Harvard Business Review

BLOG

Roger Martin

When Strategy Fails the Logic Test

8:00 AM Wednesday November 24, 2010

I pretty much knew that the reaction to my last blog analyzing the flawed logic of the AOL-Time Warner merger would elicit comments blasting me for using 20-20 hindsight. However, being right was not the point. My objective is to clarify a fundamental logical fallacy, so I will forge onward.

Let's take another example: AT&T's acquisition of cable companies TCI, MediaOne and Cablevision (Boston only) for approximately $130 billion in 1999-2000 and its subsequent sale of the resultant AT&T Broadband to Comcast for $44 billion in 2002. It is difficult to destroy that much value in only two years!

At the time, AT&T national long distance market share was approximately 40% and the cable assets it bought had about a 10% cable market share. The theory was that there if AT&T could own the 'last mile' to the customer's home, it would be able to both provide a more compelling service and protect its long distance market share.

Now there are two possible arguments following from the assumption that there is — or is not — a synergy between long distance telephony and cable:

1. IF customers are motivated by the cable long distance synergies, THEN we will do well with the 25% of our long distance customers that are now also our cable customers

BUT we will need to pay another half a trillion dollars to buy the cable companies that would be necessary to serve the other 75% of our long distance customers.

2. IF customers aren't motivated by the synergies, THEN then we won't get any advantage from investing in cable BUT we know we won't have to make any more cable investments.

In paying a huge price premium to buy the three cable companies, AT&T made a bet — a very big bet — on this proposition:

3. IF customers are motivated by the cable-long distance synergies, THEN we will do well with the 25% of our long distance customers that are also our cable customers AND we won't have to make any more cable investments.

Sadly for AT&T, that 'AND' is logically inconsistent with the preceding 'IF/THEN'. The inevitable consequence for AT&T would have been the need to make impossibly large investments in more cable systems if the 'IF/THEN' was right. In fact, the main beneficiary of the deal was cable giant Comcast, who was outbid by AT&T for MediaOne in 1999 and only had to wait two years to buy all of AT&T Broadband for less than its losing MediaOne bid.

Still hindsight? Well, let's try one that is not retrospective.

Consider the approach the entire business community takes to corporate governance. Agency Theory tells us that corporate executives are 'agents' who are hired by 'principals' (owners and shareholders) to work on their behalf. But this creates a problem, because these agents have an inherent incentive to optimize activities and resources for themselves rather than for their principals, driving a greater share of the company's profits into their own pockets instead of back to the investors. To discipline this inherent self-interest, we have constructed boards of directors, who are meant to be the representatives of shareholders, providing oversight of management activities and ensuring that executives make decisions that are in the best interests of shareholders.

Again, we have a nice tidy structure that seems to have logical consistency; until we look a little deeper. Our theory holds that we can solve the principal-agent problem by having the board of directors discipline management. However, board directors are not principals either; they, too, are agents — hired and paid for by the shareholders — and, as such, they have every bit as much interest in maximizing their own welfare as do executives. Returning to an IF-THEN-BUT structure, we again see an illogical mash up of predicates and consequents. The logical propositions:

1. IF the principal-agent divide is a real problem THEN managers would be susceptible to the nest-feathering urge BUT so would directors.

2. IF the principal-agent divide isn't a problem, THEN directors would be capable of providing oversight untainted by self-interest BUT managers would not be self-interested either, so we wouldn't need directors.

Become the illogical:

3. IF the principal-agent divide is a real problem THEN managers would be susceptible to the nest-feathering urge AND directors would be capable of providing oversight untainted by self-interest.

OK. Enough examples. My point is not about how silly people can be, but rather that there is something seductive about having a pair of models with pieces that can be fit together to produce a wonderful outcome that is accepted and acted upon, even if it is profoundly illogical.

It is a dangerous trap in strategy and in life. Next time: a better strategic approach to opposing models. Until then, any illogical IF/THEN/BUT constructs out there that you've seen?

Roger Martin (www.rogerlmartin.com) is the Dean of the Rotman School of Management at the University of Toronto in Canada. He is the author of The Design of Business: How Design Thinking is the Next Competitive Advantage (Harvard Business Press, 2009).