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Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Seeing strategy alternatives in the momentum case

by Tim Koller, Dan Lovallo, and Werner Rehm

March 2020

The dilemma

Complacency can wreak all kinds of havoc on companies' strategies. A maker of printing products learned this the hard way. Competitors from Asia and Germany announced that they would be releasing new printing devices and accessories within the next three years. Many of those new products would be redundant with the manufacturer's own. Still, the company's strategy team believed it was best to stay the course. Name recognition for the brand was still strong among US customers (the manufacturer's largest market), and the company had invested a lot on R&D in the preceding several years; it believed it had the horses to keep up in any innovation race. Meanwhile, the company could cut operating costs to make up for any decrease in pricing. Margins would stabilize eventually. Everything would be fine, right? Wrong. Over time, the company began missing growth targets, and its share price dropped sharply.

The research

There's no shortage of management literature and research showing the degree to which executives at all levels hold overly optimistic views about projects and performance, and seek to maintain the status quo. For reasons of comfort, and sometimes even self-preservation, they focus on their own perceptions of the market rather than external points of view, and they use mostly internal data to build forecasts and set strategy—something researchers call the "inside view."[1] No one asks hard questions: Exactly *why* do we believe the company can grow faster than the market in two years? Exactly *which* investments are supporting this optimistic outlook, and are they accurately reflected in the operating plan for the next 12 months? And what about the pricing pressures and new competitors that will surely emerge? Absent an "outside view," strategy teams fall back on hockey-stick plans that don't reflect market realities. Underinvestment and underperformance are common outcomes.[2]

The remedy

One way to infuse the outside view into strategy discussions is to build a momentum case for consideration alongside base-case and other forecasting scenarios.[3] A momentum case is an objective assessment of industry growth

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[1] Daniel Kahneman and Dan Lovallo, "Delusions of success: How optimism undermines executives' decisions," *Harvard Business Review*, July 2003, hbr.org.
[2] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[3] Werner Rehm and Anurag Srivastava, "Are your strategy discussions stuck in an echo chamber?," April 2018, McKinsey.com.

and competitive dynamics. It’s built using external variables, such as market share, competitors’ reactions, pricing or margin drops, and changes in cost structure. Companies can use it to set more realistic performance targets, point out gaps in their product portfolios, and reveal the investments necessary just to keep the current business going.

Unlike a base case, a momentum case can also reveal potential negative consequences if the company takes only limited or no strategic action. It would have been a useful tool for those banks in the early 2000s, for instance, that were deciding whether to embrace digital along with the rest of the industry: building or buying new mobile banking applications likely would have required high investment for only limited returns in the short term, but doing nothing would have resulted in lower market share and revenues over time.

It often doesn’t take much time to develop at least an initial momentum case. Companies can work with the data they have and refine those data as they go. In the case of the maker of printing products, a relatively simple “best guess” forecast on how pricing would change as new entrants emerged would have revealed challenges to the company’s top and bottom lines. As the strategy team incorporated more external data and reference cases, it might have discovered how companies in similar situations reacted to similar competitor threats—and it might have noted the 20 to 40 percent drop in prices that materialized in those scenarios. These data, though imperfect, would have anchored the momentum case in some facts, making it harder for the strategy team to cling to its optimistic view—and harder for senior management to overlook a declining forecast.

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