

## CHAPTER 1

# Survival and Performance in the Era of Discontinuity

This company will be going strong one hundred and even five hundred years from now.

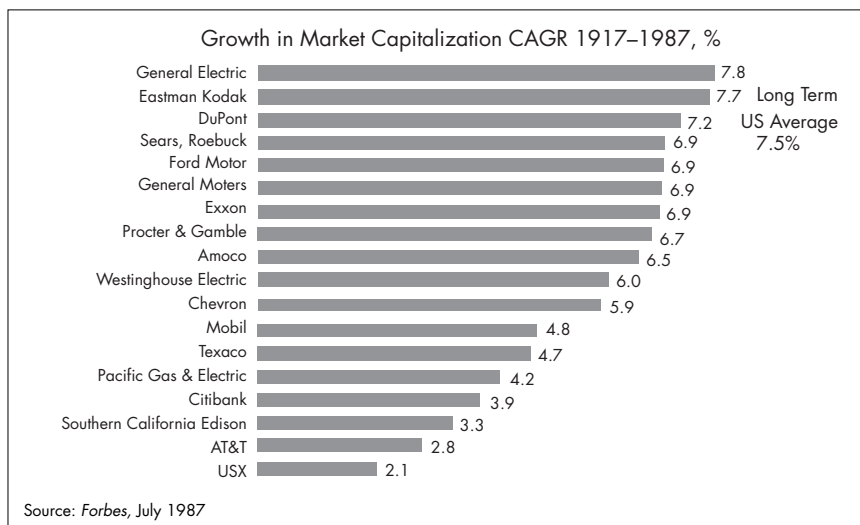
C. JAY PARKINSON, PRESIDENT OF ANACONDA MINES  
*statement made three years in advance of Anaconda's bankruptcy*

In 1917, shortly before the end of World War I, Bertie Charles (or B.C., as he was known) Forbes formed his first list of the one hundred largest American companies. The firms were ranked by assets, since sales data were not accurately compiled in those days. In 1987, *Forbes* republished its original “Forbes 100” list and compared it to its 1987 list of top companies. Of the original group, 61 had ceased to exist.

Of the remaining thirty-nine, eighteen had managed to stay in the top one hundred. These eighteen companies—which included Kodak, DuPont, General Electric, Ford, General Motors, Procter & Gamble, and a dozen other corporations—had clearly earned the nation’s respect. Skilled in the arts of survival, these enterprises had weathered the Great Depression, the Second World War, the Korean conflict, the roaring ’60s, the oil and inflation shocks of the ’70s, and unprecedented technological change in the chemicals, pharmaceuticals, computers, software, radio and television, and global telecommunications industries.

They survived. But they did not perform. As a group these great companies earned a long-term return for their investors during the 1917–

### Long-Term Survivor Performance



1987 period 20% less than that of the overall market. Only two of them, General Electric and Eastman Kodak, performed better than the averages, and Kodak has since fallen on harder times.

One reaches the same conclusion from an examination of the S&P 500. Of the five hundred companies originally making up the S&P 500 in 1957, only seventy-four remained on the list through 1997. And of these seventy-four, only twelve outperformed the S&P 500 index itself over the 1957–1998 period. Moreover, the list included companies from two industries, pharmaceuticals and food, that were strong performers during this period. If today's S&P 500 today were made up of only those companies that were on the list when it was formed in 1957, the overall performance of the S&P 500 would have been about 20% less *per year* than it actually has been.

For the last several decades we have celebrated the big corporate survivors, praising their “excellence” and their longevity, their ability to last. These, we have assumed, are the bedrock companies of the American economy. These are the companies that “patient” investors pour their money into—investments that would certainly reward richly at the end of a lifetime. But our findings—based on the thirty-eight years of data compiled in the McKinsey Corporate Performance Database, discussed in the Introduction—have shown that they do not perform as we might suspect. An investor following the logic of patiently investing money in these survivors will do substantially less well than an investor who merely invests in market index funds.

McKinsey's long-term studies of corporate birth, survival, and death in America clearly show that the corporate equivalent of El Dorado, the golden company that continually performs better than the markets, *has never existed*. It is a myth. Managing for survival, even among the best and most revered corporations, does not guarantee strong long-term performance for shareholders. In fact, just the opposite is true. In the long run, markets always win.

## THE ASSUMPTION OF CONTINUITY

How could this be? How could a stock market index such as the Dow Jones Industrial average or the S&P 500 average—which, unlike companies, lack skilled managers, boards of experienced directors, carefully crafted organizational structures, the most advanced management methods, privileged assets, and special relationships with anyone of their choosing—perform better, over the long haul, than all but two of *Forbes's* strongest survivors, General Electric and Eastman Kodak? Are the capital markets, as represented by the stock market averages, “wiser” than managers who think about performance all the time?

The answer is that the capital markets, and the indices that reflect them, encourage the creation of corporations, permit their efficient operations (as long as they remain competitive), and then rapidly—and remorselessly—remove them when they lose their ability to perform. Corporations, which operate with management philosophies based on the assumption of continuity, are not able to change at the pace and scale of the markets. As a result, in the long term, they do not create value at the pace and scale of the markets.

It is among the relatively new entrants to the economy—for example, Intel, Amgen, and Cisco—where one finds superior performance, at least for a time. The structure and mechanisms of the capital markets enable these companies to produce results superior to even the best surviving corporations. Moreover, it is the corporations that have lost their ability to meet investor expectations (no matter how unreasonable these expectations might be) that consume the wealth of the economy. The capital markets remove these weaker performers at a greater rate than even the best-performing companies. Joseph Alois Schumpeter, the great Austrian-American economist of the 1930s and '40s, called this process of creation and removal “the

gales of creative destruction.” So great is the challenge of running the operations of a corporation today that few corporate leaders have the energy or time to manage the processes of creative destruction, especially at the pace and scale necessary to compete with the market. Yet that is precisely what is required to sustain market levels of long-term performance.

The essential difference between corporations and capital markets is in the way they enable, manage, and control the processes of creative destruction. Corporations are built on the assumption of continuity; their focus is on operations. Capital markets are built on the assumption of *discontinuity*; their focus is on creation and destruction. The market encourages rapid and extensive creation, and hence greater wealth-building. It is less tolerant than the corporation is of long-term underperformance. Outstanding corporations do win the right to survive, but not the ability to earn above-average or even average shareholder returns over the long term. Why? Because their control processes—the very processes that help them to survive over the long haul—deadens them to the need for change.

## THE REALITY OF DISCONTINUITY

This distinction between the way corporations and markets approach the processes of creative destruction is not an artifact of our times or an outgrowth of the “dot.com” generation. It has been smoldering for decades, like a fire in a wall, ready to erupt at any moment. The market turmoil we see today is a logical extension of trends that began decades ago.

The origins of modern managerial philosophy can be traced to the eighteenth century, when Adam Smith argued for specialization of tasks and division of labor in order to cut waste. By the late nineteenth century these ideas had culminated in an age of American trusts, European holding companies, and Japanese zaibatsus. These complex giants were designed to convert natural resources into food, energy, clothing, and shelter in the most asset-efficient way—to maximize output and to minimize waste.

By the 1920s, Smith’s simple idea had enabled huge enterprises, exploiting the potential of mass production, to flourish. Peter Drucker wrote the seminal guidebook for these corporations in 1946, *The Concept of the Corporation*. The book laid out the precepts of the then-modern corporation, based on the specialization of labor, mass production, and the efficient use of physical assets.

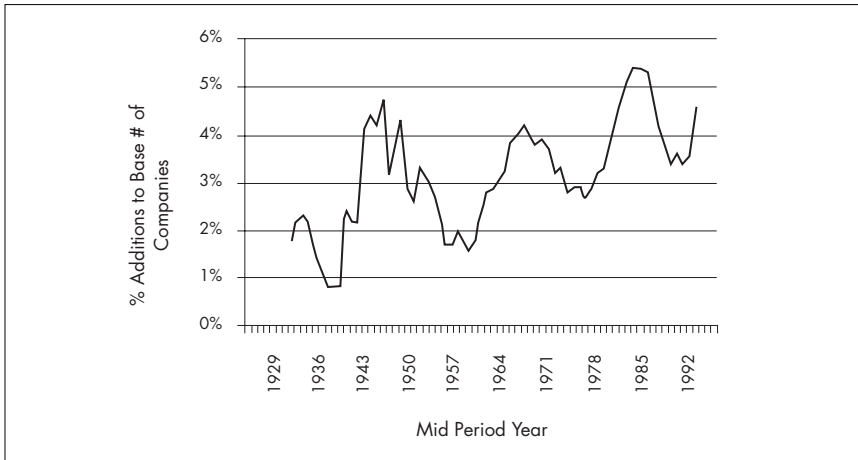
This approach was in deep harmony with the times. Change came slowly in the '20s, when the first Standard and Poor's index of ninety important U.S. companies was formed. In the '20s and '30s the turnover rate in the S&P 90 averaged about 1.5% per year. A new member of the S&P 90 at that time could expect to remain on the list, on average, for more than sixty-five years. The corporations of these times were built on the assumption of continuity—perpetual continuity, the essence of which Drucker explored in his book. Change was a minor factor. Companies were in business to transform raw materials into final products, to avoid the high costs of interaction between independent companies in the marketplace. This required them to operate at great scale and to control their costs carefully. These vertically integrated configurations were protected from all but incremental change.

We argue that this period of corporate development, lasting for more than seventy years, has come to an end. In 1998, the turnover rate in the S&P 500 was close to 10%, implying an average lifetime on the list of ten years, not sixty-five! Drucker predicted the turning point with his 1969 book *The Age of Discontinuity*, but his persuasive arguments could not overcome the zeitgeist of the '70s. The '70s were, for many managers, the modern equivalent of the 1930s. Inflation raged, interest rates were at the highest levels since before World War II, and the stock market was languishing. Few entrants dared risk capital or career on the founding of a new company based on Drucker's insights. It was a fallow time for corporate start-ups. As the long-term demands of survival took over, Drucker's advice fell on deaf years.

The pace of change has been accelerating continuously since the '20s. There have been three great waves. The timing and extent of these waves match the rise and fall of the generative and absorptive capabilities of the nation. The first wave came shortly after World War II, when the nation's military buildup gave way to the need to rebuild the consumer infrastructure. Many new companies entered the economy at this time, then rose to economic prominence during the 1940s and 1950s, among them Owens-Corning, Textron, and Seagram.

The second wave began in the 1960s. The rate of turnover in the S&P 90 began to accelerate as the federal defense and aerospace programs once again stimulated the economy, providing funds for the development of logic and memory chips, and later the microprocessor. They were heady days—"bubble days," in the eyes of some. The hot stocks were called

### Change in the S&P 500 7-Year Moving Average



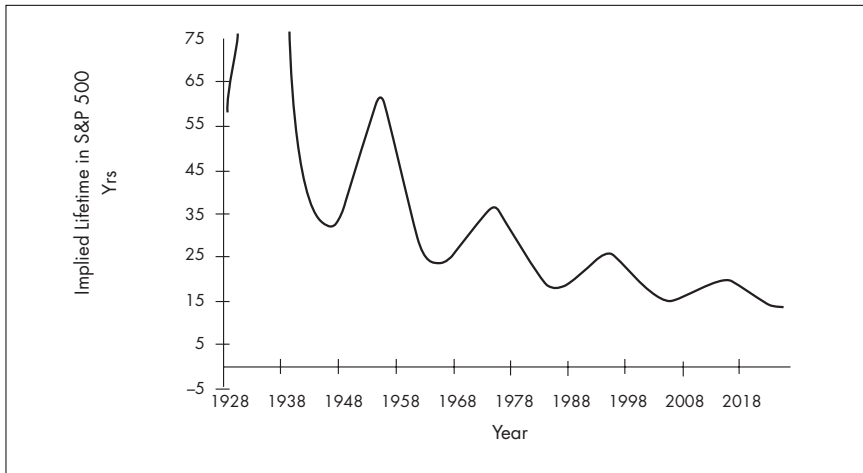
“one-decision” stocks: Buy them once and never sell them, and your future fortune was assured.

The bubble burst in 1968. The New York Stock Exchange, which had risen to almost 1000, did not return to that level again until the early 1980s. During this absorptive, or slack, period, when the country was beset with rising oil prices and inflation, and when bonds earned returns substantially greater than equities, few new companies joined—or left—the S&P 500. Interestingly enough, though, despite the worst economic conditions the nation had endured since the Depression, the minimum rate of corporate turnover did not drop to the low rate of turnover seen in the 1950s. The base rate of change in the economy had permanently risen.

Paul Volcker, chairman of the Federal Reserve Bank, finally led the charge that broke the back of inflation, and the number of new companies climbing onto the S&P 500 accelerated. In the 1980s, once again the S&P began substituting new high-growth and high-market-cap companies for the slower-growing and even shrinking-market-cap older companies. The change in the S&P index mix also reflected changes in the economic mix of business in the United States. When the markets collapsed in the late '80s and a short-lived recession hit the American economy in the early '90s, the rate of substitution in the S&P 500 fell off. But again, even at its lowest point, the rate of turnover was higher than it was during the 1970s decline. The minimum level of change in the economy had been quietly building, and was increas-

ing again. This was even more evident as the technology-charged 1990s kicked into gear, accelerating the rate of the S&P Index turnover to levels never seen before. By the end of the 1990s, we were well into what Peter Drucker calls the “Age of Discontinuity.” Extrapolating from past patterns, we calculate that by the end of the year 2020, the average lifetime of a corporation on the S&P will have been shortened to about ten years, as fewer and fewer companies fall into the category of “survivors.”

**Average Lifetime of S&P 500 Companies**



## THE GALES OF DISCONTINUITY

The Age of Discontinuity did not arrive in the 1990s by happenstance. It arose from fundamental economic forces. Among these are:

- The increasing efficiency of business, due to dramatic declines in capital costs. As industry shifted from goods to services, there was a concurrent decline in interaction and transaction costs. These costs declined because of the advent of information technology and the steady rise in labor productivity due to advances in technology and management methods.
- The increasing efficiency of capital markets, due to the increasing accuracy (and transparency) of corporate performance data.

- The rise in national liquidity, due to the improved profitability of U.S. corporations, and a favorable bias, unparalleled anywhere else in the world, toward U.S. equities.
- Strengthened fiscal management by the federal government, including an effective Federal Reserve, and reduced corporate taxes.

These forces have helped to create the likes of Microsoft, with a market capitalization greater than all but the top ten nations of the world (Microsoft's real assets make up about 1% of its market value). Computer maker Dell has virtually no assets at all. Internet start-up companies begin with almost no capital. For these companies, returns on capital are unimaginably large by previous standards. Productivity is soaring. The pipeline of new technology is robust. There are more than 10,000 Internet business proposals alone waiting for evaluation at venture capital firms, even after the Nasdaq collapse in March and April of 2000. By all reports, the number (if not the quality) of these proposals is increasing all the time. Information technology is not nearing its limits. The effectiveness of software programming continues to grow; communications technology is just beginning. The global GDP will double in the next twenty years, creating approximately \$20–\$40 trillion in new sales. If, through the productivity improvements the Internet enables, the world can save 2% of the \$25 trillion now produced, the market value of those savings will run into the trillions.

Incumbent companies have an unprecedented opportunity to take advantage of these times. But if history is a guide, no more than a third of today's major corporations will survive in an economically important way over the next twenty-five years. Those that do not survive will die a Hindu death of transformation, as they are acquired or merged with part of a larger, stronger organization, rather than a Judeo-Christian death, but it will be death nonetheless. And the demise of these companies will come from a lack of competitive adaptiveness. To be blunt, most of these companies will die or be bought out and absorbed because they are too damn slow to keep pace with change in the market. By 2020, more than three quarters of the S&P 500 will consist of companies we don't know today—new companies drawn into the maelstrom of economic activity from the periphery, springing from insights unrecognized today.

The assumption of continuity, on which most of our leading corporations have been based for years, no longer holds. Discontinuity domi-



nates. The one hundred or so companies in the current S&P 500 that survive into the 2020s will be unlike the corporate survivors today. They will have to be masters of creative destruction—built for discontinuity, remade like the market. Schumpeter anticipated this transformation over a half century ago when he observed: “The problem that is usually being visualized is how capitalism *administers* existing structures, whereas the relevant problem is how it *creates* and *destroys* them.”

## THE NEED TO ABANDON THE ASSUMPTION OF CONTINUITY

How can corporations make themselves more like the market? The general prescription is to increase the rate of creative destruction to the level of the market itself, without losing control of present operations. As sensible as this recommendation is, it has proven difficult to implement.

Hundreds of managers from scores of U.S. and European countries have told us that while they are satisfied with their operating prowess, they are dissatisfied with their ability to implement change. “How do the excellent innovators do it?” they ask, presuming that excellent innovators exist. “What drives an innovation breakthrough?” Others question how one grows a company beyond its core business. And most fundamentally of all: “How do we find new ideas?”

The difficulties behind these questions arise from the inherent conflict between the need for corporations to control existing operations and the need to create the kind of environment that will permit new ideas to flourish—and old ones to die a timely death. This may require trading out traditional assets, challenging existing channels of distribution, or making dilutive acquisitions. But whatever the challenges, we believe that most corporations will find it impossible to match or outperform the market without abandoning the assumption of continuity. Author James Reston, in his book *The Last Apocalypse*, observed Europe’s fear that the first millennium would end in a fiery conclusion:

*When the millennium arrived the apocalypse did take place; a world did end, and a new world arose from the ruins. But the last apocalypse was a process rather than a cataclysm. It had the suddenness of forty years.*

The current apocalypse—the transition from a state of continuity to a state of discontinuity—has the same kind of suddenness. Never again will American business be as it once was. The rules have changed forever. Some companies have made the crossing. Under Jack Welch, General Electric has negotiated the apocalypse and has seen its performance benefit as a result. Johnson & Johnson is moving across the divide quickly, as we will see later. Enron has made strong progress by transforming itself from a natural gas pipeline company to a trading company. Corning has been successful in shedding its dependence on consumer durables and becoming a leader in high-tech optical fiber. In France, L'Oréal seems to be on the right track, having found a new way to organize itself and transfer beauty concepts from one economy to another. But these are the exceptions. Few have attempted the journey. Fewer still have made it to the other side successfully.

## CULTURAL LOCK-IN

For half a century, Bayer aspirin drove the growth of Sterling Drug until Johnson & Johnson introduced Tylenol. Out of fear of cannibalizing its Bayer aspirin leadership, Sterling Drug refused to introduce its leading European non-aspirin pain reliever (Panadol) to the United States. Instead, it tried to expand its Bayer line overseas. This failure ultimately led to its acquisition by Kodak. Sterling Drug had become effectively immobilized, unable to change its half-century-old behavior out of fear. Its strong culture—its rules of thumb for decision making, its control processes, the information it used for decision making—blocked its progress and ultimately sealed its fate. It had locked itself into an ineffective approach to the marketplace despite clear signs that it needed to act in a new way.

“Cultural lock-in”—the inability to change the corporate culture even in the face of clear market threats—explains why corporations find it difficult to respond to the messages of the marketplace. Cultural lock-in results from the gradual stiffening of the invisible architecture of the corporation, and the ossification of its decision-making abilities, control systems, and mental models. It dampens a company's ability to innovate or to shed operations with a less-exciting future. Moreover, it signals the corporation's inexorable decline into inferior performance. Often, as in the case

of Sterling Drug, cultural lock-in manifests itself in three general fears—the fear of cannibalization of an important product line, the fear of channel conflict with important customers, and the fear of earnings dilution that might result from a strategic acquisition. As reasonable as all these fears seem to be to established companies, they are not fears that are felt in the market. And so the market moves where the corporation dares not.

Cultural lock-in is the last in a series of “emotional” phases in a corporation’s life, a series that mirrors remarkably that of human beings. In the early years of a corporation, just after its founding, the dominant emotion is passion—the sheer energy to make things happen. When passion rules, information and analysis are ignored in the name of vision: “We know the right answer; we do not need analysis.”

As the corporation ages, the bureaucracy begins to settle in. Passions cool and are replaced by “rational decision making,” often simply the codification of what has worked in the past. Data is gathered, analysis is performed, alternatives are postulated, and scenarios are developed. Attempts are made to avoid the game of information sculpting. Only when “rational” decision making is in vogue does all the relevant information flow to the right decision maker, at the right time, and in the right form to be easily analyzed and interpreted. Rational decision making is triumphant, at least for a while. This stage is often pictured as the normal state of the corporation, although in our experience, particularly as the pace of change increases, rarely does this ideal state accurately describe how the company actually operates.

Eventually, rational decision making reveals that the future potential for the business is limited. Often at this point, threatened by the prospects for a bleak future, the corporation falls back on defensive routines to protect the organization from its fate, just as defensive emotions emerge in our lives when we sense impending trauma. Management now sees the future filled more with trouble than with promise. Decisions are made to protect existing businesses. The fear of discarding the old for the new (product cannibalization), the fear of customer conflict, and the fear of earnings dilution through acquisition paralyze acts of creative destruction, and often effectively shield the corporation from the perception of future trouble—as well as the need to act—for a long time. Cultural lock-in is established, thwarting the emergence of a leader or team that might save the day.

## THE CAUSES OF CULTURAL LOCK-IN

Why does cultural lock-in occur? The heart of the problem is the formation of hidden sets of rules, or mental models, that once formed are extremely difficult to change. Mental models are the core concepts of the corporation, the beliefs and assumptions, the cause-and-effect relationships, the guidelines for interpreting language and signals, the stories repeated within the corporate walls. Charlie Munger, a longtime friend of and co-investor with Warren Buffet, and vice chairman of Berkshire Hathaway, calls mental models the “theoretical frameworks that help investors better understand the world.”

Mental models are invisible in the corporation. They are neither explicit nor examined, but they are pervasive. When well crafted, mental models allow management to anticipate the future and solve problems. But once constructed, mental models become self-reinforcing, self-sustaining, and self-limiting. And when mental models are out of sync with reality, they cause management to make forecasting errors and poor decisions. The assumption of continuity, in fact, is precisely the kind of disconnect with reality that leads corporations into flawed forecasting and poor decisions.

Mental models manifest themselves in corporate control systems. These systems are designed to ensure predictable goal achievement, whether it be cost control, the control of capital expenditures, or the control of the deployment of key personnel. Effective control means that an informed manager can be reasonably confident that unpleasant surprises will not occur.

Unfortunately, control systems can also create “defensive routines” in organizations, including the failure to challenge the status quo, the failure to encourage a diversity of opinions, failure to disagree with superiors (thereby displeasing them), communicating in ambiguous and inconsistent ways, and making these failures, even when known, “undiscussable.” Change becomes impossible.

Corporate control systems also undermine the ability of the organization to innovate at the pace and scale of the market. Under the assumption of continuity, for example, the arguments for building a new business can be turned back, since its probable success cannot be proven in advance. Under these circumstances, it is more likely that ideas based on the incremental growth of current capabilities and mental models will be encouraged.

Corporate control systems limit creativity through their dependence

on *convergent thinking*. Convergent thinking focuses on clear problems and provides well-known solutions quickly. It thrives on focus. Order, simplicity, routine, clear responsibilities, unambiguous measurement systems, and predictability are the bedrock of convergent thinking. Convergent thinking is tailor-made for the assumption of continuity. Convergent thinking can be effective at handling small, incremental changes and differences, but transformational changes completely flummox the system.

Discontinuity, on the other hand, thrives on a different kind of thinking, *divergent thinking*. Divergent thinking focuses on broadening—diverging—the context of decision making. It is initially more concerned with questions than getting to the answer in the fastest possible way. Divergent thinking places enormous value on getting the questions right, then relinquishes control to conventional convergent thinking processes.

Divergent thinking thrives as much on the broad search as on the focused search. It focuses as much on careful observation of the facts as on interpretation of the facts. It focuses as much on the skills of reflection (which requires time away from the problem) as on the skills of swift decision making (which seek to avoid delay). We refer to these three skills—conversation, observation, and reflection—as the COR skills of divergent thinking. Unfortunately, conventional corporate control systems, built on the assumption of continuity, stifle the COR skills of divergent thinking, or kill it outright.

When mental models are out of sync with reality, corporations lose their early-warning system. Leaders with genuine vision are suppressed. As Ron Heifetz, director of the Program on Leadership at the Kennedy School of Government at Harvard, observed: “People who lead frequently bear scars from their efforts to bring about adaptive change. Often they are silenced. On occasion, they are killed.”

Abbott Laboratories, for example, flush with the success of their strategy to build strong positions in the medical diagnostic and test equipment business, was anxious to avoid the shocks to the pharmaceutical industry posed by the emergence of Medicare and Medicaid in the early to mid 1970s. Yet it found itself with an incumbent CEO who squelched three potential successors seeking to change strategy.

Once cultural lock-in guides a company's decisions, in the absence of some great external shock, the corporation's fate is sealed.

## HOW THE MARKETS ENABLE CHANGE

Markets, on the other hand, lacking culture, leadership, and emotion, do not experience the bursts of desperation, depression, denial, and hope that corporations face. The market has no lingering memories or remorse. It has no mental models. The market does not fear cannibalization, customer channel conflict, or dilution. It simply waits for the forces at play to work out—for new companies to be created and for acquisitions to clear the field. The markets silently allow weaker companies to be put up for sale and leaves it to the new owners to shape them up or shut them down. Actions are taken quickly on early signs of weakness. Only when governments are brought in, as with a bailout, does the market mimic a probable corporate response. Most of the time, the market simply removes the weak players, and in removing them, improves overall returns.

Lacking production-oriented control systems, markets create more surprise and innovation than do corporations. They operate on the assumption of discontinuity, and accommodate continuity. Corporations, on the other hand, assume continuity and attempt to accommodate discontinuity. The difference is profound.

## REDESIGNING THE CORPORATION BASED ON DISCONTINUITY

The right of any corporation to exist is not perpetual but has to be continuously earned.

ROBERT SIMONS

The market has pointed the way to a solution. In response to the tension that builds between the potential for improved performance and the actual performance of large businesses, in an era of increasing pace of change in the economy, there are certain kinds of firms—particularly private equity firms, as we discuss in Chapter 7—that have demonstrated the ability to change at the pace and scale of the market, and they have earned sustained superior returns for doing so. The two kinds of private equity firms—principal investing firms and venture capitalists—are quite different from each other, but each looks somewhat like the holding companies of the late nineteenth century. It is possible to imagine that

they will form the seeds of the industrial giants of the twenty-first century.

These newly important firms have been able to outperform the markets for the last two to three decades, longer than any other company we know of. The difference between these partnerships and the conventional corporation is in their approach to organizational design. These financial partnerships have discovered how to operate at high levels of efficiency and scale while engaging in creative destruction at the pace of the market, exactly as Joseph Schumpeter envisioned. Created around the assumption of discontinuity, they have then determined how best to incorporate or fold in the requirements of continuity.

These firms never buy any company to hold forever. Rather, they focus on intermediate (four- to seven-year) value creation. Corporations, in contrast, concentrate on the very short term (less than eighteen months) for operations and the very long term (greater than eight years) for research.

Private equity firms make as much money by expanding the future potential of their properties as they do from increasing the properties' operating incomes. When a private equity firm invests in a company, or buys all of the equity, it buys it with a "take-out" strategy in mind: Management knows what it must do in the next four to seven years to build the property so that it has long-term value for the next buyer.

Finally, private equity companies think of their business as a revolving portfolio of companies in various stages of development. They realize they will sell some of their properties each year and buy others. They keep the pipeline full of new properties at the front end and supplied with buyers at the back end, cultivating both simultaneously (a skill at which they excel).

These firms differ from conventional corporations not only in their divergent thinking, but also in the depth and speed of their research activities. Moreover, private equity firms allow each of the companies they buy to retain their own control systems. This allows the private equity firm to concentrate on creation and destruction to a far greater extent than do traditional corporations, and even to a greater extent than their own wholly or partially owned subsidiaries do.

## THE ROAD AHEAD

Long-term corporate performance has not matched the performance of the overall markets because corporations do not adapt as fast as the mar-

kets do. This is due to the way they evolve, not because of the way they accomplish their day-to-day work. For historical reasons, as we have discussed above, corporations have been designed to operate—to produce goods and services—rather than to evolve. In order to evolve at the pace of the markets, they have to get better at creation and destruction—the two key elements of evolution that are missing.

Redesigning the corporation to evolve quickly rather than simply operate well requires more than simple adjustments; the fundamental concepts of operational excellence are inappropriate for a corporation seeking to evolve at the pace and scale of the markets. One cannot just “add on” creation and destruction; one has to design them in. And only if the corporation is redesigned to evolve at the pace and scale of the market will long-term performance improve. Markets perform better than corporations because markets allow new companies to enter more freely, and they force the elimination of those companies without competitive prospects more ruthlessly than corporations do. Moreover, markets do these things faster and on a larger scale than do corporations.

We believe that corporations must be redesigned from top to bottom based on the assumption of discontinuity. Management must stimulate the rate of creative destruction through the generation or acquisition of new firms and the elimination of marginal performers—without losing control of operations. If operations are healthy, the rate of creative destruction within the corporation will determine the continued long-term competitiveness and performance of the company. Today’s financial partnerships give us confidence that this realignment can work. They also suggest a way to do it.

To create new businesses at a faster rate, corporations also need to ponder the details of divergent thinking. Divergent thinking is a prelude to creativity. Many divergent thinkers possess apparently opposing traits: They may be passionate and objective, or proud and humble; they may be both extroverted and introverted; in negotiations they may be flexible and unyielding, attentive and wandering. They possess what Mihalyi Csikszentmihalyi, one of today’s leading thinkers on creativity and the author of *Flow*, has called “a sunny pessimism.” F. Scott Fitzgerald described it in this way:

*The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function.*



*One should, for example, be able to see that things are hopeless and yet be determined to make them otherwise.*

Managing for divergent thinking—that is, managing to ensure that the proper questions are addressed early enough to allow them to be handled in an astute way—requires establishing a “rich context” of information as a stimulus to posing the right questions. It requires control through the selection and motivation of employees rather than through control of people’s actions; ample resources, including time, to achieve results; knowing what to measure and when to measure it; and genuine respect for others’ capabilities and potential. It also requires the willingness to remove people from responsibility when it becomes clear they cannot perform up to standard. In the end, both divergent and convergent thinking must successfully coexist.

Next, to improve long-term performance, the overall planning and control processes of the corporation need to be rethought. The conventional strategic planning process has failed most corporations. As practiced, it stifles the very dialogue it is meant to stimulate. New ways of conducting a dialogue and conversation among the leaders of the corporation and their inheritors are needed.

Finally, corporate control systems must be built that can manage both to control operations and increase the rate of creative destruction. Control what you must, not what you can; control when you must, not when you can. If a control procedure is not essential, eliminate it. Measure less; shorten the time and number of intermediaries between measurement and action, and increase the speed with which you receive feedback.

The point is to let the market control wherever possible. Be suspicious of control mechanisms—they stifle more than they control. Let those who run a business determine the best mix of controls for their business (they know the system best) and shift the burden of integration to the corporate level, rather than designing uniform systems that have to be implemented throughout a corporation independent of the business. When such changes are implemented, the focus of the corporation will shift from minimizing risk, and thereby inadvertently stifling creativity, to facilitating creativity—and that is what is needed to strengthen long-term performance.

To implement these ideas, the role of leadership must be rethought. Ron Heifetz of Harvard says:

*The adaptive demands of our societies require leadership that takes responsibility without waiting for revelation or request. One may lead perhaps with not more than a question in hand. A leader has to engage people in facing the challenge, adjusting their values, changing perspectives, and developing new habits of behavior.*

If these steps are taken effectively, they will help prevent the emergence of cultural lock-in.

This book offers a clear storm warning to dot.com companies: You have been born at a special time—one where all the elements of the ideal creative environment exist simultaneously. By focusing on “getting the product out” and “building the website,” you are following in the footsteps of millions of companies since the time of Adam Smith. You are blessed to exist at a time of rapid change, which gives you the opportunity to peer into the future and design your corporation accordingly. But after the early heady days of growth, your challenges will be the same as those of other companies of the past: to grow and avoid being trapped by cultural lock-in.

## A NEW BEGINNING

The agenda outlined above is substantial. Not all companies will be willing to take it on. The first step is to recognize the description of the business world as an increasingly *discontinuous* place. In the following pages, we will lay out in more detail why we see the world as a place of discontinuity, and outline the specific problems—and solutions—corporations must address if they are to break the paradigm of underperformance over the long term and truly act as companies built on excellence. Building a company to last—managing to survive—is no longer enough in an age of discontinuity. The chapters that follow will help point the way.