

# A Darwinian perspective on Business Strategy

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## Introduction:

My purpose is to explore the applicability of Darwin's theories to modern paradigms of Organization and Business Strategy. The working hypothesis is that we can gain practical insights into the likely effectiveness of organizations' business strategies and their use of resources by viewing these activities from the perspective of evolutionary biology. Simplifying assumptions have been made concerning the analogous elements of Darwin's theory and the modern business environment but hopefully not so much so as to invalidate all the derived implications.

Some of the key analogies that I have used are as follows:

- The external, natural environment is equivalent to the market place for any given industry.
- Food and energy sources are represented by customers.
- Organisms and species are analogous to individual firms and their respective industries.
- Genes are represented as the "Strategic Assets" of any given organisation. A Strategic Asset is a term coined by Professor John Kay (formerly of London Business School) to describe the core assets that a company has and which are the sole source of its competitive advantage – that is to say, what makes it uniquely able to earn money over and above its cost of capital. Typically these can be reduced to the following:
  - Reputation, most often captured in brands, but not exclusively. In essence, what creates and signals trust & creates a preference in a crowded market place.
  - Intellectual Property rights that prevent direct competition in the provision of a product or service.
  - Government or other regulatory conferred rights to use a rare asset. For example, aircraft landing rights or spectrum use or territorial rights for exploration. This may also include other preferred access rights to supply a given market independent of Government or regulators.
  - All forms of monopoly or quasi-monopoly whether Government regulated or not.
  - Firm specific capabilities and know-how that are built on skills and routines over time and which are not readily transferable or identifiable in their constituent parts.
- The non genetic material – in other words the outwardly visible body that carries, defends and nurtures the genetic material – is analogous to all other assets, structures and costs that support a fully functioning organization. This would typically include all the employees as well as all physical assets on the balance sheet.

## Propositions:

1. In recent years it has become increasingly accepted that organisations and sub groups within them exhibit characteristics and behaviours that are analogous to living systems found in nature. Many students of organizations recognise the usefulness of analysing them as if they were adaptive, organic structures as opposed to machines with highly predictable causal linkages
2. More recently, particularly as we search for adequate explanations for the glaring market failures at the heart of the financial markets, there is an emerging view that we can better understand these failures if we view markets as “adaptive”. A shift is taking place towards an “adaptive market” hypothesis as opposed to the inadequate “efficient market” hypothesis that has dominated financial economics for decades.
3. What I want to propose is that we can extend the biological insights identified above into the domain of Organization & Business Strategy: specifically in terms of the relationship between firms and the product markets in which they compete as well as the financial markets upon which they depend for funding.
4. At the core of this idea is the notion that “Strategic Assets” are equivalent to the Genes of an organisation, and all other Complementary Assets and supporting costs exist to promote the survival and replication of these Strategic Assets over time and place. Complementary Assets and the whole supporting organizational edifice are analogous to the bodies that house, protect and promote the survival of the organizational genes. In much the same way as ants and their colonies exist solely to protect the Queen and thereby ensure the survival of the next generation eggs.
5. The external environment is the driving force for observed change. The internal mechanism of actual change is the experimentation with new ideas and innovations which, over time and based on positive feedback from the marketplace, develop into new adapted structures & activities which better protect and nurture the Strategic Assets of the firm.
6. From time to time the external environment changes so fast or radically that the incumbent organization is unable to adapt adequately and faces extinction or is taken over by others. In the former case the genes die out, in the latter case some of the genetic material survives and is propagated in a different body. Interestingly, there is a poor track record of firms successfully acquiring others; it is almost as if the biological reaction is too strong and the imported genes are rejected.
7. Customers in the market place are analogous to food in the external environment.

## Implications:

1. The Strategic Focus of all firms should be to identify, develop and nurture Strategic Assets. These are the genes of all commercially orientated organizations and are its only source of lasting value. This stands in contrast to the more familiar paradigms of Business Strategy based around Customer and/or Shareholder value creation. Both these objectives are, in fact, consequences of a successful “Gene survival” paradigm of Business Strategy, not causes.
2. The surrounding structure and substance of the organization are the complementary assets and supporting costs. To take the concept of Richard Dawkins’ “Selfish Gene” at face value, we can infer that the structure of the surrounding firm as well as its multiple complementary assets and costs should be viewed as entirely subservient to the survival and replication needs of the core strategic assets – i.e. genes.
3. This means that there needs to be constant innovation and adaptation taking place to test for better fit between the market place and the effectiveness of the strategic assets. Only in a permanently stable external environment would adaptation be unnecessary. In practice this doesn’t exist, although sometimes it is wrongly inferred by otherwise distracted managers of complacent organizations.
4. We can’t know, a priori, whether any particular innovation is likely to be more successful or not. Only with the benefit of hindsight does that become apparent. This puts a severe limitation on the value of too much deliberate strategizing and long term planning, particularly if this commits an organization to a single, non reversible, direction. In time, single bets will fail to pay off, but maybe are justified in the extreme case where extinction is the consequence of taking no bet at all.
5. Companies that are currently earning super normal profits (i.e. that have well functioning strategic assets generating consistent returns above the company’s cost of capital) should therefore be very careful not to “bet the company” on a single innovation or organisational solution in response to small changes in the external environment. Odds are against landing in a better place than they currently enjoy. Only major changes in the external environment would warrant an “all or nothing” bet on a new organizational form or strategic direction.
6. This biological paradigm also argues in favour of some diversification of a firm’s activities, provided the organization’s activities remain united by the survival and propagation of its particular genetic material. Too often diversification is “unrelated” and therefore not consistent with the survival of its own genetic material. More likely, the diversification activities are consistent with the survival interests of agents of the firm, notably professional managers and secondary market investors, pursuing other interests than the long term survival of the genes of the organization.
7. The implication of some degree of diversification is contrary to the mantra of the investment community which has argued for years about the value destroying nature of diversification.

Whilst it is true that investors can diversify their portfolio risk without individual companies doing it for them, the Darwinian paradigm of strategy strongly suggests that single companies are dependent on diversification more than the interests of secondary market investors would require or acknowledge. Is it really in the interests of investors - particularly long term savers as opposed to short term speculators - that they ask organizations to be non-adaptive, single micro environment dependent, particularly if they have genetic material that can be effective in several environments?

8. This paradigm also supports the notion of decentralised and bottom up forms of management and organizational structure. The likelihood of useful forms of innovation and adaptation are multiplied if the edges of the company are free to experiment. These extremities of the organization are typically closer to the market place realities and therefore better at picking up signals from the external environment.
9. If customers in the market place are analogous to the food in a given organism's environment, then the Darwinian view of strategy may have several powerful implications for the management of an organization.
  - a. First, the customer is no longer king, but merely the sustaining source of energy which enables the organization to survive and propagate its genetic material.
  - b. Second, the objective of the firm relative to its customers is to capture them more successfully than competitors and not necessarily to be as friendly and attractive to them as we are told by the cheerleaders of "customer centricity".
  - c. Different approaches to selecting and capturing customers is a point of differentiation worth developing and may explain differences between firms' success. And this process is essentially one of trial and error with rewards accruing to the successful innovators and adaptors. However, other than in markets where there is an acute shortage of customers, such small points of differentiation will not be decisive to survival.
  - d. Following on from the above, there should be pause for thought before committing too many resources to excessive marketing trench warfare either for the sake of market share or in order to deliver incremental volume to fixed cost factories operating below capacity. This is not where the battle for genetic survival is likely to be won and lost.
  - e. Third, adaptation that makes an organization more effective at capturing customers is legitimate, but only to the point of satisfying its survival needs, not more. Capturing surplus customers beyond this point becomes a distraction from the central need of protecting and propagating its genetic survival.
  - f. Incremental effort capturing surplus customers will doubtless divert energy from efforts to innovate and adapt for inevitable changes in the external environment. The only justification for capturing surplus customers would be to build temporary resources for significant investments in alternative adaptive models and innovative ideas. Unfortunately, most surpluses seem to become subject to "agency capture", symptoms of which are excessive bonuses and value destroying acquisitions.
10. An important distinction exists between the motivation of start up managers and their investors, who create the initial genetic material, and of secondary investors and

professional managers. The latter have strong incentives to mimic the behaviour of their peers, thus driving herd type, homogeneous, behaviour; whereas entrepreneurs, by definition, demonstrate heterogeneous & innovative behaviour. Darwin's theory explains well why species' survival depends on heterogeneous experimentation and subsequent adaptation to changes in the external environment. Perhaps the herd instinct of professional managers and secondary market investors militates against adequate risk taking by large incumbent firms relative to start ups and therefore, unwittingly, weakens the innovation & adaptation imperative so essential to the evolution and survival of the organization's genetic material.

11. The above distinction also partly explains another consequence of "agency capture". Agents, notably secondary market investors and managers of large, established organizations, often place short term financial interests ahead of the longer term survival and propagation needs of the organization's genetic material. Organizations subject to Agency Capture may therefore be compromising their chances of long term survival, either because surplus resources are misdirected or, as argued in point 10 above, because the survival instinct of agents militates against innovation & adaptability.
12. Young entrepreneurial organizations are typically financed and managed with a stronger "ownership" ethos which is more aligned and a clear appreciation of the need to develop and nurture the initial genetic material. Young organizations are also acutely aware of their own survival imperative. These conditions focus minds and energy on the imperative of building strategic assets and only using energy to this end.
13. The size & growth fetish of corporations is a symptom of "agency capture" and rarely serves the needs of the "genetic survival" strategic imperative. On the other hand size does seem to result in excessive bonuses and opportunities to engage in corporate activity that is lucrative for bankers and advisors. No wonder many corporations, often unknowingly, lose sight of their core purpose, namely the propagation and survival of their strategic assets.
14. Finally, Darwin's observation that: *"It's not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change"*, deserves a good deal more prominence in conversations & decisions pertaining to Strategy and Organization than is currently the case.