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Strategy, Risk, and the Global Financial Crisis

By Walter Kiechel III — Adapted from the author's latest book, *The Lords of Strategy: The Secret Intellectual History of the New Corporate World* (Harvard Business Press, 2010)

The global financial crisis was above all a failure of risk management. But what role, if any, did strategy—or its omission—play in the crisis? Walter Kiechel, arguably the dean of management journalism (and former editorial director of Harvard Business Publishing, former managing editor at Fortune), explores the question pointedly in his latest book, The Lords of Strategy. In this excerpt, he probes the influences that led Wall Street astray and explains how strategy will help organizations surmount the “fiercening” of capitalism—the complex challenges business leaders face in the volatile twenty-first century.

The precepts of strategy have helped make companies more competitive, alert to their circumstances, and resilient. Why, then, toward the close of 2008 did many enterprises thoroughly dosed in the discipline become enmeshed in a worldwide financial crisis, with some accused of precipitating it? Were the ideas behind the strategy revolution at fault? Did strategy consultants lead astray the management of the great banks and financial services firms?

Consultants were clearly there in the alley when the lights were turned off on the global financial system. But a look at recent history shows a more complicated picture, and one that suggests that consultants' culpability, if any, was the result of their waning, and not waxing, influence. The precepts of strategy (and management), it appears, were often cast aside with the spectacular growth of the mortgage markets and financial derivatives.

At the crest of the financial system's success in 2007, banks and other financial services firms represented an attention-commanding proportion of major consulting firms' business—for one of the “lords of strategy” firms, it was the largest single client sector.¹ That year, the sector's share of U.S. corporate profits amounted to 41% of the whole, up from a mere 15% in the early 1980s.

A constellation of forces—deregulation, competition from new quarters, new technologies—led to consolidation in the financial services industry and a blurring of the traditional industry lines. These forces, coupled with relentless innovation in

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¹ The book pays particular attention to four figures in the history of strategy, among the original “lords” of the title: the founders of two dominant management consulting firms (Boston Consulting Group and Bain & Company); the man who brought strategy to McKinsey & Company; and Michael Porter of the Harvard Business School.

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financial instruments—arcane instruments, such as credit default swaps, that eluded regulators' watch, a shadow banking system that grew to represent about \$60 trillion in assets—led to the sector's surge. At the same time, the champions of strategy no longer had the ear of the CEOs at most major financial institutions. Innovation was now dominated by the “quants”—that new breed of financial engineer behind the new instruments. The major consultants' work for banking clients, though it helped the clients save millions, was reduced chiefly to “Greater Taylorism” efforts: cost cutting and sourcing.²

With the quants leading the innovative charge, executives making strategy for financial services outfits—usually senior management, and usually of a more senior age cohort—were at a disadvantage, particularly in judging the risk that all the newfangled financial instruments in their portfolios might carry.

Strategists had been incorporating risk into their calculations for years, but over time, the advisers' concern with risk had been subordinated to other themes or consigned to particular projects (for example, for a mining or oil company, whether to make a colossal investment to try to discover new reserves). When asked what sin of omission or commission they may have committed in connection with the global financial crisis, most consultants will allow that in their advice they failed to make sufficient provision for risk, particularly systemic risk. But, in fairness, one reason they didn't see this danger was that the new financial products that eventually triggered the crisis followed a very different start-up trajectory than the ones strategists were used to. New financial products—subprime

mortgages, credit default swaps—could be ginned up as fast as Wall Street rocket scientists could create them. The businesses selling them billowed out to global proportions almost overnight. Moreover, if your company was going to get in on the latest bonanza, you'd have to jump in fast, before somebody else could build a dominant position (another apparent lesson of the strategy revolution).

By this point, the fair-minded observer might reasonably conclude that while strategy and its champions may not have been a main causal factor in bringing on the global financial crisis, they did not do much to avert it, either. Looking more widely across the burned-over economic landscape of 2008 and 2009, a disappointed student of the revolution could even be tempted to entertain notions along the lines of “What good was strategy, anyway? A plague on the original lords, their successors in consulting and management, and all that they have wrought.”

Consider the Alternative

In registering the pain from the biggest financial crisis since the Great Depression and one whopper of a recession, let us not point fingers too quickly or forget contributions made over the longer pull of history. For example, although consultants may have abetted the process, they weren't the ones who elevated shareholder value (aka the stock price) to its place as god above all others. That was Wall Street, egged on by swinish types like you and me, who came to expect our investment portfolios and 401(k) plans to increase in value by 10% a year. The larger story of what happened in the economy is complicated, with few unadulterated villains. Even the private equity sharpies,

whom critics deride as utter greedheads, can point out that most of their investors are players like your child's college or the pension fund that pays out your parents' retirement benefits. Don't you want them to be earning a superior return?

Yes, strategy and strategy consultants did help companies possessed of the requisite intelligence to become more efficient and competitive. Leaner and, yes, occasionally meaner. But as the world grew steadily more capitalist, with Chinese, Indians, and other entrepreneurial populations piling into the capitalist fray, isn't that what you'd hope your favorite companies would be doing?

Consider the alternative, as represented by the Big Three American auto companies—General Motors, Ford, and Chrysler—each of which at one time or another availed itself of the services of the strategy firms. So arrogant, silo-ridden, and inert were the Detroit giants that they never bothered to get their minds around the three Cs of the strategy revolution (customers, costs, competitors), despite much advice to do just that. (When it came to the auto companies' core operations, “We never laid a glove on them,” ruefully admits the former head of one of the great strategy consultancies, speaking both of his own firm and that of his competitors.) Customers? Who are you talking about? Laws in every state prohibit automakers from selling a car directly to you or me; the sale has to go through a dealer, which the car companies came to regard as their real customer, with predictable, dismal effects. Costs? Easier to buy a few more years of peace with the United Auto Workers—kick the can down the road a little farther—even if it means that it costs us a few thousand more to make each vehicle than it does those devils from abroad. Competitors? As Datsuns and Toyotas began pouring into the U.S. market, Henry Ford II dismissed them as little “sh*tboxes.”

² Frederick Winslow Taylor, who developed time-motion studies of work at the end of the nineteenth century, is the father of a fundamental element of the strategy revolution: the search for operational efficiencies. “Greater Taylorism” is my term for the application of this type of efficiency analysis at the corporate, rather than individual, level, encompassing the company's total functions and processes.

Without strategy and strategy consultants, we could have broad swaths of the U.S. industry that look like the automakers—that is, uncompetitive on a global basis (as are, for instance, many sectors of the Japanese economy once you get beyond automobiles and consumer electronics). The fiercening of capitalism isn't going away; if anything, it looks likely to grow more intense. In response, strategists will have to heighten and broaden their sensitivity to potential dangers, shedding any remnants of the profit-fueled complacency that, for example, allowed them to remain oblivious to systemic risk. To update former Intel CEO Andy Grove's maxim, in this new world, only the really, really paranoid may survive. Add to this William Burroughs's observation that sometimes paranoia is just having all the facts. Strategy and its handmaiden Greater Taylorism will have to do a better job on that front as well. All this will probably entail a rewiring of certain circuits in the corporate brain, but as strategy contemplates its future, there are signs that the effort may already be under way.

The Future of Strategy

At about the same time that the global financial system was freezing up, the Boston Consulting Group (BCG) canvassed nearly 20 global companies—corporate titans from India and Japan as well as Europe and the United States—on the giants' latest thinking about strategy. More than one replied with a version of “We don't do strategy.”

Attentive students of the subject's history won't be shocked by this. They will recall Michael Porter's concern in the early 1990s that companies had largely abandoned strategy in favor of more faddish pursuits. Nor have they forgotten the backlash in the early 1980s, when corporate disappointment over the failure of strategic planning to deliver on its early promises led to widespread cutbacks in internal staffs devoted to the discipline.

Indeed, when the consultants probed for the reasons behind the companies' response, much of what they turned up was dissatisfaction you might have heard two or three decades ago. With the world changing so fast, how can we make forecasts about the future? The old concepts and frameworks don't seem to make sense of the river of data pouring in on us. What good are a bunch of plans that just end up in binders sitting on the shelf? Isn't execution, after all, what really gives you a competitive edge?

Of more interest were the trends the BCG consultants identified in parsing the economic data, most of these trends reflecting the continued fiercening of capitalism (along lines traced in my book). Yes, indeed, the length of time a company might expect its competitive advantage to last had steadily declined since the 1960s, a trend reflected in a surge upward in what the consultants not-so-charmingly called “the positional volatility of leaders.” Even while a few corporations were growing to a size larger than many governments, in most businesses, being the biggest was less and less likely to make you the most profitable. With a value-chain analysis in hand, companies were increasingly eager to outsource some of their activities, not just information technology and human resources but also procurement and logistics. And in a

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particular irony, just as many companies were realizing that people were the key to their future strategic success, they were also discovering that shareholder-value-driven pressures to work longer hours coupled with heightened job insecurity were making employees more likely to feel unmotivated and disenfranchised.

How is strategy likely to change to meet this, the latest round of challenges? Put that question to consultants from the leading firms, and you will find the same word coming up in the answers from each: strategy will necessarily become more adaptive. But then, hasn't strategy always been adaptive, a set of conceptual responses to the most vexing problems companies were facing at the time? What's new here?

Over its history, strategy has usually been smart, if not always wise. It has seldom been humble. Part of what the consultants are pointing toward would seem to be a discipline that is less sure of itself, less certain that its concepts apply to every situation, particularly if that certainty gets in the way of accurately sizing up business circumstances that are radically new or rapidly changing.

Martin Reeves and his colleagues at BCG's Strategy Institute, the firm's in-house think tank on the subject, have ideas about what adaptive strategy might look like in corporate practice. Instead of headquarters dictating a strategy based on “analysis, prediction, and deduction,” the goal would be to set “optimal conditions for the continuous emergence of superior strategies through an adaptive—or evolutionary—process.” In concrete terms, this would mean giving more

responsibility for strategy to the people on the corporate “periphery,” the troops in daily contact with customers, competition, and changing market conditions. They would be encouraged to probe and experiment, even if this meant the occasional failure, with their findings being continuously fed back to the corporate center for incorporation into its strategic

consciousness. As the consultants note in a series of white papers, adaptive strategy would require distinct competences on the part of a company, and one übercompetence in particular: what they italicize as “*learning how to learn across industries.*”

The call for companies to become learning organizations may seem familiar. It has been sounded from other quarters since the days of Tom Peters and Robert Waterman (coauthors of the landmark 1982 book *In Search of Excellence*), perhaps most notably in Peter Senge’s 1990 book, *The Fifth Discipline*. What makes the summons mildly notable in this case is the fact that it comes from the Boston Consulting Group, through most of strategy’s history not exactly a font of interest in the human dimensions of the discipline. But BCG isn’t alone in its appreciation of the heightened, ever-more-critical importance of making your people and your strategy as one. While Bain & Company’s Chris Zook (author of *Profit from the Core*) won’t go as far in conceding power to the periphery—the troops’ entrepreneurial undertakings need to be bounded by clear strategy guidelines laid down by the corporate center, he argues—he freely concedes

ness of companies, whether that consciousness is centralized or more widely distributed: risk, boundaries, corporate purpose, and, as the apostles of the new adaptiveness suggest, figuring out for the twenty-first century how to power a company’s strategy with the maximum energy and imagination available from its people.

Coping with Risk

Since strategy’s beginnings, the experts have wrestled with how to build contingency into their calculations. Frequently, this has translated into prescriptions for the use of debt—usually more debt. As the recent turmoil in the world’s financial markets brings home, calculations of risk need to be constantly reexamined as the global economy evolves, and disturbing new possibilities somehow taken into account. And not just financial risk. Economic collapse in countries far away, Internet bubbles that pop, terrorist threats to ever-tighter, leaned-down supply chains—how can the people in charge make provisions for these in the corporate strategies they devise?

At the heart of many consulting projects nowadays is “building the model,” that is, using software to plot the variables

for judgment, even intuition, that can hold its own with the numbers.

Defining Boundaries

Throughout its first 50 years, strategy has tussled with boundary questions. What’s the right way to define or segment our market? Which activities should be included in this business unit? How broad a scope must we consider for our value chain?

As the trend toward outsourcing and the necessity to think in terms of business networks forewarn us, such questions are only going to get knottier, or woollier, and of greater import. The analytics born of Greater Taylorism make it possible now to bore down to “markets of one,” that single consumer about whom you can learn volumes. In the other direction, the melting winds of globalization have dissolved the difference Americans traditionally saw between business and international business. Why not the entire world as market for your product?

Experts on strategic alliances estimate that currently, perhaps 20% of the revenues of large corporations derive from joint ventures. Where do they fit in your portfolio of businesses? Or if, like Procter & Gamble, you aim to increasingly outsource your product development, letting a small company invent the new wonder and then buying the innovation from its creator, how does that affect your lineup of core competencies?

The tightly bounded company so long at the core of strategy’s deliberations increasingly seems a limiting assumption. The twenty-first-century version of the discipline will have to offer more help if, or when, the dominant verb for corporate behavior becomes not *compete*, but something like *co-create*.³

Wherefore the Corporation?

As we’ve seen, strategy was an abettor of shareholder capitalism, not a propulsive force behind it. For too much of its history, the discipline has had little to say about

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that there is a “higher synthesis” of organization and strategy under way. “I don’t know whether organization is the new strategy,” he admits, “or strategy the new organization, but it’s something like that.”

Corporations will be under mounting pressure to sort the matter out, as will the practitioners, consultants, and scholars who will create strategy’s future. Our history suggests four issues in particular that will press on the strategic conscious-

ness in a situation, chart how they affect one another, and run iterations of how it all might play out. But what if the models, with all their comforting quantified precision, prove wrong—as they have of late for the bankers, hedge fund managers, inventors of derivatives, quants in general, and most of the other wizards of finance? In some ways, the challenge to strategy here is another one related to integrating the human element—namely, finding a place in strategy’s deliberations

³ For more on co-creation, see “Building a Co-Creative Performance Management System,” by Venkat Ramaswamy and Francis Guillard, in *BSR March–April 2011* (Reprint #B1103A).

the interrelated issues of shareholder primacy, the rights conferred by ownership, and corporate purpose. But that failure to think the matter through has begun to chafe, and in unlikely quarters. When Michael Hammer died in the fall of 2008, the *New York Times* ended his obituary with a surprising quotation, coming from one of the fathers of reengineering: “I’m saddened and offended by the idea that companies exist to enrich their owners. That is the very least of their roles; they are far more worthy, more honorable, and more important than that.”

The global financial crisis only added to the ranks of those questioning the maximization of shareholder wealth as the be-all and end-all of corporate activity. In March 2009, former GE CEO Jack Welch—of all people—told the *Financial Times* that “on the face of it, shareholder value is the dumbest idea in the world.” The man once viewed as the poster CEO for value creation went on to explain: “Shareholder value is a result, not a strategy,” and, more surprisingly, “Your main constituencies are your employees, your customers, and your products.”

Other onetime champions of the shareholder are prepared to go further. McKinsey’s Dick Foster, who placed the shareholder at the absolute top of the capitalist food chain, has changed his mind in the wake of the financial meltdown. He now believes that the crisis has completely discredited the efficient-market hypothesis, the theoretical underpinning for the idea that the stock market knows best about the value of an enterprise. The turmoil also confirmed his belief, first enunciated in his 2001 book *Creative Destruction*, that management’s actions can affect no more than 20% or 30% of what determines a company’s stock price. So, if the yardstick of shareholder value is to be abandoned as the principal measure of strategic success, what should a company be managed for? “Stability and growth,” Foster says.

Foster is radical in his apostasy. The consensus emerging among strategy consul-

What would be the right way to think about the goals of a corporation if the superordinate goal were not to maximize the wealth of its owners, the shareholders? And would an accounting that somehow accurately reflected all the ways employees contribute to corporate success make for organizations less inclined to chew up people?

tants, and seemingly what Jack Welch was getting at, is that the recent paroxysms should remind us that shareholder value is not something to be tracked quarter by quarter, much less trading day to trading day. It is, rather, an edifice that takes years to construct, four or five at a minimum. And hasn’t that always been one of the messages of strategy, veterans of the discipline add: that you have to look to and build for the long term?

Most strategists would probably like to leave the question of corporate purpose right there. They sense that they walk a path on the edge of much larger questions, some of which the recent financial crisis threatened to open to the size of yawning chasms. Principal among these is how to parcel out fairly the wealth created by companies as well as the pain their activities can sometimes generate.

For the past two decades, corporate profitability has increased steadily—strategy at work—as has the size of the slice of the overall economic pie that profits represent. That has made for higher stock prices, which helped satisfy all those greedy shareholders (like you or me or anyone else who invested in the market). Higher profits have also entailed relentlessly pushing costs down—strategy abetted by Greater Taylorism—and the largest line item for most companies is still their people. Strategy had already helped shred the old social compact between employer and employee. (At some companies, you could almost hear the light bulb clicking on in the heads of senior executives back in the early 1990s: “Now that we know what our costs are and understand how they stack up against our competitors’, how can we possibly afford so large a payroll or such a generous deal for our people? Besides, if

we can’t shape the business up, we’ll just sell it off to somebody who will.”)

Over the past 10 years, the additional pressure from globalization on these trends has led to an increasingly lopsided distribution of incomes—the CEOs, deal doers, and strategy makers getting a larger share of the wealth generated—and a squeeze on what used to be known as the middle classes. Unlike the 1950s and 1960s, when increased corporate prosperity meant general prosperity and an ever-larger population of well-off consumers, now the only way most folks can maintain the levels of consumption they’ve come to expect for themselves is by taking on greater debt—run up those credit cards, take out a home equity loan—to the point where household indebtedness has reached record levels. In some ways, it was an eerie echo of a lesson that strategy taught most companies: you ought to be borrowing more.

Are we now, as a society—or a number of societies all inhabiting a capitalist world—ready to rethink our reliance on market mechanisms to produce the larger good? Are we prepared to sacrifice a degree of corporate profitability if that were to bring with it lessened extremes of wealth and poverty? What would be the right way to think about the goals of a corporation if the superordinate goal were not to maximize the wealth of its owners, the shareholders? And would an accounting that somehow, finally, accurately reflected all the ways employees contribute to corporate success make for organizations less inclined to chew up people? These are questions with enormous implications for strategy, but not ones that strategists have shown much willingness to engage.

Yes, you can outsource even high-level functions to India or China and open your nation's labor markets to immigrants. But here and there, the decline in the number of available workers may outstrip the ability of companies to rationalize and do with fewer people.

They have lots of company. Even in the aftermath of the global financial crisis, there seems little prospect that the fiercening of capitalism will abate anytime soon. Too many people across the planet have opened their lives to the power of free markets, clambering to make those lives richer, but at the same time speeding up the gears of competition. While many a strategy consultant—Philip Evans is one—warns of years of slower growth ahead, as of the summer of 2009 the world economy had avoided total, Depression-type collapse. Voices calling for a root-and-branch rethinking of our economic arrangements have quieted, their place taken by others calling our attention to the “green shoots” of recovery.

“Animal Spirits” and the Human Element

With respect to its fourth—and perpetual—challenge, demographic trends will only add urgency to the necessity that strategy finally come to terms with its Jungian shadow.⁴ Populations in Europe and Japan are aging, the baby boom in the United States is gradually disengaging. Yes, you can outsource even high-level functions to India or China and open your nation's labor markets to immigrants. But here and there, the decline in the number of available workers may outstrip the ability of companies to rationalize and do with fewer people.

Companies nevertheless continue to push mightily in that direction. Every day, Greater Taylorism applies its analytic engines to more aspects of what workers are doing, slicing the data ever finer—IBM modeling individual employees, retailers using so-called human-capital management systems to time even the smallest task and to schedule people accordingly.

This is another form of the intellectualization of business, of course, as are all the computer models employed by finance and strategy. It also represents Greater Taylorism's finally grinding its way down to plain old Taylorism, but with computer algorithms to complement the stopwatch.

What the systems don't capture is Keynes's famous “animal spirits,” entrepreneurial energies and imaginings that bring a business to life. They also miss out on the aspirations employees may harbor to think a bit on their own, experiment with new ways of doing the same old drill, and perhaps even be recognized by the company for what they create. For most of strategy's history, those are precisely the factors that the paradigm hasn't found a way to work into its calculations. If the discipline is to continue to be of service, it will have to find that way. ■



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To learn more

Balanced Scorecard co-creator Robert S. Kaplan explores corporate philosophy, the history of strategy, and the relationship of strategy management and risk management (in the context of the global financial crisis) in the following BSR articles:

“Strategy or Stakeholders: Which Comes First?” BSR March–April 2008 (Reprint #B0803D)

“Excellence Redux: How the Balanced Scorecard Enhances the McKinsey 7-S Model,” BSR March–April 2005 (Reprint #B0503D)

“Why System, Not Structure, Is the Way Toward Strategic Alignment: A Historical Perspective,” BSR July–August 2006 (Reprint #B0607A)

“Risk Management and the Strategy Execution System,” BSR November–December 2009 (Reprint #B0911A)

We also recommend:

“The Importance of Being Strategic,” by Michael E. Porter, BSR March–April 2002 (Reprint #B0203D)

“Finding—and Firing Up—Your Next Growth Engine,” by Chris Zook, BSR November–December 2008 (Reprint #B0811D)

“Dealing with Darwin: How Great Companies Cope with Globalization and Commoditization,” by Geoffrey Moore, BSR March–April 2007 (Reprint #B0703E)

Continue the dialogue

Do you think strategy and its advocates bear any culpability in creating or abetting the global financial crisis? Are companies sometimes so preoccupied with maximizing efficiencies that they lose sight of the human element in performance success? And how can companies keep risks at bay without stifling the boldness that creates market leaders? Join Walter Kiechel in a discussion of these and more issues on XPC at www.thepalladiumgroup.com/bsr/kiechel.

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⁴ The author's term for the people component, the component that has historically been most neglected in strategy. The Jungian shadow, explains Kiechel, was conceived by Swiss psychotherapist Carl Jung (1875–1961). It refers to “that part of oneself—energies, desires, ambitions—that we repress as we become the individuals we are, ‘rejected aspects of ourselves and undeveloped potential,’ as one expert defines it.” (*The Lords of Strategy*, pp. 6–7.)