This **Quarter**

The **human factor** in strategic decisions

In the academic world, the emphasis is increasingly on specialization. Scholars in today's universities are encouraged to pursue research in ever-greater depth, which creates ever-narrower areas of expertise and reduces a scholar's opportunity to interact with colleagues and gain cross-disciplinary insights into different branches of learning. Since many of the world's scientific breakthroughs come when experts bring a fresh perspective to problems outside their own particular field (as historian Thomas Kuhn showed in his now-classic *The Structure of Scientific Revolutions*), this trend is particularly troubling.

By isolating branches of learning that are better considered together, scholars risk failing to recognize how problems intertwine and the ways in which this interconnection can amplify their effect. The academic world, for example, traditionally separates the study of agency problems (in which individuals promote their own interests over those of their employer) from that of cognitive science (which looks to explain human behavior). In the real world, however, agency problems and cognitive biases intermingle to create persistent difficulties in a variety of areas, such as capital allocation, where "corporate socialism" results in the misallocation of resources across business units; in compensation, where companies reward executives for being lucky; and in investment, where the fear of being associated with a losing venture can lead investors to throw good money after bad.

Although a great deal of work remains to discern the intersecting causes and effects of agency problems and cognitive biases, this issue of *The McKinsey Quarterly* makes a start with "Distortions and deceptions in strategic decisions," by Dan P. Lovallo and Olivier Sibony. The authors find that principal-agent problems often compound cognitive biases, such as overoptimism, to undermine strategic decision making. They also explore how managers and companies can overcome the limitations of human nature to improve their chances of making good strategic decisions.

Strategic choice also figures prominently in another of this issue's articles, "The right service strategies for product companies," by Byron G. Auguste, Eric P. Harmon, and Vivek Pandit. The authors note that few product companies make money from their "embedded" service units and find that strategic confusion is the source of this difficulty. By determining whether the goal of a service business is to enhance product offerings or to function as a growth platform in its own right—and by clarifying whether a competitive advantage can be achieved through economies of scale or skill—companies with embedded service units can price and deliver their offerings more profitably and better manage their product and service organizations.

Also in this issue are two provocative interviews. The first of them—"Shaking up the labor movement: An interview with the head of the Service Employees International Union"—should be required reading for all executives with a big, globally distributed workforce. SEIU President Andy Stern describes how a global federation of unions, organized by sector, could bring cross-border pressure to bear on multinational service companies.

In the other, "Making China your second home market: An interview with the CEO of Danfoss," Jørgen Clausen tells how the privately held Danish industrial-controls manufacturer came to increase its commitment to the Chinese market. The company made the decision soon after Clausen and his wife experienced a revelation of sorts while traveling the old Silk Road between Kazakhstan and China. After deciding to do more than skim the high end of the market and to serve its low-income segments as well, Danfoss had to rethink its approach to R&D, manufacturing, distribution, and project finance, among other things.

In combination with pieces we have published previously—including "Hidden flaws in strategy," in 2003, and "Beating the odds in market entry," in 2005—this issue of the *Quarterly* extends McKinsey's interest in adapting behavioral economics to the biggest decisions that corporations make. In future issues, we look forward to exploring further how cognitive biases and agency problems apply to resource allocation, M&A, and market exit decisions.

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