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# Building Competitive Advantage Through People

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# Building Competitive Advantage Through People



Human, not financial, capital must be the starting point and ongoing foundation of a successful strategy.

**Christopher A. Bartlett  
and Sumantra Ghoshal**

**M**ost managers today understand the strategic implications of the information-based, knowledge-driven, service-intensive economy. They know what the new game requires: speed, flexibility and continuous self-renewal. They even are recognizing that skilled and motivated people are central to the operations of any company that wishes to flourish in the new age.

And yet, a decade of organizational delayering, destaffing, restructuring and reengineering has produced employees who are more exhausted than empowered, more cynical than self-renewing. Worse still, in many companies only marginal managerial attention — if that— is focused on the problems of employee capability and motivation. Somewhere between theory and practice, precious human capital is being misused, wasted or lost.

Having studied more than 20 companies in the process of trying to transform themselves, we have concluded that although structure is undoubtedly an impediment to the process, an even bigger barrier is managers' outdated understanding of strategy. (See "The Evolving Focus of Strategy.") At the heart of the problem is a failure to recognize that although the past three decades have brought dramatic changes in both external strategic imperatives and internal strategic

resources, many companies continue to have outmoded strategic perspectives.

In the competitive-strategy model in which many of today's leaders were trained, sophisticated strategic-planning systems were supposed to help senior managers decide which businesses to grow and which to harvest.<sup>1</sup> Unfortunately, all the planning and investment were unable to stop the competition from imitating or leapfrogging their carefully developed product-market positions.

In the late 1980s, the search for more dynamic, adaptive and sustainable advantage led many to supplement their analysis of external competition with an internal-competency assessment. They recognized that development of resources and capabilities would be more difficult to imitate: The core-competency

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perspective focused attention on the importance of knowledge creation and building learning processes for competitive advantage.<sup>2</sup> But this approach, too, faced limits as companies recognized that their people were not equal to the new knowledge-intensive tasks. By definition, competency-based strategies are dependent on people: Scarce knowledge and expertise drive new-product development, and personal relationships with key clients are at the core of flexible market responsiveness. In short, people are the key strategic resource, and strategy must be built on a human-resource foundation. As more and more companies come to that conclusion, competition for scarce human resources heats up.

### The Role of the Executive in the “War for Talent” Era

Senior managers at most traditional companies have been left gasping for air at the breadth and rapidity of change during the past two decades. Hierarchy has to be replaced by networks, bureaucratic systems transformed into flexible processes, and control-based management roles must evolve into relationships featuring empowerment and coaching. In observing companies going through such change, we have come to the conclusion that as difficult as the strategic challenges may be, they are acted on faster than the organizational transformation needed to sustain them. And however hard it is to change the organization, it is even harder to change the orientation and mind-set of its senior managers. Hence today’s managers are trying to implement third-generation strategies through second-generation organizations with first-generation management.

In an earlier study we analyzed the evolution of CEO Jack Welch’s thinking at General Electric Co. and the simultaneous adjustment of his leadership role during the company’s two-decade transformation.<sup>3</sup> In many ways, however, Welch is an exception: Very few top executives have been able to transform themselves from being analytically driven strategy directors to people-oriented strategy framers. Yet for a traditional company

to make the transition into the New Economy, that transformation is vital. In our ongoing research, we have identified three important changes the CEO must make.

**A Changing View of Strategic Resources** The hardest mind-set to alter is the longstanding, deeply embedded belief that capital is the critical strategic resource to be managed and that senior managers’ key responsibilities should center around its acquisition, allocation and effective use.

For the vast majority of companies, that assumption simply is no longer true. Without denying the need for prudent use of financial resources, we believe that, for most companies today, capital is not the resource that constrains growth. Global capital markets have opened up the supply side, while widespread excess industry capacity has reduced the demand side. The recent reversals in some sectors notwithstanding, most companies are awash in capital. Of them, many cannot even generate sufficient high-

### The Evolving Focus of Strategy

	Competition for Products and Markets	Competition for Resources and Competencies	Competition for Talent and Dreams
<b>Strategic Objective</b>	Defensible product-market positions	Sustainable competitive advantage	Continuous self-renewal
<b>Major Tools, Perspectives</b>	<ul style="list-style-type: none"> <li>• Industry analysis; competitor analysis</li> <li>• Market segmentation and positioning</li> <li>• Strategic planning</li> </ul>	<ul style="list-style-type: none"> <li>• Core competencies</li> <li>• Resource-based strategy</li> <li>• Networked organization</li> </ul>	<ul style="list-style-type: none"> <li>• Vision and values</li> <li>• Flexibility and innovation</li> <li>• Front-line entrepreneurship and experimentation</li> </ul>
<b>Key Strategic Resource</b>	Financial capital	Organizational capability	Human and intellectual capital

quality capital-budget projects to use the available resources — and therefore go on merger-and-acquisition expeditions.

The stock market is telling managers what the scarce strategic resource is. When it values a mature, capital-intensive company like GE at 10 times its book value, it is seeing something of greater worth than the physical assets recorded in financial accounts. Though the dot-com bubble burst, the exuberant and often irrational funding of technology-savvy entrepreneurs

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## Recognizing that the company's scarce resource is knowledgeable people means a shift in the whole concept of value management within the corporation.

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pointed to the same lesson: There is a surplus of capital chasing a scarcity of talented people and the knowledge they possess. In today's economy, that is the constraining — and therefore strategic — resource.

The implications for top management are profound. First, human-resources issues must move up near the top of the agenda in discussions of the company's strategic priorities. That means that a first-class human-resources executive must be at the CEO's right hand. Eventually, traditional strategic-planning processes will need to be overhauled and the financially calibrated measurement and reward systems will have to be redesigned to recognize the strategic importance of human as well as financial resources.

**A Changing View of Value** Recognizing that the company's scarce resource is knowledgeable people means a shift in the whole concept of value management within the corporation.

In the early 1980s, competitive strategy was seen as a zero-sum game. Michael E. Porter, for example, saw the company surrounded by its suppliers, customers, competitors and substitutes, engaged in a battle with them to capture the maximum economic value possible.

The subsequent interest in building and leveraging unique internal capabilities caused a gradual shift in emphasis from value appropriation to value creation. As information and knowledge came to provide competitive advantage, the game shifted. Unlike capital, knowledge actually increases when shared, thus eliminating the zero-sum game. Clearly, the focus on value creation demands a different approach than a focus on value appropriation.<sup>4</sup>

One of the most basic issues is how the value that the company creates should be distributed. Most companies operate under the assumption that shareholders, as contributors of capital, have the primary claim. But recruiting difficulties that large traditional companies face, employees' eroding sense of loyalty and cynicism over the growing gap between the compensation of those at the top and those on the front lines all indicate that value distribution must change. The rapid spread of stock options as a form of compensation shows that companies have begun to recognize that the owners of the scarce resources are no longer only the shareholders but also the employees.

The implications are profound. Top management must begin renegotiating both implicit and explicit contracts with key stakeholders, particularly with employees. Unless those who contribute their human and intellectual capital are given the opportunity to enjoy the fruits of the value creation they are driving, they will go where they have that opportunity — typically to newer, less tradition-bound companies.

**A Changing View of Senior Managers' Roles** Unlike capital, scarce knowledge and expertise cannot be accumulated at the top of the company and distributed to those projects or programs in which it will yield the greatest strategic advantage. It resides in the heads of individuals at all levels and is embedded in the relationships of work groups — those closest to the customers, the competitors and the technology. Therefore, rather than allocate capital to competing projects (the zero-sum game), senior managers must nurture individual expertise and initiative, then leverage it through cross-unit sharing (the positive-sum game).

Already we have seen downsizing of corporate planning departments, simplification of strategic-planning and capital-budgeting processes, and massive overhauls of corporate structures and processes — all in an effort both to shift initiative to those deep in the organization who possess valued expertise and to break down the barriers to effective sharing of that expertise.

But senior managers also must rethink their role in shaping strategic direction. Their main contribution has shifted from deciding the strategic content to framing the organizational context. That means creating a sense of purpose that not only provides an integrating framework for bottom-up strategic initiatives, but also injects meaning into individual effort. It means articulating company values that not only align organizational effort with the overall enterprise objectives, but also define a community to which individuals want to belong. And it means developing organizational processes that not only get work done effectively, but also ensure the empowerment, development and commitment of all members of the organization. The philosophical shift requires executives to expand beyond strategy, structure and systems to a simultaneous focus on the company's purpose, process and people.

## Implications for HR Professionals

In many companies the transition process is becoming an important proving ground for the human-resources function, with many old-school HR executives finding that neither their training nor their experience has prepared them for a leading strategic role. In the 1980s era of competitive-strategy analysis, their function was typically supportive and administrative. Once line managers had translated top management's strategic objectives into specific operational priorities, the role of HR staff was to ensure that recruitment, training, benefits administration and the like supported the well-defined strategic and operational agenda.

When strategic priorities became more organizationally focused in the 1990s, human-resources managers increasingly were included in the strategic conversation, often to help define and develop the company's core competencies — and almost always to align the organizational design and management skills to support those strategic assets.

Now, as companies move into the war for talent and as individuals with specialized knowledge, skills and expertise are recognized as the scarce strategic resource, HR professionals must become key players in the design, development and delivery of a company's strategy. (See "The Evolving Role of Human Resources.")

Unfortunately, many top-level human-resources managers view the new task through old lenses. They continue to treat employees as raw materials to be acquired and then made useful through training and development, or at best they acknowledge employees to be valuable assets on whom expenditures in the form of development and generous compensation are worthwhile investments. In response to the demands resulting from the growing importance of human capital, they develop more-aggressive approaches to recruitment, create more-innovative training programs, and experiment with more-sophisticated compensation packages. The problem is twofold: They are tackling a strategic task with old, functional tools, and they are trying to bring about major systemic change with incremental, programmatic solutions. Human-resources managers must see employees as "talent investors," to be treated as partners and rewarded the way other investors are.

We have identified three core tasks that align the human-resources function with the strategic challenge of developing the company's human capital for sustainable competitive advantage: building, linking and bonding.

**The Building Challenge** Many companies claim that their people are their most important asset, but few have built the human-resources systems, processes or cultures that can even offset, let alone challenge, the deeply embedded bias toward financial assets. For example, in almost any company, decisions relating to capital expenditures are subjected to well-documented capital-budgeting procedures. Typically, guidelines define approval levels (for example, division presidents may approve expenditures up to \$1 million, the CEO up to \$5 million, and the board above that level), require clear evaluation processes (for example, positive discounted-cash-flow returns above the weighted cost of capital) and set specific benchmarks (for example, payback on new equipment in three years).

When it comes to hiring a district sales manager or a shift foreman, however, decisions are routinely made by front-line managers who choose the best available among three or four marginal applicants to address a short-term difficulty. Yet that is at least a \$2 million decision if one calculates recruiting costs, training costs and a discounted cash flow of the expected future stream of salary and benefits payments over the average tenure of such employees. But by recruiting a merely average individ-

### The Evolving Role of Human Resources

	Competition for Products and Markets	Competition for Resources and Competencies	Competition for Talent and Dreams
<b>Perspective on Employees</b>	People viewed as factors of production	People viewed as valuable resources	People viewed as "talent investors"
<b>HR's Role in Strategy</b>	Implementation, support	Contributory	Central
<b>Key HR Activity</b>	Administering of recruitment, training and benefits	Aligning resources and capabilities to achieve strategic intent	Building human capital as a core source of competitive advantage

ual, the company loses the opportunity to gain competitive advantage through a hiring decision. If the company were to make the decision strategic, it would have to set standards, monitor activities and measure recruiting outcomes in a way that made the decision as precise and rigorous as those guiding capital allocation.

Converting recruitment into a strategic task means making an ongoing commitment to locating and attracting the best of the best at every level and from every source. Microsoft Corp. is unusually thorough in its recruitment process, annually scanning the entire pool of 25,000 U.S. computer-science graduates in order to identify the 8,000 in whom it has an interest. After further screening, it targets 2,600 for on-campus interviews and

invites just 800 of those to visit the company's Redmond, Washington, headquarters. Of them, 500 receive offers, and 400 — the top 2% of that year's graduates — typically accept. Yet that massive college-recruiting effort provides less than 20% of the company's new-people needs. To locate the rest, the company maintains a team of more than 300 recruiting experts whose full-time job is to locate the best and brightest in the industry. That strike force builds a relationship with literally thousands of the most capable systems designers, software engineers and program managers, often courting them for years. In the late 1990s, the effort resulted in more than 2,000 of the most talented people in the industry joining Microsoft annually.

## One Company's Way of Valuing People

The global management-consulting firm McKinsey & Co. is an example of a company that truly values its employees, as it demonstrates through its commitment to their development. Although formal training plays an important role, by far the most critical development tools are intensive individual feedback and coaching.

Such activities absorb 15% to 20% of the average partner's time. Every consultant receives a formal performance review from his or her office's partner group twice a year, with the individual's designated development director offering detailed feedback, counseling and career advice. The input for that biannual review comes from reports prepared by each of the client-engagement managers, senior-level consultants who are responsible for the day-to-day management of the team to which the individual belongs and who have supervised the individual's work. The engagement managers also provide the consultant with feedback, evaluation and development advice after each of the four or five engagements that span a typical year's assignment. During each engagement, the consultant also has dozens of additional one-on-one feedback and coaching sessions with the more senior people managing and directing the project. In total, each consultant receives scores of specific, detailed coaching sessions per year. The company maintains that its in-depth approach to development is one of the main reasons why people join McKinsey — and why they stay.

After a company has acquired top talent, the building challenge also requires the human-resources function to lead company efforts in constantly developing those talented individuals. That requires more than traditional training programs provide. Today development must be embedded in the company's bloodstream, with all managers responsible for giving their team members ongoing feedback and coaching. That is some-

thing McKinsey does unusually well, which helps to explain why M.B.A.s worldwide are more likely to seek employment there than at any other employer. (See "One Company's Way of Valuing People.")

There is one other aspect of building human capital that is grossly undermanaged at most companies. As any good gardener knows, to promote healthy growth, in addition to fertilizing and watering you also must prune and weed. That is a metaphor Jack Welch used often in describing the performance-ranking process he introduced to cull chronic underperformers at GE. Yet in most companies, the human-resources department focuses considerable effort on planting, staking, watering and fertilizing — and practically none on cutting out deadwood or growth-inhibiting underbrush.

Culling is no longer confined to hard-driving U.S. industrial companies. South Korea's LG, traditionally a cradle-to-grave employer, uses a "vitality index" as a critical performance measure. All managers have to rank their direct reports on a 1-to-5 scale (with 1 equal to the bottom 10% and 5 representing the top 10%). The vitality index is the ratio of new recruits who are ranked at 4 or 5 to employees of rank 1 or 2, who are counseled to move on.

**The Linking Task** Just as there is value in attracting and developing individuals who hold specialized knowledge, there is value in the social networks that enable sharing of that knowledge. Indeed, unless a company actively links, leverages and embeds the pockets of individual-based knowledge and expertise, it risks underutilizing it or, worse, losing it. As companies seek the best ways to convert individual expertise into embedded intellectual capital, the classic response is to give the task to the chief information officer — along with the faddish title of chief knowledge officer.

Not surprisingly, people with information-systems background immediately focus on the task of mapping, modeling and codifying knowledge. Under their leadership, companies have developed databases, expert systems and intranets to help capture and make accessible the company's most valuable information. Yet in many companies, managers do not take full advantage of those elegant new knowledge-management systems.

At the heart of the problem is a widespread failure to recognize that although knowledge management can be supported by an efficient technical infrastructure, it is operated through a social network. Information technologists may help in orga-

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nizing data and making it accessible, but they must be teamed up with — and operate in support of — those who understand human motivation and social interaction. Only then can individual roles and organizational processes be designed to ensure the delicate conversion from available information to embedded knowledge.

Thus, the second core strategic role of the top HR executive is to take the lead in developing the social networks that are vital to the capture and transfer of knowledge. Because that requires an understanding of organization design, process management, interpersonal relationships and trust-based culture, it calls for leadership from sophisticated human-resources professionals who also have a strong understanding of the business.

The most obvious challenge is to build on the process reengineering that most companies implemented during the 1990s to break down bureaucracy and unlock core competencies. The reengineered processes (whether at a micro level, as in order entry, or a macro level, as in new-product development) had two major objectives: breaking down hierarchical barriers to rapid decision making, and opening up new horizontal channels and forums for cross-unit communication and collaboration. Those activities are precisely what will link isolated individuals and organizational units into dynamic social networks.

In the early 1990s, British Petroleum built such networks under the leadership of John Browne, who at the time was overseeing the development of BP's prototype knowledge-management and organizational-learning program as head of BP Exploration. Transferring the approach to the whole company when he became CEO in 1995, Browne avoided installing a new set of information systems, focusing instead on a practice he described as "peer assists." The assist was a small-scale project that encouraged those on the front line in one business unit (operators on a drilling platform in the North Sea, for example) to contact other BP operations (offshore drillers in the Gulf of Mexico, for instance) that had the expertise to help solve particular problems. Cutting through formal layers and complex procedures, the process became an accepted way of doing business, and managers soon recognized that it was not acceptable to refuse a request for help.

The process was supplemented by "peer groups" of business

units engaged in similar activities at similar stages of their life cycle (for example, all start-up oil fields, all mature oil fields or all declining-yield oil fields) and facing similar strategic and technical challenges. The idea was to create a way that managers of BP's newly decentralized operations could compare experiences and share ideas. In recent years "peer assist" has been expanded into "peer challenge," in which peers not only review one another's goals and business plans, but the best performers are formally made responsible for improving the performance of the worst performers.

In a third major element of the program, technology was introduced — but only as the transmission pipeline and storage system for ideas that were already flowing. Rejecting the notion of trying to capture and encode the company's knowledge, the virtual teams built networks to give those with problems access to those with expertise.

Although the initiative involved a major investment in hardware and software, including multimedia e-mail, document scanners, videoclip encoders, desktop videoconferencing and chat rooms with chalkboards, the IT function took responsibility only for installing the equipment. The project was driven by the Virtual Teamwork group and its subteams. About one-third of the Virtual Teamwork budget was allocated for coaches to help managers use the new tools to achieve their business objectives. In the end, it was the ability to change individual behavior and to shape group interaction using the powerful IT tools that allowed BP's process change to succeed.

BP has created processes and a supportive culture to link and leverage the expertise of individual employees, embedding knowledge within the organization. Its social networking is strategic because it drives innovation, responsiveness and flexibility yet is extremely difficult for competitors to imitate.

**The Bonding Process** The third major strategic task HR must undertake is to help management develop the engaging, motivating and bonding culture necessary to attract and keep talented employees. In such a culture, the potential in competent individuals and fully functioning networks can be converted into engaged, committed action. Companies must reject the notion that loyalty among today's employees is dead and accept the challenge of creating an environment that will attract and

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energize people so that they commit to the organization. Such advice flies in the face of conventional wisdom, which maintains loyalty has been replaced by a free-agent talent market that requires companies to convert their long-term trust-based relationships with employees to short-term contracts. Higher employee turnover, the use of temporary help and the expansion of outsourcing are all part of the envisioned future.

But if a company can outsource services or hire temporary expertise, so can its competitors. Such actions, therefore, are unlikely to lead to any competitive advantage. And if recruitment and retention are based primarily on the compensation package, the person lured by a big offer will almost certainly leave for a bigger one.

Consider SAS Institute, a billion-dollar software company based in Cary, North Carolina, which rejects the use of contract programmers and other outsourcing yet still attracts people to work without stock options and maintains turnover below 5%. How is that possible? CEO Jim Goodnight explains that what has consistently given his company a prominent place in Fortune's survey of the best U.S. companies to work for is not stock-option programs, which he calls Ponzi schemes, but rather, competitive salaries and generous bonuses based on the company's performance and the individual's contribution.

In an industry featuring high pressure and burnout as the norm, SAS Institute has created an island of common sense. Actions and decisions are based on four simple principles: to treat everyone equally and fairly, to trust people to do a good job, to think long term and to practice bottom-up decision making. Then there are the hours. The software-industry joke may be generally apt (flex time means the company doesn't care which 15 hours you work each day), but company policy at SAS Institute is to work 35 hours per week. Exceptional benefits also reflect the value SAS puts on its people: There is a free, on-site medical facility for employees and family members, a subsidized on-site day-care facility, a gymnasium free to employees and their families, subsidized restaurants and cafés, and so on. That environment makes employees feel like valued members of a community, not replaceable gunslingers for hire. And for these self-selected individuals, that is reason enough to want to spend their career at SAS.

But the bonding process involves more than creating a sense of identity and belonging. It also must lead to an engaging and energizing feeling of commitment to the organization and its goals. But the visioning exercises and values cards many companies have developed in response to that need often fall short. The role of the HR professional is to get senior managers to move beyond hollow, slogan-driven communications, which are more likely to lead to detached cynicism than to engaged motivation, and to help them develop a clear personal commitment to an organizational purpose. Commitment implies a strongly held set of beliefs that not only are articulated in clear human terms, but also are reflected in managers' daily actions and decisions.

Henri Termeer, CEO of Genzyme, a biotechnology firm based in Cambridge, Massachusetts, regularly meets with people suffering from the diseases on which his researchers are working. He wants to feel angry about the pain and loss the disease is causing and passionate about the need to help. And he wants to transmit that passion to those working at Genzyme. Equally important, Termeer backs his words with actions. Because the company focuses on therapies for rare diseases, the cost of treatment is high. But the company refuses to let economics get in the way of its commitment to treat the afflicted and literally searches them out in Third World countries to provide free treatment. By acting on the company's beliefs, Termeer stirs the passion and engages the energy of Genzyme's employees.

The bonding process can succeed only when senior management realizes that the company is more than a mere economic entity; it is also a social institution through which people acting together can achieve meaningful purpose. In the war for talent, organizations are engaged in what one senior executive describes as "a competition for dreams."

### **The Heart of Strategy**

The arrival of the information-based, knowledge-intensive, service-driven economy has forced massive change on companies worldwide, most dramatically in the way they must redefine their relationship with their employees. The shift in strategic imperatives over the past 25 years has necessitated new battle plans. The competition remains intense for strategic market

positions and for scarce organizational resources and capabilities, but the war for talent has shifted the locus of the battle front. Today managers must compete not just for product markets or technical expertise, but for the hearts and minds of talented and capable people. And after persuading them to join the enterprise, management also must ensure that those valuable individuals become engaged in the organization's ongoing learning processes and stay committed to the company's aspirations.

It was this recognition that led McKinsey's partners to reexamine their long-established mission "to serve clients superbly well." After much debate, the partners decided that the changes occurring in the world of business were significant enough for them to reconsider the core purpose of their firm. Now McKinsey has a dual mission: "to help our clients make distinctive, substantial and lasting improvements in their performance and to attract, develop, excite and retain exceptional people." McKinsey and other organizations making the change have found new meaning in the term competitive strategy as they compete for the hearts, minds and dreams of exceptional people.

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