A Brief Review of the Impact of Industry Structure and Competitive Advantage on Shareholder Returns

The study of business strategy is, in essence, about the search for an answer to a single fundamental question: what accounts for superior firm performance? In recent years, two schools of thought about the answer to this question have emerged.

The first school has focused on industry structure and company scale as the primary determinants of the total returns different firms deliver to their respective shareholders. This school's point of view was most famously put forth by Michael Porter, in his book Competitive Strategy, which asserted that "five forces" were critical determinants of a company's profitability. In essence, these five forces all boil down to the same issue: the extent of a firm's power versus other entities: customers, suppliers, potential new entrants, substitute products, and rival firms in the industry. The more power all the firms in an industry had versus the first four, the higher the expected level of overall industry profitability; the more power the firm had versus its rivals within the industry (which is largely a function of relative scale), the higher its profitability relative to the industry average.

The second school of thought has focused on a company's specific competitive advantages as the main determinant of its relative profitability. In particular, this school has looked to differences in each firm's endowment of distinctive assets and capabilities, rather than simply differences in operating scale, to explain differences in relative competitive advantage and firm performance. This approach has come to be known as the "resource based view of the firm", and has been popularized by any number of writers, including C.K. Prahalad and Gary Hamel ("The Core Competence of the Corporation"), and, most recently, by Michael Porter whose 1996 Harvard Business Review article "What is Strategy?" reflects his evolving views.

Which school has the right answer? We recently completed a piece of analysis to help shed some data driven light on this question.

We started with 1996 total shareholder returns data (dividends plus change in share price) for the companies included in the Standard and Poors 500 Index. These companies were further divided into 24 major industry groups, using S&P's standard definitions. We used total return data instead of return on equity for three reasons: first, it is uniform across companies, and not subject to accounting distortions; second, it contains more forward looking information, in as much as it

reflects investors' evaluation of future industry structure and competitive advantage; finally, it is shareholder returns, not ROE per se, that is the relevant concern for most CEOs with whom we work.

For each industry group, we calculated the average total shareholder return for 1996, as well as the standard deviation of 1996 shareholder returns for companies within the industry group. Our interpretation of these data were that the average return for an industry group as a whole reflects its structural characteristics, while the standard deviation of returns between firms reflects the potential impact of relative competitive advantage (or disadvantage) within the industry.

To assess the relative importance of industry structure versus competitive advantage, we calculated the average 1996 total shareholder return across all industry groups (18.7%) and the standard deviation of these average returns (12.4%). We also calculated the average standard deviation of returns within an industry group (24.4%). Comparing the two standard deviations suggests that in general, making choices that result in the achievement of competitive advantage within an industry has approximately twice the potential impact on shareholder returns as choosing to compete in an industry with favorable structural characteristics.

In general, this leads to the conclusion that managers should focus the majority of their strategic thinking on how to develop distinctive assets and capabilities, and combine them into new sources of competitive advantage. However, there are exceptions to this general rule; we found some industries that had standard deviations of shareholder returns that were substantially below the all industry average (eg., aerospace and defense; banks; paper and forest products). In these industries, thinking about how to achieve and maintain a healthy industry structure may be more important than developing new sources of competitive advantage. This leads us to our third, and most important conclusion: when it comes to strategy, there is clearly no "right answer" or simple, generic formula for generating superior shareholder returns. Successful strategies are unique creations, and must be based on both industry structure and a company's current and prospective endowment of distinctive assets and capabilities.

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