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By Invitation:

The halo effect, and other managerial delusions

Companies cannot achieve superior and lasting business performance simply by following a specific set of steps.

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The quest of every high-quality corporate executive is to find the keys to superior performance. Achieving market leadership is hard enough, but staying at the top—given intense competition, rapidly changing technology, and shifting global forces—is even more difficult. At the same time, executives are under enormous pressure to deliver profitable growth and high returns for their shareholders. No wonder they constantly search for ways to achieve competitive advantage.

But many executives, despite their good intentions, look in the wrong places for the insights that will deliver an edge. Too often they reach for books and articles that promise a reliable path to high performance. Over the past decade, some of the most popular business books have claimed to reveal the blueprint for lasting success, the way to go from good to great, or how to craft a fail-safe strategy or to make the competition irrelevant.

At first glance, many of the pronouncements in such works look entirely credible. They are based on extensive data and appear to be the result of rigorous analysis. Millions of managers read them, eager to apply these keys to success to their own companies. Unfortunately, many of the studies are deeply flawed and based on questionable data that can lead to erroneous conclusions. Worse, they give rise to the especially grievous

Article at a glance

In the quest to achieve superior performance, executives often rely on advice in business books, articles, and business school case studies that claim to reveal a blueprint for gaining lasting competitive advantage.

The research underpinning this advice, however, is often deeply flawed and, worse, obscures the basic truth that success in the business world is based on decisions made under uncertainty and in the face of factors executives cannot control.

This article, an adaptation of material from the author's book, The Halo Effect: . . . and the Eight Other Business Delusions That Deceive Managers, *explores some of the misconceptions and delusions found in the business world, particularly those concerning the ability of executives to achieve durable superior performance. These include the idea that variables such as leadership and corporate culture have a causal relationship to financial performance.*

The article also explores ways for executives to improve their powers of critical thinking, an important but overlooked tool for crafting effective corporate strategy.

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notion that business success follows predictably from implementing a few key steps. In promoting this idea, authors obscure a more basic truth—namely, that in the business world success is the result of decisions made under conditions of uncertainty and shaped in part by factors outside our control. In the real world, given the flux of competitive dynamics, even seemingly good choices do not always lead to favorable outcomes.

Rather than succumb to the hyperbole and false promises found in so much management writing, business strategists would do far better to improve their powers of critical thinking. Wise executives should be able to think clearly about the quality of research claims and to detect some of the egregious errors that pervade the business world. Indeed, the capacity for critical thinking is an important asset for any business strategist—one that allows the executive to cut through the clutter and to discard the delusions, embracing instead a more realistic understanding of business success and failure.

As a first step, it's important to identify some of the misperceptions and delusions commonly found in the business world. Then, using these insights, we might replace flawed thinking with a more acute method of approaching strategic decisions.

Beware the halo effect

Many studies of company performance are undermined by a problem known as the halo effect. First identified by US psychologist Edward Thorndike in 1920, it describes the tendency to make specific inferences on the basis of a general impression.

How does the halo effect manifest itself in the business world? Imagine a company that is doing well, with rising sales, high profits, and a sharply increasing stock price. The tendency is to infer that the company has a sound strategy, a visionary leader, motivated employees, an excellent customer orientation, a vibrant culture, and so on. But when that same company suffers a decline—if sales fall and profits shrink—many people are quick to conclude that the company's strategy went wrong, its people became complacent, it neglected its customers, its culture became stodgy, and more. In fact, these things may not have changed much, if at all. Rather, company performance, good or bad, creates an overall impression—a halo—that shapes how we perceive its strategy, leaders, employees, culture, and other elements.

As an example, when Cisco Systems was growing rapidly, in the late 1990s, it was widely praised by journalists and researchers for its brilliant strategy, masterful management of acquisitions, and superb customer focus. When the tech bubble burst, many of the same observers were quick to make the opposite attributions: Cisco, the journalists and researchers claimed, now had a flawed strategy, haphazard acquisition management, and poor customer relations. On closer examination, Cisco really had not changed much—a decline in its performance led people to see the company differently. Indeed, Cisco staged a remarkable turnaround and today is still one of the leading tech companies. The same thing happened at ABB, the Swiss-Swedish engineering giant. In the 1990s, when its performance was strong, ABB was lauded for its elegant matrix design, risk-taking culture, and charismatic chief executive, Percy Barnevik. Later, when the company's performance fell, ABB was roundly criticized for having a dysfunctional organization, a chaotic culture, and an arrogant CEO. But again, the company had not really changed much.

The fact is that many everyday concepts in business—including leadership, corporate culture, core competencies, and customer orientation—are ambiguous and difficult to define. We often infer perceptions of them from something else, which appears to be more concrete and tangible: namely, financial performance. As a result, many of the things that we commonly believe are *contributions* to company performance are in fact *attributions*. In other words, outcomes can be mistaken for inputs.

Wise managers know to be wary of the halo effect. They look for independent evidence rather than merely accepting the idea that a successful company has a visionary leader and a superb customer orientation or that a struggling company must have a poor strategy and weak execution. They ask themselves, "If I didn't know how the company was performing, what would I think about its culture, execution, or customer orientation?" They know that as long as their judgments are merely attributions reflecting a company's performance, their logic will be circular.

The halo effect is especially damaging because it often compromises the quality of data used in research. Indeed, many studies of business performance—as well as some articles that have appeared in journals such as *Harvard Business Review* and *The McKinsey Quarterly* and in academic business journals—rely on data contaminated by the halo effect. These studies praise themselves for the vast amount of data they have accrued but overlook the fact that if the data aren't valid, it really doesn't matter how much was gathered or how sophisticated the analysis appears to be.

This reliance on questionable data, in turn, gives rise to a number of further errors in logic. Two delusions—of absolute performance and of lasting success—have particularly serious repercussions for business strategists.

The delusion of absolute performance

One of the most seductive claims in business best sellers is that a company can achieve success if it follows a specific set of steps. Some recent books are explicit on this point, claiming that a company hewing to a certain formula is virtually sure to become a great performer. On closer inspection these studies rely on sources of data (including retrospective interviews, articles from the business press, and business school case studies) that are routinely undermined by the halo effect. Whereas a given set of factors may appear to have led predictably to success, the reverse is more likely—it would be more accurate to say that successful companies tended to be described in the same way. The direction of causality is wrong.

Following a given formula can't ensure high performance, and for a simple reason: in a competitive market economy, performance is fundamentally relative, not absolute. Success and failure depend not only on a company's actions but also on those of its rivals. A company can improve its operations in many ways—better quality, lower cost, faster throughput time, superior asset management, and more—but if rivals improve at a faster rate, its performance may suffer.

Consider General Motors. In 2005 GM's debt was reduced to junk bond status—hardly a vote of confidence from financial markets. Yet compared with the automobiles GM produced in the 1980s, its cars today boast better quality, additional features, superior comfort, and improved safety. Owing to myriad factors, including the increased prominence of Japanese and South Korean automakers, GM's share of the US market keeps slipping, from 35 percent in 1990 to 29 percent in 1999 and 25 percent in 2005. Its declining performance must be understood in relative terms. Paradoxically, the rigors of competition from Asian automakers are precisely what have stimulated GM to improve. Is GM a better automaker than it was a generation ago? Yes, if we look at absolute measures. But that's little comfort to its employees or shareholders.

The delusion of absolute performance is very important because it suggests that a company can achieve high performance by following a simple formula, regardless of the actions of competitors. If left unchecked, executives may avoid decisions that, although risky, could be essential for success. Once we see that performance is relative, however, it becomes obvious that a company can never achieve success simply by following certain steps, no matter how serious its intentions. High performance comes from doing things better than rivals can, which means that managers have to take risks. This uncomfortable truth recognizes that some elements of business performance are beyond our control, yet it is an essential concept that clear-thinking executives must grasp.

The delusion of lasting success

The halo effect leads to a second misconception about the performance of companies: that they can achieve enduring success in a predictable way. These studies typically begin by selecting a group of companies that have outperformed the market for many years and then gather data to try and distill what led to that high performance. Regrettably, however, much of the data come from sources that are commonly contaminated by the halo effect. What the authors claim to be the causes of long-term performance are more accurately understood as attributions made about companies that had been selected precisely for their long-term performance.

In fact, lasting success is largely a delusion, a statistical anomaly. As McKinsey's Richard Foster and Sarah Kaplan showed,[1] corporate longevity is neither very likely nor, when we find it, generally associated with high performance. On the whole, if we look at the full population of companies over time, there's a strong tendency for extreme performance in one time period to be followed by less extreme performance in the next. Suggesting that companies can follow a blueprint to achieve lasting success may be appealing, but it's not supported by the evidence.

High performance is difficult for companies to maintain, for an obvious reason: in a free-market economy, profits tend to decline as a result of

[1] *Creative Destruction: Why Companies That Are Built to Last Underperform the Market—and How to Successfully Transform Them*, New York: Currency/Doubleday, 2001.

imitation and competition. Rivals copy the leader's winning ways, new companies enter the market, best practices are diffused, and employees move from one company to another. Of course, it is always possible to pick out a handful of enduring success stories after the fact. Then if we study those companies by relying on data that are suffused with the halo effect, we may think we have discovered the keys to success. In fact, we have only managed to show how successful companies were described—an entirely different matter.

The delusion of lasting success is a serious matter because it casts building an enduringly high-performing company as an achievable objective. Yet companies that outperform the market for long periods of time are not just rare but statistical anomalies whose apparent greatness is observable only in retrospect. More accurately, companies that enjoy long-term success have probably done so by stringing together many short-term successes, not because they somehow unlocked the secrets of sustained greatness. Unfortunately, pursuing a dream of enduring greatness may divert attention from the need to win more immediate battles.

Clear thinking for business strategists

These points, taken together, expose the principal fiction at the heart of so many popular business books and articles: that following a few key steps will inevitably lead to greatness and that a company's success is of its own making and not often shaped by external factors.

The simple fact is that no formula can guarantee a company's success, at least not in a competitive business environment. This truth may seem disappointing. Many managers would like to find a formula that can be easily applied—a tidy plug-and-play solution that ensures success. But on reflection, the absence of a simple success formula should not be disappointing at all. Indeed, it might even come as a relief. If success could be reduced to a formula, companies would not need strategic thinking but could rely on administrators to tick the right boxes and ensure that formulas were followed with precision. What makes strategic decision making so difficult, and therefore so valuable to companies, is precisely that there are no guaranteed keys to success. The ability to make the sorts of difficult, complex judgments that are pivotal for a company's fortunes is, in the last analysis, a business executive's most important contribution. Here are some approaches that may help.

Recognize the role of uncertainty

Rather than search in vain for success formulas, business executives would do better to adjust their thinking about the context of strategic decisions. As a first step, they should recognize the fundamental uncertainty of the business world. Doing so does not come naturally. People want the world to make sense, to be predictable, and to follow clear rules of cause and effect. Managers want to believe that their business world is similarly predictable, that specific actions will lead to certain outcomes. Yet strategic choice is inevitably an exercise in decision making under uncertainty. Another source of uncertainty involves customers: will they embrace or reject a new product or service? Even if a company accurately anticipates what customers will do, it has to contend with the unpredictable actions of new and old competitors.

A third source of uncertainty comes from technological change. Whereas some industries are relatively stable, with products that don't change much and customer demand that remains fairly steady, others change rapidly and in unpredictable ways. A final source of uncertainty concerns internal capabilities. Managers can't tell exactly how a company—with its particular people, skills, and experiences—will respond to a new course of action. Our best efforts to isolate and understand the inner workings of organizations will be moderately successful at best. Combine these factors and it becomes clear why strategy involves decisions made under uncertainty.

See the world through probabilities

Faced with this basic uncertainty, wise managers approach problems as interlocking probabilities. Their objective is not to find keys to guaranteed success but to improve the odds through a thoughtful consideration of factors. Some of these are outside the company—including industry forces, customer trends, and the intentions of competitors. Others are internal—capabilities, resources, and risk preferences. On the foundation of that analysis, the role of the business strategist is to make decisions that improve a company's chances for success while never imagining that a company can simply will its success.

Rather, the goal should be gathering accurate information and subjecting it to careful scrutiny in order to improve the odds of success. As former US Treasury Secretary and Goldman Sachs executive Robert E. Rubin wrote in his memoirs,[2] "Once you've internalized the concept that you can't prove anything in absolute terms, life becomes all the more

[2] Robert E. Rubin and Jacob Weisberg, *In an Uncertain World: Tough Choices from Wall Street to Washington*, reprint edition, New York: Random House, 2004.

about odds, chances, and trade-offs. In a world without provable truths, the only way to refine the probabilities that remain is through greater knowledge and understanding.” Wise managers know that business is about finding ways to improve the odds of success—but never imagine that it is a certainty.

Separate inputs from outcomes

Finally, clear-thinking executives know that in an uncertain world, actions and outcomes are imperfectly linked. It’s easy to infer that good outcomes result from good decisions and that bad outcomes must mean someone blundered. Yet the fact that a given choice didn’t turn out well doesn’t always mean it was a mistake. Therefore it’s important to examine the decision process itself and not just the outcome. Had the right information been gathered or had some important data been overlooked? Were the assumptions reasonable or were they flawed? Were calculations accurate or had there been errors? Had the full set of eventualities been identified and their impact estimated? Had the company’s strategic position and risk preference been considered properly?

This sort of rigorous analysis, with outcomes separated from inputs, requires the extra mental step of judging actions on their merits rather than simply making after-the-fact attributions, favorable or unfavorable. Good decisions don’t always lead to favorable outcomes, and unfavorable outcomes are not always the result of mistakes. Wise managers resist the natural tendency to make attributions based solely on outcomes. They avoid the halo bestowed by performance and insist on independent evidence.

Our business world is full of research and analysis that are comforting to managers: that success can be yours by following a formula, that specific actions will lead to predictable outcomes, and that greatness can be achieved no matter what rivals do. The truth is very different: the business world is not a place of clear causal relationships, where a given set of actions leads to predictable results, but one that is more tenuous and uncertain.

The task of strategic leadership is therefore not to follow a given formula or set of steps. Instead it is to gather appropriate information, evaluate it thoughtfully, and make choices that provide the best chance for the company to succeed, all the while recognizing the fundamental nature of business uncertainty. Paradoxically, a sober understanding of this risk—along with an appreciation of the relative nature of performance and the general tendency for performance to regress—may offer the best basis for guiding effective decisions. These complex decisions, made without any guarantee of success, are ultimately the main contribution of business strategists. If a set of steps that could guarantee success did exist, and if greatness were indeed simply a matter of will, then the value of clear thinking in business would be lower, not greater. Q

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