with the exposure of so much private material? It was complicated, for a couple of reasons. There was the celebrity-related stuff people were reading in the newspapers, which was distracting to employees, especially those whose e-mails were being published. And then there was the fact that employees could look up one another's e-mails and read them.

Was there any way to contain that? We encouraged people not to rubberneck—meaning "Don't go and look at the e-mails."

What could you do about the e-mails that went public? Nothing, other than try to turn a blind eye and say that it was a distraction that needed to be treated as just that.

How did you survive the criticism of celebrities that was in the e-mails? In your business, you're dealing with some of the biggest egos in the world. In some cases we had to pick up the phone and apologize. But for the most part, people shrugged it off. The Hollywood community, while close, is also transactional. People want to make movies and television shows. And frankly, I think a lot can be forgiven in that process.

"When you take a job in a movie studio, this is not what you think you're signing up for."

Have you lost any talent? No, we haven't.

You did lose one senior colleague: Amy Pascal, who stepped down from her job as cochair. Was that necessary for the company to move forward—particularly since she had written some of the most troubling e-mails? No, that wasn't the issue. Our mutual decision for her to move over to a producing role coincided with her contract's coming due. It was time for a change in the motion picture group.

You won't be the last company that's breached. What are some lessons to impart from your experience? I think everybody is more cautious about what they put in e-mail, and the instinct nowadays is more often to pick up the phone or meet in person, particularly when you're talking about difficult stuff.

Didn't we already know not to put stuff in e-mail? Yes, but you say to yourself, *Ah, it's never going to happen.* And I have to say that people's short-term memories are unbelievably short. I'm receiving e-mails now that make me think as I read them, *Really?*

Have you looked at the leaked e-mails? I haven't. And they weren't leaked. They were stolen.

So the only content you know about personally is what blew up into media stories. Yes. I didn't even look at my own. And to pore through other people's e-mails would require thousands of hours. I didn't see the point of that.

Besides caution with e-mail, what are some takeaways from all this? There's the fundamental issue of what should or shouldn't be up on the network. The FBI said that 90% of companies would have been unable to withstand the attack. Nonetheless, everything that's up on the network is by definition susceptible to a breach. It's complicated, because ease of communication and access to data are part of what makes business operations run efficiently. But the more you have up there, the more vulnerable you are to hacking.

You even lost entire movies, right? The hackers stole a few movies that they released, including *Annie* and *Still Alice.* We believe they may also have stolen *The Interview,* but if they did, they chose not to release it.

To Release or Not to Release?

Do you accept the theory that North Korea did the hacking? I actually haven't been concerned about who did this. I've been more concerned about getting the business up and running and making sure folks here feel calm enough and secure enough to keep on with their jobs. What the FBI and others in the government have told me, and what the president of the United States has said, is that it was North Korea. I have to believe them. They did the forensics; they did the intelligence work.

As you know, some people think that's not true for a number of reasons, including the fact that the hackers said nothing about *The Interview* in their earliest communications. The U.S. government has access to more information about this than anyone else, and I have no reason to disagree. Experts have told me that the level of destruction and sophistication suggests it was a very expensive operation requiring a lot of people. I personally don't know whether it was the North Koreans or another entity, but I don't think it was some disgruntled employee. It was way too sophisticated.

Given that it may have been North Korea, do you have any regrets about aspects of *The Interview*—such as that it identified Kim Jong-un and North Korea by name? No. Once you decide to go forward with making a movie, you're under an obligation to yourself and the creative community to ensure that it gets out. We stayed true to that.

As a moviegoer, I was a bit bothered that *The Interview*—this sudden poster child for the First Amendment—wasn't better. The whole affair seemed unlike the fatwa on Salman Rushdie. Well, have you read *The Satanic Verses?* It's not *Midnight's Children.* I mean, it wasn't Rushdie's greatest book. And I daresay the cartoons in Paris were not works of art. So the issue isn't what you're defending. It's your obligation to defend. *The Interview* probably got a lot more scrutiny than it would have if we'd just put it out at Christmas as an R-rated comedy. Yes, I wish it were some great thing. It's not a great work of art. But the examples I just described weren't either.

You took a lot of heat when you initially postponed the movie's theatrical release. That was a dark moment. And then President Obama spoke out, criticizing us. It wasn't that we didn't want to get the movie out but that theaters didn't want to screen it. And we were already trying to line up digital distribution partners. But it's not fun having the president wag his finger at your company.

"This event was a relatively inexpensive, very noisy canary in the coal mine."

How did you scramble to make things happen when it was clear you couldn't have a normal theatrical release? I started calling people to ask if they would release it digitally. The majority said no. A lot of the e-commerce players and large cable operators and satellite operators were concerned about getting hacked themselves. For the first time, I thought, *We may not be able to get this out.* But then I spoke to Eric Schmidt, at Google, who said, "This is just the moment we've been waiting for. We think our security is up to this." And Google helped get the film out on YouTube and Google Play.

Did anything useful come out of the patchwork distribution model that you put in place with Google and others? People often ask that, because there's an ongoing debate in our industry about whether we should release movies digitally at the same time we release them theatrically. I still believe very strongly in the theatrical experience. And what happened here was one of a kind. We cobbled together an e-commerce site with a couple of small companies, Kernel and Stripe; we had Google and Microsoft involved; and others trickled in later.

Were there attempts to hack Google? I gather a lot of stuff was going on. But in the end, nothing bad came to Google, or Microsoft, or the others.

Does It Ever End?

Is the crisis over? Will it ever be over? I don't want to jinx things, but I think it's over. I hope so. Most of our systems have come back online. And I don't think any revelations are still to come.

I read that the eventual cost to the company was $15 million. The $15 million Sony reported was the cost as of December 31. But the bottom line—and it's a testament to the people here—is that we didn't miss a single day's start on a single television show or on a single movie.

WikiLeaks, meanwhile, is keeping the stolen data public and cataloging it for ease of search. I think Julian Assange's argument is that Sony is a big, influential public company and thus these documents deserve to be publicly accessible. I take it you don't agree. I don't agree, particularly because there's so much personal information in there. I think people have a right to their privacy. And anyway, the e-mails were stolen. For that matter, I don't agree with the way the press has been looking through the e-mails.

How much success did you have putting a halt to the press reports? Certain publications behaved honorably. They basically held back from doing a deep dive into the e-mails. Others didn't; they assigned large groups of reporters to go through the e-mails.

Were you surprised, or disappointed, by the lack of solidarity from others in your industry—that they didn't say, "We are all Sony"? I was surprised at first. But in retrospect I think our competitors were worried about getting hacked themselves, and worried about shareholder lawsuits if they came forward in support of us and then were hacked.

Did anything positive come out of this debacle? If you think about it, this event was a relatively inexpensive, very noisy canary in the coal mine for the United States. Imagine if it had happened to General Electric, and Jeff Immelt's e-mails were opened up. I have no idea what's in them, but I daresay they're not e-mails about big movie stars. The damage to an organization the size of GE would have been much greater than what happened here. So if there's a silver lining, it's that this was a call for America to wake up and pay attention. This is going to happen—in fact, it already is happening, on a regular basis.

Is your security better than it was before the hack? We're about to bring new systems online, which will have new protocols and security. But a lot of it, as I mentioned, is about what you put on the network. My wife made it obvious to me at one point, when she reminded me that she keeps her jewelry in a safe deposit box and takes it out only when she plans to wear it over a weekend. She doesn't leave it at home. That's how you have to view a network. You have to think carefully about what data needs to be up there.

Why are you willing to talk about this incident? For a number of reasons. First, I don't think people properly appreciate what the folks at Sony Pictures went through and what a spectacular job they did in keeping the company going. I also don't think people understand the level of destruction we suffered. Coverage about the stolen e-mails did a lot to obscure what was really at stake here. When you get attacked like this, your entire business is in jeopardy.

The Voice of Experience

What other advice would you offer executives caught up in a hacking crisis like this? Staying calm is essential. And you need to be open and candid and constantly communicating. If you aren't, morale will suffer and people will leave. You also have to set priorities. The businesses we brought back first were the ones that generated revenue, even as other things fell by the wayside. Lastly, it's important to bring the FBI in early. Some companies are reluctant to do so; I think that's a mistake.

Have your personal priorities changed? This is going to sound naive, but the crisis demonstrated how overreliant we are on e-mail and the network. We should wean ourselves off it. Not that we have to walk around with abacuses, but nonetheless.

Has Sony Pictures managed to preserve its culture? You can't prepare for a black swan event. It just happens. But this did bring the place together. It forced everybody to work closely in a way that they hadn't in the past. And they liked that experience. I got to meet a lot of people I normally wouldn't meet and hear their concerns. We're trying to wrestle now with how to preserve all that.

What did this experience teach you about leadership? You have to be incredibly optimistic at all times about getting through a crisis—even if you're not quite sure how you're going to get through it. You need to be a thousand percent convinced in your own head, or you won't get across the finish line.

Isn't that just temperament? Aren't you just an optimistic person? I'm actually not very optimistic, for the most part. But in times of crisis I become unreasonably so.

You mean falsely optimistic? No, it's not about false optimism, because—and this will sound like bad movie dialogue—failure just isn't an option. You need to project a sort of cheerleading optimism, or you're not going to find your way.

HBR Reprint R1507J

HR Collaboration that Drives Business Performance

A new breed of partnership is emerging between human resources and business leaders. The collaboration involves HR harnessing business-focused strategic tools and business leaders mastering a breadth of talent management skills.

Behind the New Breed

Like other C-suite roles, HR is being asked to become more strategic and build new skills. CFOs have been making the transition in recent decades by parlaying financial skills to manage overall corporate investment and risk. CIOs and CTOs are increasingly charged with innovation as technology becomes a driver of competitive success. For HR, the change is being driven by a mounting focus on talent as a primary source of competitive advantage.

Through their transitions, finance and IT have remained enterprise functions since business leaders have little or no need to master the technical skills in these areas. For HR, the case is different. It has long been an expectation that all business leaders have people management skills and maximize performance by adeptly attracting, organizing, motivating and developing teams and their members. Now that expectation is fostering a new breed of partnership between HR, the C-suite, and line-of-business heads. HR is beginning to apply powerful strategic tools to identify and solve talent challenges, and business leaders are improving their people skills to make the solutions happen.

Showing the Money—Collaboration Drives Performance

In a 2014 report, "Partnering for Performance," EY found that 80% of CFOs and CHROs said the level of collaboration between them had increased during the past three years. We also found that close collaboration boosts financial and nonfinancial performance. More than 40% of organizations that had a strong partnership between the CFO and CHRO had significantly higher EBITDA (10% or greater during the past 12 months) than did companies without that level of collaboration. Organizations with strong CFO/CHRO collaboration also experienced significant improvements in employee engagement and productivity.

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Confidence in a company's HR leaders is the crux of effective collaboration. Earning that confidence has two prerequisites. The first is flawless delivery of HR services. If there are issues with benefits or payroll, HR's relationship with the C-suite and their business partners will stagnate. But once the basics are firing on all pistons, we found that forward-looking HR leaders are building new levels of confidence by taking the lead in identifying talent challenges and the path to their solution.

HR Tools Speaking the Language of Business

New strategic tools that harness talent data and HR's expertise are forging that path. John Boudreau, a professor and research director at the University of Southern California, urges HR professionals to use approaches that business leaders can easily relate to. For example, HR leaders are starting to analyze and address talent pipeline issues with the same framework that businesses use to tackle supply chain challenges—focusing on quantity, quality, cost and timing of needed talent, and what stands in the way of meeting those needs.

Anthony Hesketh, of Lancaster University, has been conducting research into tools and metrics that allow companies to apply the same discipline to talent investments that they do to other forms of capital investment. As executives, board members and investors clamor for insights into the effectiveness of a company's talent management; Hesketh is delving into how HR is moving from a focus primarily on cost metrics toward robust calculations of a company's return on talent investment. He shows how CHROs can quantify the direct link between talent management expenditures and organizational performance in order to optimize the return on HR spend.

Analytics power these tools. Although HR needs to catch up to other functions in using analytics, that may happen faster than many think. Evan Sinar, chief scientist at Development Dimensions International (DDI), says that HR already has much to contribute in talent analytics, particularly as companies struggle with the analysis paralysis that comes with big data projects. Sinar points out that many HR professionals have social sciences backgrounds which have honed their ability to develop hypotheses and pose specific research questions to test them. Increasingly, according to Sinar, companies are putting analytics professionals in HR, sometimes from other units, to accelerate HR analytics capability.

Business Leaders Learning Talent Skills

DDI's 2014/2015 Global Leadership Forecast, conducted with The Conference Board, found a strong desire on the part of business leaders to spend more time interacting with their employees rather than just managing them (e.g. delegating or monitoring projects). However, nearly half—41%—spend most of their time managing but would like to tip the scale the other way. But the majority of companies still place a premium on managing. HR's expertise in how to interact with employees can play a major role in shifting this corporate mindset.

The Future of HR

As the new breed of partnership emerges and evolves, the structure of HR is likely to change. Its transactional responsibilities, such as benefit administration, will probably remain an enterprise function. Talent management, which is so specific to individual industries and companies, will move to the top of business leaders' agendas. But talent management will still need professional support and guidance. A deep understanding of how to develop leaders and change human behavior is not something that business leaders can pick up in a few months or even a few years. As a result, businesses will turn to HR as the center of excellence while HR, in turn, frames its support in the language of business performance.

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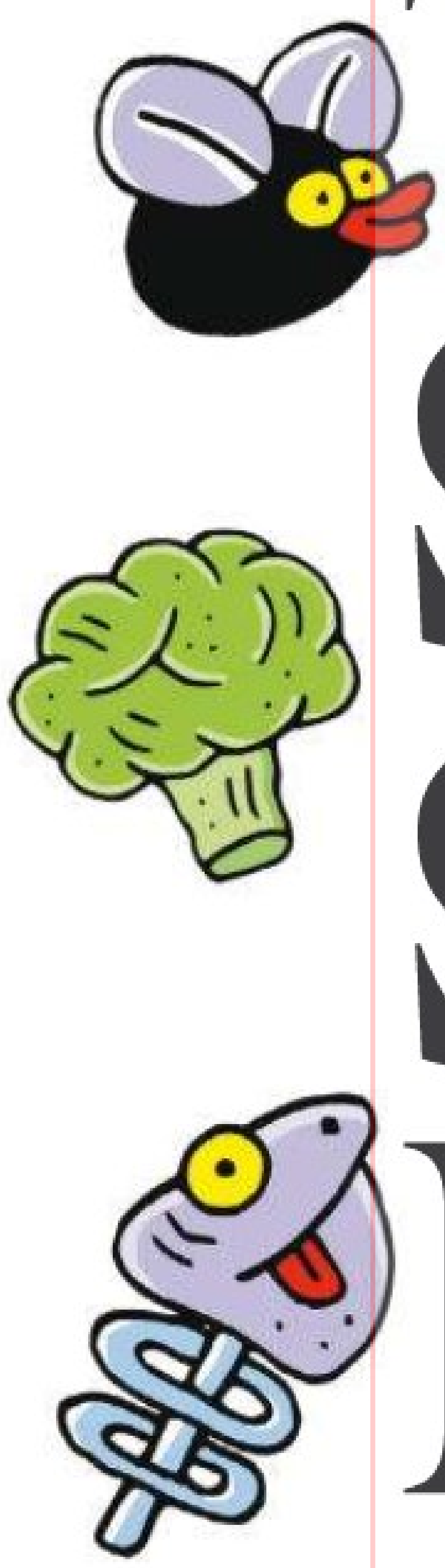
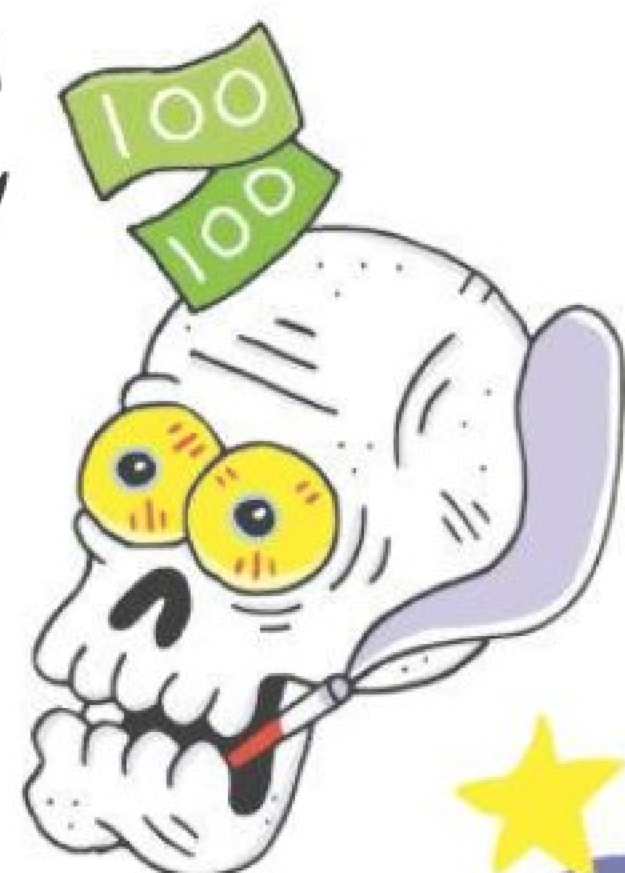
Experience



The Sad State of Happiness



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SAM TAYLOR

RYAN CHAPMAN

Managing Yourself
Ace the Assessment

More employers are using tests as part of the hiring process. Here's how to prepare for them. *by Tomas Chamorro-Premuzic*

If you thought your test-taking days ended when you left school, think again. Recent research shows that about 76% of organizations with more than 100 employees rely on assessment tools such as aptitude and personality tests for external hiring. That figure is expected to climb to 88% over the next few years. We're not talking just about screening for junior recruits. The more senior the role, the more likely the employer is to use assessments to identify candidates with the right traits and abilities. Global estimates suggest that tests are used for 72% of middle management positions and up to 80% of senior roles, compared with 59% of entry-level positions. So even if you've never taken an assessment, chances are you'll have to in your next job search.

How can you get better at taking these tests so that they're opportunities to shine instead of stumbling blocks in your career? After 15 years of studying assessments and developing more than 100 of them for organizations, I can tell you there's no easy way to game well-designed tools. Companies use them to identify people with the traits and skills required for particular jobs, and new hires who have misrepresented themselves are quickly found out.

That said, if you're an informed test taker, you'll be more likely to showcase your best self. You'll also be in a better position to evaluate whether the job is right for you, just as potential employers are evaluating whether you are right for the job.

Organizations take these tests seriously, so you should, too. Here's what you need to know about the most common types and how companies are using them.

76% of organizations with more than 100 employees rely on assessment tools such as aptitude and personality tests for external hiring.

What Assessments Measure

Prehire assessments have been around at least since the Han dynasty in the third century. Chinese imperial leaders used them to gauge knowledge, intellect, and moral integrity when selecting civil servants. Modern personality and intelligence tests were introduced in the United States and Europe during World War I, to aid in military selection, and after World War II companies started adopting them to screen applicants.

Today employers like assessments because they greatly reduce the time and cost of recruiting and hiring. Tests also prevent interviewers from accepting or rejecting candidates on the basis of conscious or unconscious biases. And because tests can be given remotely and scored electronically, they widen the pool of candidates.

Most important, valid tests help companies measure three critical elements of success on the job: competence, work ethic, and emotional intelligence. Though employers still look for evidence of those qualities in résumés, reference checks, and interviews, they need a fuller picture to make smart hires. Research shows that tests for such traits are much better predictors of performance than are years of experience or education—the sort of data that candidates typically highlight in their applications.

Let's look at the three traits employers are testing for.

Competence. Competence is usually measured with aptitude tests, which consist of questions or problems (with objectively correct answers) designed to assess raw reasoning power. Ranging from generic IQ assessments to tests of specific abilities or skills, aptitude tests are used to evaluate what you know, what you can do, or what you're able to learn. The most common types measure verbal, numerical, abstract, or logical thinking. (For example, "True or false: 6/8 + 6/8 = 1.25 + 2/8." Or "Castle is to aristocrat as sewer is to ____.") For employers they are a great complement to résumés, especially when candidates are too junior, too similar, or too different to be compared on experience.

The key thing to remember about aptitude tests is that employers rely on them merely to establish that you have sufficient reasoning and learning skills. In most cases you don't need to be a top scorer; you just need to meet a baseline.

In recent years employers have also evaluated competence with situational judgment tests (SJTs). Like aptitude tests, SJTs present problems to solve, but the problems don't have objectively correct answers. Instead, experts or judges determine which answers are most and least desirable. These tests are typically untimed and focus more on tacit knowledge or practical know-how than on reasoning performance. And their content is more explicitly connected to a particular job role than is the content of traditional aptitude tests. (See the sample question below.)

When you're confronted with an SJT, think carefully about the culture of the company that's administering it—just as you would to prepare for an interview in which you might be expected to answer scenario-based questions.

Work ethic. Most companies seek employees who are ambitious, reliable, and trustworthy. These

TESTING FOR COMPETENCE

SAMPLE QUESTION

Imagine that you're a hotel concierge, and a guest asks you to make a dinner reservation at a specific restaurant. You know the place fairly well, and previous guests have given you negative feedback about it. But this guest seems very excited about the prospect of eating there and has not asked for your opinion. What do you do?

- ○ **A.** Congratulate the guest on his or her choice and make the booking.
- ○ **B.** Make the booking without providing your opinion.
- ○ **C.** Offer a couple of alternatives, explaining that they are probably better.
- ○ **D.** Share your opinion and say that several guests have been disappointed with the restaurant.
- ○ **E.** Pretend the restaurant is fully booked and offer to find an alternative.

Options C and D seem wiser than A and B (you don't want your guest to be unhappy); E is dishonest and a bit extreme. But the "right" answer may actually differ from hotel to hotel; it will be whatever the establishment's top-performing employees would do.

TESTING FOR WORK ETHIC

SAMPLE QUESTION
Choose the most accurate statement below.

- **A.** It is important for me to excel at everything I do.
- **B.** I am good at everything I do.
- **C.** If you want to be successful, you can't always put others' needs first.

People who select B tend to be narcissistic—research shows that narcissists don't hesitate to reveal themselves in assessments. Those who select C are likely to be overly ambitious. (If that seems obvious, you probably don't fall into either camp.) Statement A captures a healthy degree of ambition.

elements of work ethic determine not only whether people will get things done but also whether they'll fit in with the organization's culture and collaborate well. Self-report questionnaires, such as personality tests, are often used to evaluate those qualities by revealing typical patterns of behavior. They might, as in the sample question above, give you a sense of which people can manage the tension between getting ahead and getting along—an ability most employers are looking for.

I say "most" because some organizations are much more accepting of extreme ambition than others. For example, a few years ago I helped Reckitt Benckiser, a multinational consumer goods company, develop an immersive personality test designed to attract candidates who were so "insanely driven" that they'd often act in bold and somewhat antisocial ways. This is a great reminder that organizations, and even departments within them, have their own profiles for success.

Emotional intelligence. Ever since the psychologist Daniel Goleman popularized the concept, employers have been paying a great deal of attention to emotional intelligence, and rightly so. Many psychological studies demonstrate that EI is linked to overall job performance, entrepreneurial potential, and leadership talent. Further, its importance is not confined to specific roles.

Employers tend to assess EI through face-to-face interviews, but increasingly they also use psychological tests. Most of these look like self-report personality tests, but they specifically gauge interpersonal and intrapersonal tendencies. Candidates might be asked whether they find other people's sadness contagious, for instance, and whether they tend to avoid upsetting situations. Their responses help illuminate how empathetic and self-aware they are.

EI can also be evaluated through SJTs. Scenarios might involve making decisions under pressure or displaying appropriate social etiquette. An extreme example is Heineken's use of real-world SJTs in interviews, which confront candidates with the unexpected or the uncomfortable (handshakes that turn into hand-holding, for instance, or an interviewer who pretends to pass out) to test their resilience, people skills, and team spirit.

Some employers are starting to assess EI with "performance tasks." Like IQ or aptitude tests, these tasks, such as the "eye test," below, present problems to solve, but the decision maker determines which answers are best. (The eye test is modeled on questions developed by Simon Baron-Cohen, the director of the University of Cambridge's Autism Research Centre. The other sample questions are in the public domain.)

TESTING FOR EMOTIONAL INTELLIGENCE

SAMPLE QUESTION
How would you describe the person in the photo below?

- **A.** Angry
- **B.** Panicked
- **C.** Mischievous
- **D.** Passionate

The expression is meant to be "panicked," and by choosing that response you'll show that you're attuned to body language, which is critical to EI. But you can see the subjective element here—we're looking at a photograph of an actor's portrayal. Even so, academic studies suggest that questions like this can be effective complements to other kinds of tests.

Though psychological assessments and other forms of EI testing might seem soft or silly, they give organizations a window into candidates' emotional literacy and social insight—qualities that are critical in many roles and organizational cultures.

Mastering the Tests

Now that you understand the types of tests and what employers hope to learn from them, I'd like to offer some general advice about how to improve your performance.

Everyone benefits when assessments reflect what people can do and what they're like. Even a candidate who desperately wants a job will regret getting one that's a bad fit. Still, it pays to do as well as you can. Here's how to set yourself up for success without compromising accuracy.

Practice. Just as sample questions and prep courses help students raise their scores on college entry exams such as the SAT, assessment practice can give you an edge in your job search. It's estimated that up to half of employment candidates engage in some sort of preparation. And for good reason: It's not uncommon for people to increase their aptitude test scores by about 20% through practice. The practice book for the GRE is an excellent resource for sharpening your verbal, numerical, and logical reasoning. You can also find questions from psychological tests, SJTs, and other types of assessments online.

A review of 50 scientific studies with more than 130,000 participants shows that practice boosts performance on pretty much any kind of test, for three reasons. First, it decreases anxiety. As you'd imagine, the more trial runs you've had, the more confident and calm you'll be when

FREEIMAGES

A one-minute increase in a city's average commute time is associated with a decline of 0.3 percentage points in the labor force participation of high school–educated women, according to an analysis of U.S. Census data.

"WHY DO SO FEW WOMEN WORK IN NEW YORK (AND SO MANY IN MINNEAPOLIS)? LABOR SUPPLY OF MARRIED WOMEN ACROSS U.S. CITIES," BY DAN A. BLACK, NATALIA KOLESNIKOVA, AND LOWELL J. TAYLOR

The Traits Employers Measure

COMPETENCE	WORK ETHIC	EMOTIONAL INTELLIGENCE
Expertise Experience Trainability	Reliability Ambition Integrity	Self-management Social skills Political skills
THE TOOLS THEY USE		
Résumés Aptitude tests Situational judgment tests	Personality tests References Peer evaluations Values tests	Interviews Personality tests Situational judgment tests Performance tasks

taking a high-stakes test, because the various formats and questions, as well as the entire experience, will seem more familiar. You'll also discover what you don't know, so you can brush up and feel more prepared. Second, practice makes proven test-taking strategies, such as skipping and revisiting difficult questions, come more naturally when the pressure is on. You'll learn to ignore irrelevant information and make fewer errors in interpretation. And third, repeated test taking can help you develop the very qualities that employers measure. Neuroscientific evidence suggests that brain-training programs, including skill-based video games, can enhance your focus and your ability to detect patterns—skills that most aptitude testing is designed to assess.

Of course, practice is more effective if you know precisely what type of test your prospective employer uses. Ask the recruiter or anyone you know who works at or has interviewed with the company. Recruiters get paid for placing candidates, and current employees often get paid for referrals, so both should be motivated to help you.

Attend to logistics. Research shows that personality, circadian rhythms, and stimulants interact to affect performance. People who are agreeable and conscientious, for example, are likely to be better test takers in the morning and so should avoid caffeine at that time, when they're naturally firing on all cylinders. The reverse is true for extroverted, creative people: They may need coffee to perform well in the morning but can be hindered by it in the afternoon, when they're already at their best. So if you have any control over when you take a test, choose wisely. Consider what time of day you are most focused and be careful about the food and drink you consume.

Be yourself, within reason. This advice applies especially to personality and psychological assessments. Don't lie—you'll just improve your chances of landing a job that's not an appropriate fit. Good tests have anticheating features that detect anomalous or fake responses, and smart interviewers are quick to pick up discrepancies between test scores and real-world behaviors. However, when taking assessments, you can and should try to live up to your most ardent supporters' image of you.

For instance, in most cases you would do well to portray yourself as driven, but not to the point of undermining others or behaving unethically. Savvy employers tend to look for moderately high scores on ambition, or a combination of high ambition and altruism. This approach is consistent with studies showing that "too much of a good thing" often has negative consequences.

Most employers map their assessments to their "competency models." That is, they note the qualities, skills, and values of their high performers and then measure those with validated tools. You can find out what traits organizations are looking for (global mindset, good judgment, resilience, and so on) by visiting their websites and reading their statements of values and purpose. That will give you a broad sense of the culture—and of how the "real" you might fare—before you even apply for a position.

BECAUSE COMPANIES find assessments so valuable in their hiring efforts, it's important to be prepared for any type that might be thrown at you. Most prehire tests are traditional self-report questionnaires, but technology is ushering in a new crop of tools. For instance, some employers are offering "gamified" tests online (complete with points and badges) in order to expand the applicant pool. They're also using algorithms to translate social media activity into an estimate of potential or fit. There's still work to be done to address validity and privacy issues, but you should expect more and more companies to use these innovative methods.

As you gear up to take a prehire assessment, remember that you're not just jumping through hoops for the employer's benefit. Tests can provide clues about an organization—how things work there, how success is defined, which traits matter most. You're getting a peek at expectations, which is invaluable in any job search.

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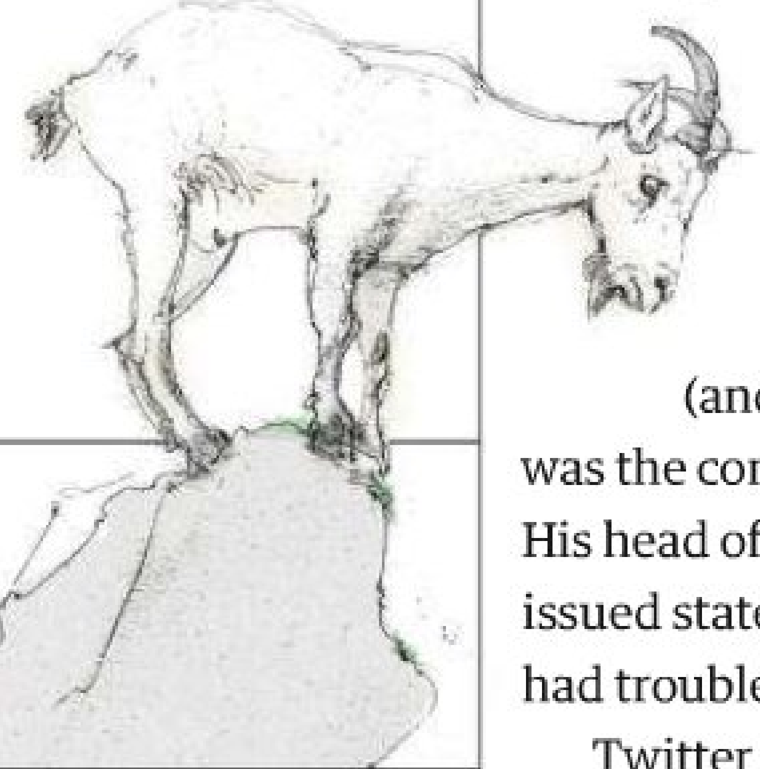
Tomas Chamorro-Premuzic is the CEO of Hogan Assessment Systems, a professor of business psychology at University College London, and a faculty member at Columbia University.

Case Study Who Should Take the Fall?

In the wake of a security breach, the board demands a scapegoat. *by Jana Seijts*



Jana Seijts is a lecturer in management communication at Ivey Business School at Western University in Ontario.

The four weeks since hackers had attacked his company had been the most stressful of Jake Santini's career. Sitting at his kitchen table after another long day of meetings and interviews, the CEO read the e-mail from his board chair again, this time out loud to his wife, Fleura:

"It's the strong feeling of the board that someone needs to be held publicly responsible for what happened. While we're confident that the issue has been handled, we feel this is a critical step in making amends with our customers and restoring our image in the public eye."

The board chair, Carly Elliot, had been a director at SimplePay, an Austin-based mobile-payment processor, since its days as a start-up. She and Jake had always worked well together, so he was a little taken aback that she was sending an e-mail rather than calling him about something so sensitive.

Fleura shook her head. "When she says 'someone,' does she mean you?"

"I don't know. When the hack first happened, she made it clear that she didn't want me to resign," Jake said.

"She just wants someone to," Fleura said, yawning. He felt bad about keeping her up—she had a flight to catch early the next morning—but she'd insisted on staying up a few more minutes and talking it through.

"Whether or not you have a job next week matters to me," she said, only half joking. "Seriously, why is Carly blowing this out of proportion? This isn't a Target situation."

She was right. Although SimplePay processed millions of credit card transactions a day through an app that enabled merchants to accept payments by tablet or phone, the hackers had infiltrated just one database, which held only consumers' e-mail addresses. They hadn't gotten financial details or any other identifiers.

Still, it had been an alarming security breach. The company had been forced to take its system down for 42 hours, notify all 10 million affected consumers, and issue a public apology. Tech bloggers had jumped all over the story; many speculated that SimplePay had begun to slow its hiring and scrimp on security investments in an effort to spiff up its balance sheet for a potential IPO. Some of that was true. The plan was to go public next year, and Jake and his CFO had been trying to cut costs, but they had mostly spared the IT group. They knew that technology (and the staff to support it) was the company's bread and butter. His head of PR, Michelle Perez, had issued statements to that effect but had trouble controlling the story.

Twitter trolls had piled on, mocking SimplePay for taking nearly two days to recover from a simple hack, but Jake's CIO, Jesse Gladstone, insisted that his team needed that much time to fully patch the vulnerability and close any access the hackers had. The IT group had been working around the clock ever since to locate and fix any other potential holes and implement new security measures.

"She's making a big deal of it because it was serious," Jake said.

"I know that," Fleura said. "But insisting on a scapegoat seems over the top. If she doesn't want you out, who is she talking about then? Jesse?"

Jake cringed. The idea of asking his CIO to leave under these circumstances was untenable. Besides, he was proud of how Jesse and everyone else at SimplePay had handled the situation. Perhaps the response had been a bit slow, but they'd all done the best they could with the team they had and the money available.

"Chances are that Carly's just the designated messenger for the rest of the board. I'm sure someone else is behind this," Jake said.

NICK ELLWOOD

"Like Theo," Fleura said, getting up from the table. Ever since Theo Conrad, a prominent tech investor, had joined the board, he'd been a thorn in Jake's side, challenging the CEO on all but the most routine decisions. At the most recent emergency board meeting, he wouldn't stop harping on the fact that 30% of SimplePay's customers hadn't used the app since the hack.

"They simply don't trust us anymore," he'd said. "And Wall Street won't either unless we're completely clear about what we're changing to make sure this never happens again."

Jake turned from his laptop to watch Fleura as she headed upstairs. "Say something else," he called after her. "Theo's name can't be the last thing I hear tonight."

"Try to get some rest, honey," she said from the stairs.

Jake smiled but knew he probably wouldn't.

It's All Under Control Now

The next morning, Jake met Jesse and Michelle at Bouldin Creek Cafe at 7:30.

"You don't look good, Jake," Michelle said when she sat down. "It's time to start sleeping again. The worst is behind us."

"I'm afraid that might not be the case," he said, stirring two packs of sugar into his double caffè macchiato. "We're not yet back to our prehack transaction numbers, and new customer acquisitions have all but halted. I know it's only been a month, and things were slow before the breach, but we need to get things back on track soon."

"As far as PR goes, we've got it under control now," Michelle said. She ticked off all the things the company had done right since the breach: immediately contacting people whose information had been compromised and presenting a clear, consistent message to customers, social media, and the press. Michelle had recommended that the company apologize but focus on the hackers as the ones responsible. Within the organization, she'd also started to downplay the severity of the breach, but Jake had told her to stop. He worried that the sentiment was leaking into her external messaging. "We just can't forget that this was a big deal, Michelle," he said.

"Of course it was," Michelle responded. "But I really think it's almost over. My phone isn't constantly beeping at me anymore. And Kara Swisher told me yesterday that, in one sense, we should think of the hack as a badge of honor. We're now big enough to be considered an attractive target."

She smiled; Jake and Jesse didn't.

"And Jesse's on top of security," she continued. "We've got the 'latest, and most comprehensive, data security measures.' Right?"

"We're getting there," the CIO answered, staring into his coffee. Jesse had been sleeping at the office. He was a perfectionist, which made him good at his job, but in the wake of this crisis, his insistence on getting everything just right was stalling their response. While Jake and Michelle were chomping at the bit to promote the new security upgrades—a hasty yet necessary investment—Jesse was still in testing mode.

"When will the new features be up and running?" Jake asked.

"We need another day or two," Jesse answered.

"Perfect," Michelle said, a forced cheerfulness in her voice. "We can issue the release by the end of the week and include an update on the FBI investigation, too. And then our sales team can start to work their magic, and we can get back to business as usual. We've got an IPO to prepare for, after all."

Jake wondered if that was why the board was pushing so hard for a resignation: Wall Street needed a pat ending to SimplePay's hacking story before the company could embark on a road show.

Heads Must Roll

"I'm sorry that so much of this is playing out over e-mail," Carly said to Jake when they met at her office later that afternoon. "I know this isn't easy." She explained that a significant majority of the board members felt that a public gesture was necessary to demonstrate how seriously SimplePay took the breach.

"But we've done that. We explained exactly what happened and how we're responding."

Case Study Teaching Notes

Jana Seijts teaches the case on which this story is based in her Management Communication course.

WHAT DREW YOU TO THIS STORY?
The original case deals with a real product many of my students are familiar with: the PlayStation. The security breach, which took place three years before the recent Sony Pictures' hack, had potentially serious implications for Sony. I knew that the story would help my students grapple with the thorny issue of whether letting key players go helps restabilize an organization after a setback.

HOW DO YOUR STUDENTS RESPOND TO IT?
Most don't see the need to find a scapegoat and instead suggest the executives outline the steps taken to date to end the crisis and how they'll make sure it doesn't happen again.

WHAT LESSONS DOES THE CASE OFFER?
One is that companies must communicate early and often with key stakeholders and craft messages that speak to each group's needs, wants, and interests. What a customer is concerned about after a breach is very different from what an investor cares about.

HBR's fictionalized case studies present dilemmas faced by leaders in real companies and offer solutions from experts. This one is based on the Ivey Business School Case Study on a Sony hack that occurred long before the one late last year: "Sony PlayStation: Security Breach" (product no. W12309-PDF-ENG), by Jana Seijts and Paul Bigus, which is available on **HBR.org**.

"It's that last part that the board is concerned about. What changes are we making to ensure that our customers trust us completely again? At Target, the CIO and then the CEO resigned. When TJX had its breach in 2007, it was a director and an SVP. They've set the precedent. We need to do something similar so that we can put this episode behind us. SimplePay is—was—the market leader in the mobile-pay space because of its reputation for being reliable and secure. Our success is based on trust. This incident has completely eroded that."

She wasn't wrong. The customer service department had been flooded with questions about security, and although the company had expected some level of merchant attrition, defections had been much greater than expected. And they weren't tapering off.

Carly pulled out her phone. "Did you see the study from this group, Interactions, that Theo sent around last night? 'Twelve percent of customers say they would stop shopping at a retailer that had a security breach; about 36% say they would be less frequent patrons. About 85% of shoppers who have had their personal information stolen say they tell others about the incident; 34% complain on social media, and 20% comment directly on the company's website.'"

"And all that goes away if we fire someone?" Jake asked, getting annoyed. "That's not what happened with Target. Their stock dropped 3% the week that Steinhafel resigned."

"They acted too late. He should have left much sooner. Besides, shares have now jumped 30% under the new CEO, to all-time highs. Everyone loves a fresh start after a disaster—analysts, pundits, and customers," Carly said.

"But that's not always necessary. Look at Zendesk, LivingSocial. They survived hacks without firing anyone."

"But our business isn't recovering. We need to make a statement—not just new technology, new people."

"So heads must roll?" Jake asked.

"Just one head."

"Well, then, it should be me," Jake said, unsure that he believed what he was saying. "We've got a strong team in place. If I leave, the statement is made, loud and clear, and then you all can get things back in order in time for the IPO."

"It doesn't have to be you," Carly responded.

"If not me, then who?" Jake asked.

She told him that Jesse's name had come up first; after all, it was his systems that had been breached and his team that had been so slow to get the service back online. As a leader, Jesse had been a bit shaky under all the pressure. But a few board members had also pointed to Michelle; had she immediately grasped the severity of the situation and gotten out well ahead of the story, trust in SimplePay might not have dipped so low.

"How would firing Michelle help fix anything? She may have not handled this perfectly, but letting her go won't allay any customer concerns. And you know as well as I do that Jesse isn't fully to blame for the situation. No IT team can predict every vulnerability or patch every hole. He did his job as best he could."

"Listen, you've been a great leader, sticking up for them all along, even when they didn't deserve it," Carly said. "But the board has made up its mind. Someone's got to go."

Take One for the Team?

Jake typed the letter out on his phone.

Please rest assured that this decision was not easy, but in light of recent events, I have decided that my stepping down is in the best interest of SimplePay and its customers.

While I cannot take any personal responsibility for this incident, it happened on my watch. As the company's CEO, I am ultimately responsible and thus resign from my position, effective immediately—mostly because the board is making me do it.

He pressed send, and 20 seconds later his phone rang. It was Fleura, calling from her hotel room in San Francisco.

"Why in the world are you up at midnight writing a fake resignation letter?" she asked. "I do love the last line, though. If only all shamed CEOs admitted that their boards made them do it. But seriously, honey, you're not resigning, are you? You love your job."

This was true. At the helm of SimplePay, Jake was happier than he'd ever been, and he certainly didn't want to give up the opportunity to lead his first IPO. But he couldn't imagine making anyone else the scapegoat.

"How did it feel typing it out?"

"Terrible," he admitted. "I'm not ready to go, but maybe I have to take one for the team."

Tell us what you'd do. Go to **HBR.org**.

To learn how Sony Pictures responded to being hacked, see "They Burned the House Down," on page 106.

Should Jake resign?

See the commentaries on the next page.

The Experts Respond

Cary Horenfeldt is the vice president of MasterCard Processing at MasterCard, Asia Pacific.

THE UNFORTUNATE reality is that this sort of breach is all too common. However, while I understand why Carly and the rest of the board want to reverse the economic and reputational damage this incident has caused SimplePay, I disagree with the commonly held idea that every crisis needs a fall guy.

Making Jake, or even Jesse, resign could backfire for two reasons. First, the act would shift the blame away from the real perpetrators of the crime—the fraudsters. This would, of course, be different if the hack were an inside job, but that doesn't sound like the case. By picking an internal scapegoat, the board hopes to put the breach behind it, but the company won't be able to move on until it fully understands what happened, why, and how it can better protect its applicable systems, before confidently communicating this to all internal and external stakeholders.

Second, forcing a resignation could actually hurt, rather than help, SimplePay's reputation. Jake and his team seem to have handled the situation reasonably well. They were transparent, told all the right people about the breach quickly, and have taken steps to mitigate any fallout. Maybe they've been a little slow to fix the problem, but in these cases "fast" is relative. If a senior executive leaves, it could undermine the message that the company has rebounded from the incident. Consumers and analysts might wonder, "What's really going on there?" And then it could take even longer for SimplePay's image to recover.

> **Forcing a resignation could actually hurt, rather than help, SimplePay's reputation.**

Like every firm that handles payment-related information, MasterCard is vigilant against the threat of hackers. But, sadly, fraudsters have become a sophisticated group. They're interconnected and international, so they can use information stolen from one region in another, making fraud difficult to track. And they're constantly adapting. MasterCard leverages extensive, dynamic risk and fraud-management policies and systems, including an emergency response team on which I serve. This team manages all aspects of responses—from detection to action plans to communications—and ensures that the right activities occur at the right time.

The breach at SimplePay should be an opportunity for the organization to come together—a catalyst that kicks off the development of a well-defined plan to mitigate economic and reputational damage. It doesn't fall on just Jake and Jesse to protect the company. Everyone—from the board chair to the end user—is responsible for carefully handling data and improving security. Rather than let Michelle manage the messaging on her own, SimplePay should create a unified voice that brings together corporate communications, executive management, and operations and technology.

It's not that making the decision to fire someone is never right. But in this instance, Jake and his team need to stay put and focus on preparing for the future, securing their systems against future attacks, and getting back to business.

Comments from the HBR.org community

The Die Has Been Cast

Let's remember, the board has the final word. The decision stinks, but the board has spoken: Someone at the top has to go. SimplePay needs to reverse its vicious cycle before it becomes a death spiral. Jake should make it clear to the directors that, as their subordinate, he will carry out their orders, just as he expects everyone else at SimplePay to carry out his.

Jeffrey Deutsch, *founder, A SPLINT*

Resigning Will Send a Message

If Jake fires either Jesse or Michelle, SimplePay might not be better off, because their replacements will need months to come up to speed. But if the board insists on someone's head, Jake can only offer his own. If he resigns himself, he's making a statement: that he believes in his team.

Teg Rood, *principal, Rood Consulting*

SimplePay Has Other Options

Firing someone is not the only way to send a strong message. The company could rebrand with a marketing campaign or update its mobile processing system with new designs and security features that are clearly visible to customers. All this will be for naught, however, if the app is hacked again. To restore customer trust, the company must continue to improve security.

Alvin Tsui, *development analyst, Qualicom Innovations*

Don't Jettison Your Talent

There is no upside to making someone take a fall for appearances. If Jake had been incompetent, he would have to go. But he appears to be a capable executive, and it doesn't make sense to lose talent, especially in tough times when the company needs a leader.

Robin Cohn, *author,* The PR Crisis Bible

Kanina Blanchard is the president of Opportunity Creation, a consultancy focused on issues and crisis management. She was a senior leader in the Ontario Ministry of the Environment and at the Dow Chemical Company.

THERE IS no doubt that SimplePay is in this situation because of a failure in operational leadership. And in the midst of the fire, with the board resolute, a resignation might be the only option. But it didn't have to come to this.

Things have changed when it comes to crisis management. Twenty or so years ago, executives called upon their PR departments to handle most public problems and rarely issued apologies, considering them weak and legally foolhardy. Since then, companies have become more transparent, and leaders now know they need to be at the forefront of crises, addressing concerns and providing answers. But that's not what the CEO, Jake, did here. SimplePay's incident was a relatively small breach, but it became a much bigger issue that threatened the company's future, in large part because Jake fell down on the job.

In any organization—but especially in a fast growing one like SimplePay—it's inexcusable for the chief executive not to invest time and energy in planning for crisis and issues management. I'm not talking about a yearly exercise in which everyone writes down best practices and then puts them in a binder on a shelf. Crisis planning should be a thoughtful and continual process that involves reflection and discussion of all potential risks, lessons from other companies, and the right strategies for your particular organization.

Jake should have led his team in this kind of scenario planning so that Michelle, Jesse, and everyone else knew in advance what they would do, who would do it and on what timeline—and most important, whether resignations would be on the table. At his level he should have a strong network of mentors, peers, and experts to counsel him. Leadership can be lonely, but good leaders have the humility to ask for help from trusted advisers. If Jake had put a strategy in place, Michelle could have been more deliberate about helping him engage with customers and the media, and Jesse's work to restore service may have gone more quickly. The breach could have been a blip on the radar, but instead it has gathered steam.

We took potential risks extremely seriously at the Dow Chemical

> Jake fell down on the job. He must take responsibility for his actions. That may well mean resigning.

Company, where I worked for 20 years, because the stakes are so high in that business. If systems failed, there was potential for environmental damage or loss of human life. But even when the risks aren't so extreme, companies should prepare for them thoroughly. The theft of personal information must also be taken seriously. Whether your company is a local flower shop or a global industrial player, it needs to have a crisis management plan.

Unfortunately, Jake can't turn back the clock. He must instead lead with humility and take responsibility for his actions. That may very well mean resigning or at least rolling up his sleeves and making sure the company learns from his mistakes and is better prepared the next time.

HBR Reprint R1507L
Reprint Case only R1507X
Reprint Commentary only R1507Z


THEY SAY
change is the only
constant
WE MAKE
value a constant, too
The big challenge for any enterprise isn't only setting a vision for change, but implementing it effectively. At KPMG, we not only help you envision a plan for the future, we work with you, shoulder to shoulder, to turn it into action that delivers real value. To learn how KPMG can transform vision into value for your business, visit **kpmg.com/transformation.**
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Business Transformation:

Driving the Optimum Value

KPMG

Business transformation is an imperative for companies to survive and grow in this global, rapid-cycle economy. Yet a new KPMG survey of 963 executives from U.S.-based multinationals found many companies are failing to achieve real business benefits from their transformation programs. Stephen G. Hasty, Jr., Global Transformation Leader at KPMG LLP, recently talked about the challenges in transformation and a methodology for creating sustainable success.

What's getting in the way of real payoff from transformation programs?

Organizational change is hard because organizations are so complex, with different functional units each with their own people, processes, and systems. And as the pace of change accelerates, companies want to accelerate results and get more out of their transformation efforts. That increases the pressure. In our survey, only one-third of the executives said their companies were highly capable of effectively executing transformation.

To achieve your goals, there are three important prerequisites. First, the objectives must have alignment with the strategic goals of the business and the leaders must be able to define and communicate them across the functional units. That is critical to the second step, executing effectively, because you must address all of the changes to the operating model and the interconnected functions. And finally, you must use metrics as key milestones for the transformation and to keep you on pace to recognize real value.

What did you learn from the survey about strategies that succeed?

It is important to understand where you want to take the organization from a strategic point of view. A successful transformation approach requires strategy development based on iterative scenario planning, looking at the disruptors inside and outside your industry, and developing an execution plan unique to your firm's competitive position, capabilities, and cultural environment. The survey found that companies that looked outside their traditional competitors in evaluating options had a 90% success rate of achieving their goals, compared to only a 70% rate among the others.

What is the disconnect between strategy and execution?

It is challenging when your transformation effort must cut across the organization because you are seeking change from every function. This is where the importance of communication comes in. If you are slightly off course at the start because people are interpreting things differently, it may initially cause a small deviation, but by the time you get to the end it may have become a significant divergence. Transformation requires discipline. Our survey found that the top barrier to successful outcomes is underestimating the significance of cross-functional changes to your operating model.

How do you think about the metrics in managing for value?

Companies say they have metrics to measure the outcome of their transformation program, but our survey found only 14% really start with those metrics to measure progress along the way. These metrics are essential because they help determine the milestones and the things that must happen to reach the outcome you want. To be successful, you need to track these metrics through the execution. Transformation metrics should directly connect with your strategic vision and business outcomes, in order to deliver sustainable value.

Business transformation begins with defining a strategy, but it doesn't end there. KPMG's approach extends from strategy development through its implementation—in the process helping clients realize sustainable competitive advantage and generate quantifiable results.

kpmg.com/transformation

Synthesis
The Happiness Backlash

Investigating the seemingly universal insistence on feeling good
by Alison Beard

Nothing depresses me more than reading about happiness. Why? Because there's entirely too much advice out there about how to achieve it. As Frédéric Lenoir points out in *Happiness: A Philosopher's Guide* (recently translated from its original French), great thinkers have been discussing this topic for more than 2,000 years. But opinions on it still differ. Just scan the 14,700 titles listed in the "happiness" subgenre of self-help books on Amazon, or watch the 55 TED talks tagged in the same category. What makes us happy? Health, money, social connection, purpose, "flow," generosity, gratitude, inner peace, positive thinking… Research shows that any (or all?) of the above answers are correct. Social scientists tell us that even the simplest of tricks—counting our blessings, meditating for 10 minutes a day, forcing smiles—can push us into a happier state of mind.

And yet for me and many others, happiness remains elusive. Of course, I sometimes feel joyful and content—reading a bedtime story to my kids, interviewing someone I greatly admire, finishing a tough piece of writing. But despite having good health, supportive family and friends, and a stimulating and flexible job, I'm often awash in negative emotions: worry, frustration, anger, disappointment, guilt, envy, regret. My default state is dissatisfied.

The huge and growing body of happiness literature promises to lift me out of these feelings. But the effect is more like kicking me when I'm down. I know I should be happy. I know I have every reason to be, and that I'm better off than most. I know that happier people are more

SAM TAYLOR

STAN MCCHRYSTAL: WHAT I'M READING

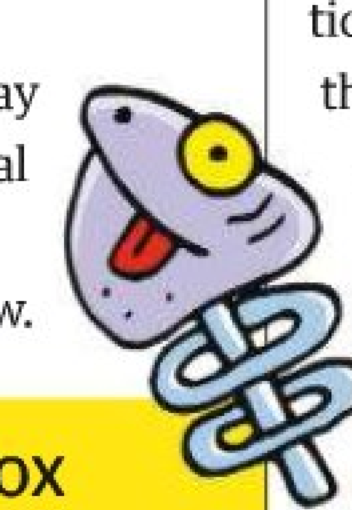
The Innovators: How a Group of Hackers, Geniuses, and Geeks Created the Digital Revolution, by Walter Isaacson (Simon & Schuster, 2014)

"Isaacson turns inside out the perception of innovator as isolated genius, reminding us that human collaboration is the foundation upon which stands all we build."

Stan McChrystal is a retired U.S. army general, a cofounder of the McChrystal Group, and the author of *Team of Teams* (Portfolio, 2015).

successful. I know that just a few mental exercises might help me. Still, when I'm in a bad mood, it's hard to break out of it. And—I'll admit—a small part of me regards my nonbliss not as unproductive negativity but as highly productive realism. I can't imagine being happy all the time; indeed, I'm highly suspicious of anyone who claims to be.

I agreed to write this essay because over the past several years I've sensed a swell of support for this point of view.



> "The great paradox of happiness is that it can be tamed while still remaining essentially beyond our control."
> Frédéric Lenoir
> *Happiness: A Philosopher's Guide*

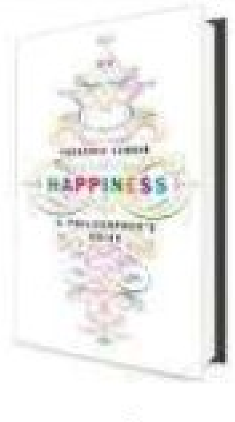
Barbara Ehrenreich's 2009 book *Bright-sided,* about the "relentless promotion" and undermining effects of positive thinking, was followed last year by *Rethinking Positive Thinking,* by the NYU psychology professor Gabriele Oettingen, and *The Upside of Your Dark Side,* by two experts in positive psychology, Todd Kashdan and Robert Biswas-Diener. This year brought a terrific *Psychology Today* article by Matthew Hutson titled "Beyond Happiness: The Upside of Feeling Down"; *The Upside of Stress,* by Stanford's Kelly McGonigal; *Beyond Happiness,* by the British historian and commentator Anthony Seldon; and *The Happiness Industry: How the Government and Big Business Sold Us Well-Being,* by another Brit, the Goldsmiths lecturer in politics William Davies.

Are we finally seeing a backlash against happiness? Sort of. Most of these recent releases rail against our modern obsession with *feeling* happy and *thinking* positively. Oettingen explains the importance of damping sunny fantasies with sober analysis of the obstacles in one's way. Kashdan and Biswas-Diener's book and Hutson's article detail the benefits we derive from all the negative emotions I cited earlier; taken together, those feelings spur us to better our circumstances and ourselves. (The Harvard psychologist Susan David, a coauthor of the HBR article "Emotional Agility," also writes thoughtfully on this topic.)

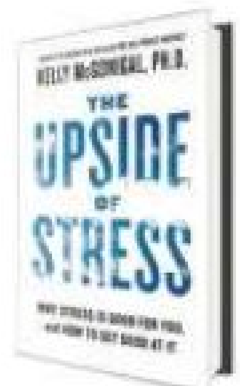
McGonigal shows how viewing one unhappy condition—stress—in a kinder light can turn it into something that improves rather than hurts our health. Those who accept feeling stressed as the body's natural response to a challenge are more resilient and live longer than those who try to fight it.

Seldon describes his own progression from pleasure seeking to more-meaningful endeavors that bring him (and should bring us) joy. Sadly, he trivializes his advice by alphabetizing it: Accepting oneself; Belonging to a group; having good Character, Discipline, Empathy, Focus, Generosity, and Health; using Inquiry; embarking on an inner Journey; accepting Karma; and embracing both Liturgy and Meditation. (One wonders what he'll use for X and Z in the next book.)

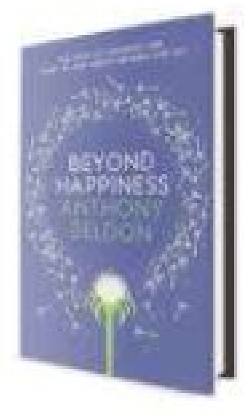
Davies comes at the issue from a different angle. He's fed up with organizational attempts to tap into what is essentially a "grey mushy process inside our brains." In his view, there's something sinister about the way advertisers, HR managers, governments, and pharmaceutical companies are measuring, manipulating, and ultimately making money from our insatiable desire to be happier.



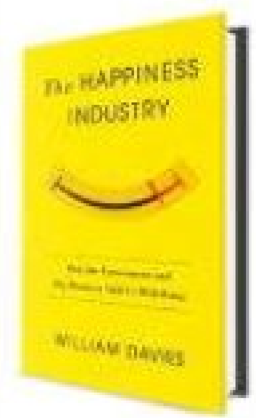
Happiness: A Philosopher's Guide
Frédéric Lenoir
Melville House, 2015



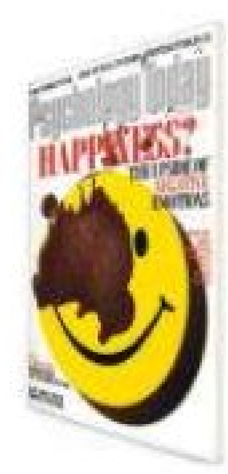
The Upside of Stress
Kelly McGonigal
Avery, 2015



Beyond Happiness
Anthony Seldon
Yellow Kite, 2015



The Happiness Industry
William Davies
Verso, 2015



"Beyond Happiness: The Upside of Feeling Down"
Matthew Hutson
Psychology Today, 2015

But none of these authors is arguing against individuals' aspiring to have a generally happy life. We call that the pursuit of "happiness," but what we really mean is "long-term fulfillment." Martin Seligman, the father of positive psychology, calls it "flourishing" and said years ago that positive emotion (that is, feeling happy) is only one element of it, along with engagement, relationships, meaning, and achievement. In the parlance Arianna Huffington uses in her recent book, it's "thriving," and Lenoir, whose history of happiness philosophy is probably the most enlightening and entertaining of the bunch, describes it as simply "love of life." Who can argue against any of those things?

Where most of the happiness gurus go wrong is insisting that daily if not constant happiness is a means to long-term fulfillment. For some glass-half-full optimists, that may be true. They can "stumble on happiness" the way the field's most prominent researcher, Dan Gilbert, suggests; or gain "the happiness advantage" that the professor-turned-consultant Shawn Achor talks about; or "broadcast happiness," as Michelle Gielan, Achor's wife and partner at the firm GoodThink, recommends in her new book. As I said, it apparently takes just a few simple tricks.

But for the rest of us, that much cheer feels forced, so it's unlikely to help us mold meaningful relationships or craft the perfect career. It certainly can't be drawn out of us by employers or other external forces. We pursue fulfillment in different ways, without reading self-help books. And I suspect that in the long run we'll be OK—perhaps even happy.

Alison Beard is a senior editor at *Harvard Business Review.*

EXECUTIVE SUMMARIES JULY–AUGUST 2015

SPOTLIGHT ON RETHINKING HUMAN RESOURCES

Today, HR comes under more fire than any other organizational function—despite the fact that first-rate talent is the scarcest resource in most companies. This package looks at how HR can reinvent itself, the CEO's role in that reinvention, and what one company is doing to bring its HR practices into line with its business strategy.

HUMAN RESOURCES

Why We Love to Hate HR... and What HR Can Do About It

Peter Cappelli | page 54

Complaints against HR, which are nothing new, have a cyclical quality. They're driven largely by the business context. When companies are struggling with labor issues, HR is seen as a valued leadership partner. When things are smoother all around, managers wonder what the function is doing for them.

This is a moment of enormous opportunity for HR leaders to separate the valuable from the worthless and secure huge payoffs for their organizations. The author outlines some basic but powerful steps they can take:

Set the agenda. CEOs are rarely experts on workplace issues, so the HR team can show them what they should care about—such as layoffs, recruiting, flexible work arrangements, and performance management—and why.

Focus on the here and now. This means continually identifying new challenges and designing tools to meet them.

Acquire business knowledge. HR needs first-rate analytic minds to help companies make sense of all their employee data.

Highlight financial benefits. HR departments don't usually calculate ROI for their programs, but quantifying costs and benefits turns talent decisions into business decisions.

Walk away from time wasters. Often programs lack impact unless top executives lead them, transforming the culture. Otherwise HR is just a booster for initiatives it can neither enforce nor measure.

HBR Reprint R1507C

LEADERSHIP

People Before Strategy: A New Role for the CHRO

Ram Charan, Dominic Barton, and Dennis Carey | page 62

Although people drive every organization's success, research shows that most CEOs undervalue their HR function and their chief human resources officer (CHRO). No wonder, then, that managing human capital is a top challenge for companies.

To address it, say the authors, CEOs must redefine and elevate the CHRO role. They should spell out their expectations in a new written contract, focusing on three contributions that the CHRO, as an expert on talent (both in-house and at the competition), should be making: *predicting the outcomes* of strategically deploying human resources, *diagnosing people-related problems* that are hurting the company's performance, and *prescribing actions* on the people side that will create value. Administrative tasks, such as managing benefits, might be delegated to others. And the CHRO should be assessed by actions that deliver revenue, margin, brand recognition, or market share.

With a new mandate from the CEO, and with appropriate business training, the CHRO can contribute to the organization just as powerfully as the CFO can. Indeed, the CEO should partner with the CHRO and the CFO in what the authors call a G3—a triumvirate to steer the company. Although reshaping the HR function could take three years or more, the authors' experience with companies such as GE and BlackRock suggests that it's well worth the effort.

HBR Reprint R1507D

CASE STUDY

Bright, Shiny Objects and the Future of HR

John Boudreau and Steven Rice
page 72

As leaders, we have ready access to potentially powerful, game-changing ideas. It's easy—and tempting—to chase after a new practice, a new expert, or new research that seems to provide some relief or a solution to a problem. What's harder, but far more valuable, is to fall in love with the problem. Then you aren't quite so eager to embrace the first possible solution and move on. You spend some time letting the challenge soak in, studying it from various angles, and understanding it more deeply. Rather than hastening to narrow the scope of your decision and the options under consideration, you remain receptive to additional, possibly better ones. This is what Juniper Networks learned as it renewed its focus on values and culture as a differentiator.

Indeed, developing a reputation as an innovative HR organization requires walking a fine line. Big new ideas often arise from popular talks and articles; if you embrace too many of those, or apply them too superficially, you'll develop a reputation for fad surfing. Dig beneath the surface to the fundamental scientific research and insights, and you can set the stage for profound effect. Juniper's approach—getting the big picture, seizing on insights, applying them wisely, and ensuring their impact—has enabled this company to move from one-off programs and unconnected experiments to a system that is always evolving in exciting and consistently business-aligned ways.

HBR Reprint R1507E

The Big Idea

HEALTH CARE

The Employer-Led Health Care Revolution

Patricia A. McDonald, Robert S. Mecklenburg, MD, and Lindsay A. Martin | page 38

To tame its soaring health care costs, Intel tried many popular approaches: "consumer-driven health care" offerings such as high-deductible/low-premium plans, on-site clinics, and employee wellness programs.

But by 2009 Intel realized that those programs alone would not enable the company to solve the problem, because they didn't affect its root cause: the steadily rising cost of the care employees and their families were receiving. Intel projected that its health care expenditures would hit a whopping $1 billion by 2012.

So the company decided to try a novel approach. As a large purchaser of health services and with expertise in quality improvement and supplier management, Intel was uniquely positioned to drive transformation in its local health care market. The company decided that it would manage the quality and cost of its health care suppliers with the same rigor it applied to its equipment suppliers by monitoring quality and cost.

It spearheaded a collaborative effort in Portland, Oregon, that included two health systems, a plan administrator, and a major government employer. So far the Portland collaborative has reduced treatment costs for certain medical conditions by 24% to 49%, improved patient satisfaction, and eliminated over 10,000 hours' worth of waste in the two health systems' business processes.

HBR Reprint R1507B

Features

INNOVATION

Engineering Reverse Innovations

Amos Winter and Vijay Govindarajan | page 80

Multinationals are starting to catch on to the logic of reverse innovation, in which products are designed first for consumers in low-income countries and then adapted into disruptive offerings for developed economies. But only a handful of companies have managed to do it successfully until now. In this article an MIT engineering professor and a Tuck professor of management explain why. After conducting a three-year study of reverse innovation projects, they've concluded that the main hurdle facing product developers is a mindset.

Western designers, who usually create products by following time-tested methods, struggle to overcome the constraints and leverage the freedoms of emerging markets. They tend to fall into common mental traps that prevent the development of reverse innovations: matching segments to existing products, lowering price by removing features, failing to think through all the technical requirements, neglecting stakeholders, and refusing to believe products created for low-income markets could have global appeal.

But companies can avoid these traps, the authors found, by adhering to five design principles. The success of several new products illustrates how. One is the Leveraged Freedom Chair, a low-cost wheelchair that can navigate rugged terrain in places with poor infrastructure; a modified version is taking Western markets by storm.

HBR Reprint R1507F

OPERATIONS

How to Negotiate with Powerful Suppliers

Petros Paranikas et al. | page 90

Buyers can no longer rely on tough talk through their procurement offices. They must approach the situation strategically.

In many industries the balance of power has shifted from buyers to suppliers. Companies that have gotten into a weak position need to tackle the problem strategically, the authors argue. They should consider the following actions and implement the least-risky one that is feasible for their organization.

Bring new value to the supplier. This is the easiest approach. Companies can provide new value in several ways—for example, by serving as a gateway to new markets or reducing the supplier's risks.

Change how they buy. Companies can consolidate their purchase orders, rethink purchase bundles, or decrease purchase volume.

Create a new supplier. This is a high-risk option, but it can transform a company's prospects. Firms have essentially two paths: They can bring in a supplier from an adjacent market or vertically integrate to become their own supplier.

Play hardball. As a last resort, companies can cancel current orders and future business or threaten litigation.

Whatever option firms choose, they need to clearly understand the problem, work on it across functions, and think analytically and outside the box.

HBR Reprint R1507G

STRATEGY

Break Your Industry's Bottlenecks

Barrett Ersek, Eileen Weisenbach Keller, and John Mullins | page 98

If you want to create a really successful business, you have to do more than win your share of customers or control costs—you have to break the rules and overturn the received wisdom about how things work in your industry.

For example, high-priced landing fees are just a cost of business in the airline industry, aren't they? Ryanair didn't think so, and it turned Europe's unused World War II landing strips into very low cost airports. To be a cell phone service provider, you need to invest in towers, networks, billing systems, and more, right? India's Airtel said no and leased virtually everything it needed from others. In sharply lowering its costs and improving its working capital model, Airtel was able to offer India's impoverished consumers cell phone service at a dramatically reduced price.

How can companies figure out which rules to break in their industries? By focusing on big structural problems endemic to their industries—not just problems they alone face.

There are five common types of industry bottlenecks: (1) an outdated purchase or usage experience, (2) a superfluous major expense category, (3) high financial risks for customers, (4) disengaged employees, and (5) detrimental side effects of the product or service.

This article lays out strategies used by real companies for busting those bottlenecks. In doing so, companies stand to significantly reduce their costs—or even eliminate entire cost categories—boost demand levels, and sometimes both.

HBR Reprint R1507H

LEADERSHIP

"They Burned the House Down"

Sony Pictures CEO Michael Lynton, interviewed by Adi Ignatius

page 106

In 2014 Sony Pictures was subjected to the most devastating hack in corporate history. Highly sensitive data—salary details, private e-mails (some of them harshly critical of top Hollywood talent), unreleased movies—was leaked for all the world to see. For good measure, the hackers wiped out everything on Sony Pictures' servers. Then they threatened retaliation against any theaters that proceeded with the release of *The Interview*, a Sony comedy involving the fictional assassination of North Korea's Kim Jong-un.

In this edited interview by HBR's editor in chief, Lynton talks about the company's initial reactions: It had to keep the business operating; deal with employees who feared that their information would be made public; deal with the press, which was publishing some of the leaked e-mails; deal with the parent company in Tokyo; and deal with the FBI. Lynton discusses lessons learned, advice for other executives caught up in similar crises, and the paramount importance of projecting "a sort of cheerleading optimism."

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How I Did It

LEADERSHIP

Tommy Hilfiger's Chairman on Going Private to Spark a Turnaround

Fred Gehring | page 33

When the author became involved with Tommy Hilfiger, as a partner in the company that had the license to sell Hilfiger products in Europe, the brand was one of fashion's hottest. Overall sales had more than doubled from 1997 to 2000. But that came at a price, the author writes. The brand was too hot, too hyped, and grew too fast. Hilfiger products began to sell at a discount in the United States—and the company's designers started creating stuff that felt like discount clothing. Soon U.S. sales were falling every year. Meanwhile, the European division had chosen not to sell the lower-quality versions, had created its own design center and supply chain, and was increasing sales by roughly 50% a year. Gehring proposed a strategy for turning the company around—and the board countered that he should find a buyer. So he did.

As the winning bidder, Apax Partners, a European private equity firm, allowed Gehring to do a dramatic restructuring and scale back the U.S. business in the short term, laying the groundwork for the brand's turnaround in less than four years.

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Managing Yourself

Ace the Assessment

Tomas Chamorro-Premuzic | page 118

Maybe you haven't had to take a test as part of a hiring process, but you probably will in your next job search. About 76% of organizations with more than 100 employees rely on assessments for external hiring, especially for senior positions. It helps to know what companies are measuring and the tools they're using.

Competence. Aptitude tests can evaluate skills, abilities, and potential. Some companies use situational judgment tests, which present scenarios that correspond to particular roles.

Work ethic. Self-report questionnaires can assess traits such as ambition and reliability.

Emotional intelligence. Psychological tests, scenario-based tests, and performance tasks can measure empathy, self-awareness, and emotional literacy.

You can set yourself up for success by practicing, scheduling tests for the time of day when you're most focused and alert, and answering questions in a way that presents your best self.

Tests aren't just for the employer's benefit. They can also reveal how things work in an organization and which traits matter most—invaluable information in any job search.

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Life's Work

Ken Burns uses his distinctive style of documentary filmmaking to take viewers into the lives of presidents, explorers, athletes, and musicians. An amateur historian at heart, Burns has for 34 years helped millions connect with America's past through his Emmy Award–winning work. His landmark series *The Civil War* will be rebroadcast on PBS in September. *Interviewed by Daniel McGinn*

HBR: Why should business leaders study history?
Burns: In the late 1970s a top executive at a large telecommunications company lamented to me that business schools were producing MBA graduates who had no knowledge of the humanities. He worried that they were a bunch of automatons. He said, "I can teach these people business skills, but I can't teach them ethics, history, or art." Business leaders ought to study history. You can't possibly know where you are or where you're going if you don't know where you've been.

In this age of waning attention spans, do you feel pressure to make your films shorter? When *The Civil War* came out, in 1990, MTV had popularized a style of fast-paced video, with lots of cuts and action. Critics said no one would watch my film, but it got huge ratings. When *The War* came out, in 2007, there were no longer just 15 channels but 515, and critics were certain no one would watch it. They were wrong. And in 2014 *The Roosevelts* drew more viewers than *Downton Abbey*. There's a deluge of information in the world, but very little understanding of it. We all know what it's like to browse the Huffington Post and not remember any of it 20 minutes later. Sustained attention is what makes companies work well and art work well, and it's what all human beings crave no matter how distracted they are. Meaning accrues in duration.

Has your view of leadership changed over the years? It has remained fairly constant. I find it delightful that "leadership" comes in so many varieties and from such different experiences. Look at Abraham Lincoln, who was born into poverty on the frontier, and Franklin Roosevelt, who was born to such great privilege that he could have spent his life in idleness.

Could the great leaders you've featured succeed in modern politics? No. We choose leaders abysmally today. We expect perfection, and when we don't find it we lament the absence of heroes. But heroism, by the very definition that came down from the Greeks, is a negotiation between strengths and weaknesses. Maybe I'm being glib when I say that people like the Roosevelts and Lincoln couldn't make it past the Iowa caucuses, but it would be very difficult for them to succeed in this environment.

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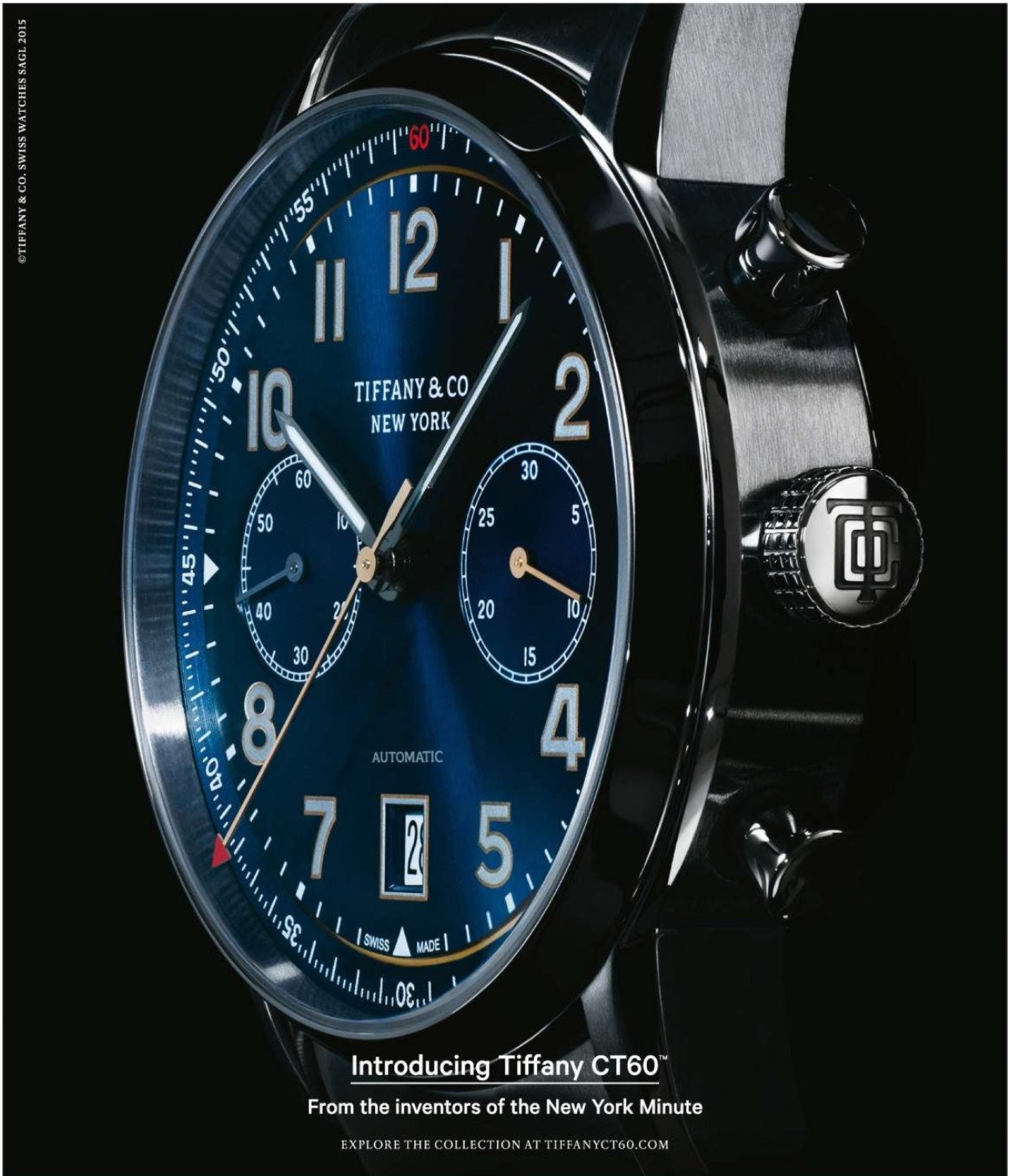
PETER MURPHY



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