

# Interview

## Roger Martin explores three big ideas: customer capitalism, integrative thinking and design thinking

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Brian Leavy

**R**oger Martin believes that the shareholder value system has been rigged to the detriment of stockholders, that great managers are distinguished by how they think before they decide what to do and that design thinking is a key competitive competency. Martin is dean of the Rotman School of Management, University of Toronto, where he is also a professor of strategic management and holds the Premier's Research Chair in Productivity and Competitiveness. His primary research interests are integrative thinking, business design, corporate social responsibility and country competitiveness. He is widely published, and his most recent books include *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* (2011) *The Opposable Mind* (2007) and *The Design of Business* (2009), all published by Harvard Business Press. In 2010 he was named one of the 27 most influential designers in the world by *Business Week*, and in 2009 he was cited by *Forbes* and the *Times* (London) as one of the world's 50 top management thinkers. Earlier in his career he spent 13 years as a director of Monitor, the global strategy consulting company, including two years as co-head of the firm.

*Strategy & Leadership* asked Professor Martin to discuss three major topics – the future of capitalism, better executive decision making and innovations that boost customer value – all at the heart of current executive concerns. In the midst of the current global financial and economic crisis, fundamental questions are being raised about what new directions capitalism might need to take if it is to have a future. In Martin's view, modern capitalism has come through two major eras over the last century, managerial capitalism (1930s to 1970s) and shareholder capitalism (1980s to 2000s). He argues that the time has come to embark on a new era, the era of "customer capitalism" and he explains why. In answer to another set of questions, he provides his own insight into one of the management field's most elusive and intriguing questions: what is the essence of outstanding leadership, particularly at the CEO level? His research has led him to the finding that exceptional leaders are distinguished most by the way they think, by their capacity for what he calls "integrative thinking." To a third set of questions, he offers his own solution to one of the major challenges facing senior executives today, how to become more innovative, not only in products and process, but in the area of business management itself. His answer – executives should look to the concept of "design thinking" and learn how to apply it more widely to processes like strategy development and business model innovation.

His interviewer, Brian Leavy, is the AIB Professor of Strategic Management at Dublin City University Business School (brian.leavy@dcu.ie) and a *Strategy & Leadership* Contributing Editor.

### Customer capitalism

**Strategy & Leadership:** In the context of the current global crisis, you argue that we need to "reinvent the purpose of the firm" to achieve what you call "customer capitalism." Can you tell us what you mean by this and why you think the time is ripe?

**Roger Martin:** I believe that the business world has adopted the notion of shareholder value maximization as the singular goal of the firm to an unhelpful extent. While it is important that shareholders earn a return on their investment that is higher than their risk-adjusted cost, it is important to ask whether that theory of the firm best produces such a return. A firm actually maximizes shareholder value by focusing on customers. If customers are delighted, shareholders will do fine. If customers aren't delighted – because the firm is spending its efforts hyping its stock, using aggressive accounting approaches or making lots of silly acquisitions all to promote increases in the stock price – then all of those attempts will have at best short-term effectiveness. So I believe that if a firm wants to do well with its shareholders, it should focus on delighting customers – and that is what I mean by customer capitalism.



Roger L. Martin.  
Photo by George Whiteside

Why now? The shareholder value maximization era began in 1976 and it has taken several decades for the various key actors – management, stock analysts, and hedge funds – to perfect their ability to exploit the theory of shareholder value maximization for their own benefit, in direct opposition to the interests of shareholders. In essence, they have all figured out how to game the game. The result is that shareholders now experience the unattractive combination of lower returns and higher volatility. That is why it is time to change.

**S&L:** What changes would this bring to the working lives of corporate managers? What are the potential benefits?

**Martin:** It would help them lead more authentic lives. Rather than doing the impossible, that is, trying to keep expectations of future performance rising forever, and serving faceless, nameless masters – the modern shareholder – they would have a doable and fulfilling job – delighting their customers – better motivation for all employees. Who wants to go to work each day saying: “I am dedicating my working life to maximizing the value of my shareholders, whoever they happen to be this week?” It is an abstract, unhelpful goal.

**S&L:** What exactly is wrong with making maximizing shareholder value the primary objective? Why is it potentially self-defeating?

**Martin:** The problem is that it not a doable task except in the very short term. Since shareholder value is defined by the stock price and the stock price is a function of the collective expectations of buyers and sellers of a firm's stock, the only way to increase shareholder value is to increase collective expectations about future performance. Since expectations have no bounds, and expectations notoriously run ahead of or behind reality, management knows that it can't keep expectations rising forever. So they have learned that the thing they can do is hype expectations in the short term – and make lots of money on their stock-based compensation – and then get out before expectations plummet. So over time shareholders experience bad things, not good things. On the other hand, if customer satisfaction is seen as the primary goal, shareholder value will by and large take care of itself.

**S&L:** Can you give us some examples of companies that benefitted over the longer run by putting customers before shareholders and explain why it has worked so well for them?

**Martin:** Johnson & Johnson and Procter & Gamble are two examples. Both explicitly put customer delight before shareholder value maximization and both have created as much shareholder value as virtually every other company on the planet. So shareholder value maximization as the singular goal is not necessary for creating massive levels of shareholder value.

**S&L:** How did they successfully make this change? What were the risks? What about their competition?

**Martin:** In the case of J&J, it didn't have to make the change. This was its philosophy from inception as a public company. In the case of P&G, CEO A.G. Lafley had to reorient the company when he took over in 2000. He declared that "the consumer is boss," removed the stock tickers that had been placed all over headquarters by his predecessor and changed compensation metrics to reward performance focused more directly on customer value creation.

There are no risks to customer capitalism. The actual risk is to maintain a singular focus on shareholder value maximization. And fortunately for both J&J and P&G, most of their other competitors continued to focus assiduously on shareholder value maximization.

### How outstanding leaders use integrative thinking

**S&L:** One of the longest running quests in the management field is the search for the "essence" of outstanding leadership. For you, this quest led to "integrative thinking." How did this come about?

**Martin:** I attempted to figure out what highly successful leaders did and found out to my chagrin that there was no discernable pattern. So I stopped focusing on what they did and started asking whether there was a pattern to how they thought. Over a five-year period I interviewed over 50 highly successful leaders about how they had thought through their most difficult and consequential decisions.

It turned out that there was a remarkable consistency in one aspect of their thinking. When these outstanding leaders faced opposing models where it appeared they had to choose one or the other, and neither was satisfactory, rather than see their job as choosing, as most of us tend to do, they saw it as harnessing the tension creatively to try to evolve a better model that is superior to either. I call that pattern "integrative thinking."

**S&L:** Do you see any direct relationship between the capacity for "integrative thinking" and "emotional intelligence"?

**Martin:** Very much so. One of the key capabilities of integrative thinking is being able to explore models that oppose one's own. The only way to do that is to have enough emotional intelligence to have a thoughtful conversation with someone whose model is antithetical or even threatening to yours. By doing so, you can gain a true appreciation of their model. This is a capacity that is crucial to "integrative thinking." A person who doesn't attempt to learn from opposing models can't be an Integrative Thinker.

**S&L:** Harvard Professor Abraham Zaleznik remarked some years ago that grasping "the significance of anomalies" was a distinguishing characteristic of "talented leaders." Other authors have said that leaders find opportunities in dilemmas. In your own experience, how significant are anomalies and dilemmas as features of integrative thinking and why are they so important?

**Martin:** Anomalies don't fit current models. But these anomalies fit perfectly in some model that has not yet been conceived. So they are the best clue one can ever find to the existence of a model that needs to be found. Hence they should be treasured – not discarded as is usually the case. The situation is not dissimilar with dilemmas and so-called "wicked problems," which typically reflect the existence of opposing or conflicting models and, likewise, signal an opportunity to find a new model.

**S&L:** Why is the capacity for integrative thinking so narrowly distributed to date?

**Martin:** I believe it is because we train people to be anti-integrative, but this can be changed.

**S&L:** The primary mechanism you present for helping executives to advance their integrative thinking skills is a Personal Knowledge System (see Figure 5.1 from *The*



Roger L. Martin.  
Photo by Steve Payne

*Opposable Mind*). Can you tell us where the idea for this came from and how the framework operates, perhaps using one of your integrative thinking exemplars?

**Martin:** First and foremost, it is important to acknowledge that the Personal Knowledge System is a product of my collaboration with learning expert Hilary Austen, and is properly credited to her fertile mind. I highly recommend her new book, *Artistry Unleashed*.

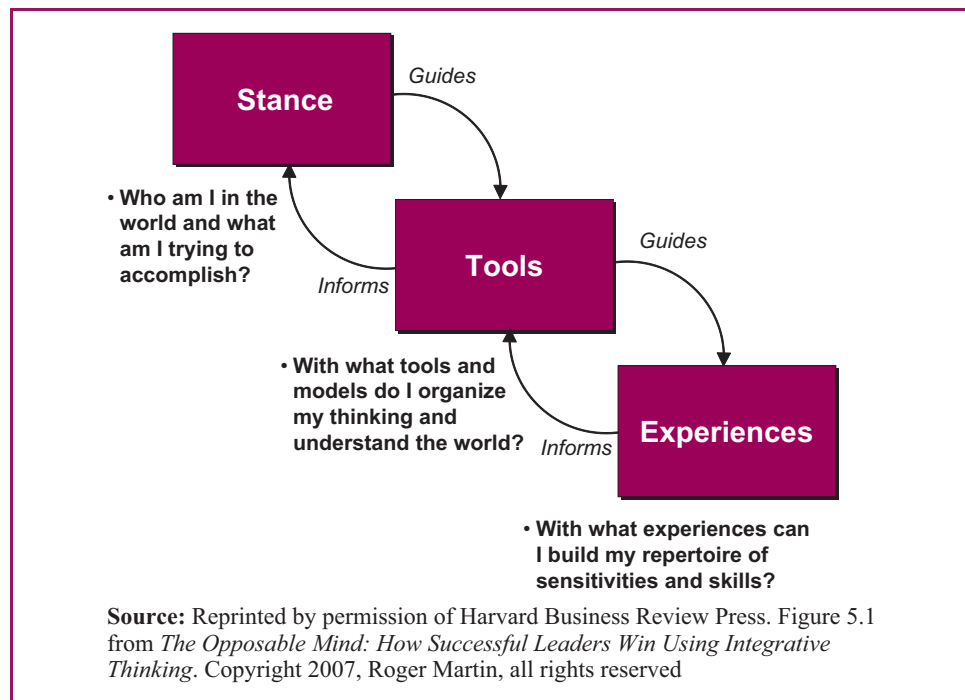
The Personal Knowledge System guides the development of personal capabilities through three interlinked elements – stance, tools, and experiences. Stance is your view of how the world works and what your role in it is. Tools are the conceptual models with which you organize and understand your world. Experiences are the opportunities to hone and refine your skills and sensitivities. Your stance shapes the tools you acquire and the experiences you undergo. It works the other way too. Your experiences influence the tools you think you need to acquire, and your new tools can influence your stance.

For example, Victoria Hale, founder of Institute for One World Health believed that the existing models of big pharma and public health were just models and that even if they were the only models, they weren't the only possibilities. More importantly, they weren't solving the problems of diseases suffered exclusively by the poor. This realization became her *stance*. She used the *tool* of causal modelling to understand the two existing models and the tool of generative reasoning to build a new model – the world's first non-profit pharmaceutical company that focused on third-world health. It found a cure to one of the world's worst killers of poor people, black fever.

But the *experience* taught Victoria that just treating a disease afflicting poor people was not a cure-all for their problems. Because black fever was endemic to the poor, the likelihood of them re-acquiring the disease was great. So she realized that she had to re-imagine her world as one in which the key goal was alleviating poverty, not just treating disease. This realization caused her to change her stance and as a consequence she selected new tools that would be effective with it.

**S&L:** Can you illustrate how an integrative thinker's approach differs from conventional thinkers?

**Figure 5.1** Your personal knowledge system





Roger L. Martin. Photo by Peter Sibbald

**Martin:** For example, in the early 1970s most leaders in the lodging business were content to believe that there were two success models in the industry and chose one or the other, either the small roadside motel model (Holiday Inn, La Quinta, Motel 6) or the large city center hotel (Hilton, Marriot, Westin). Isadore Sharp, the integrative thinker who created the Four Seasons chain sought a better model, one that combined the intimacy and comfort of the small motel with the amenities of a large hotel – and built the world’s most successful luxury hotel chain.

**S&L:** A characteristic you attribute to integrative thinkers is their willingness to embrace and “wade through” complexity patiently, even at the risk of appearing indecisive. Can you give an example of what you mean and why you see this as so important?

**Martin:** Seeking integrative solutions can be daunting because it requires the full understanding and appreciation of two or more models – and in particular, models that don’t agree with one another. That is a lot of complexity. Leaders who are uncomfortable with complexity won’t tend to immerse themselves in it for long enough to allow an integrative solution to emerge. As Victoria Hale described her successful, patient approach: “I just stay with it, sit with it, spin it around.”

### Design thinking and business management

**S&L:** You are one of the most prominent advocates for what “design thinking” has to offer to business management. Why?

**Martin:** Companies have competed successfully for a long time by building design into their business. Many would argue that General Motors was most successful decades ago when design was integral to everything it did. Apple has been using design to amaze consumers and distance itself from competitors since its inception. So has Herman Miller.

I think design has gotten more important recently because competitive cycles are shortening in many industries. This means that depending entirely on honing and refining one’s current competitive positioning is going to be less effective than it used to be. Competitors, both new and existing, will be creating new ways to leapfrog rivals.

To a greater extent, the requirement will be to create ways of competing that do not now exist – a better way of meeting the customers’ desires, a new channel, or a different economic model. All of these things require design thinking – going beyond the rigorous analysis and refinement of the past to the creation of a future that does not now exist.

**S&L:** One of the major impediments standing in the way of business managers and designers developing a better mutual understanding is the schism between the “reliability orientation” of established firms and the “validity orientation” of start-ups. What do you mean by this, and how might it be overcome?

**Martin:** Indeed there is a tension – or in some organizations an out-and-out battle – between reliability and validity. Reliability is the production of a consistent, replicable business outcome. Validity represents the production of an outcome that you really want. The way to get more reliability is to limit one’s consideration to only variables that are objectively quantifiable. The way to get more validity is to consider a broader range of variables including those that are not quantifiable and require judgment to assess.

As organizations get larger, reliability tends to drive out validity. This is what people mean when they complain that their organization has become “process-oriented.” They mean that running the process becomes an end in itself.

**S&L:** Terms such as “reliability” and “validity” are likely to be more familiar to R&D researchers than to business managers. Can you give an example that would be familiar to a broader audience?

**Martin:** As an example, the Stanford-Binet IQ test is highly reliable. It gains its reliability by defining intelligence as the ability to solve little logical puzzles. There is no subjective judgment or bias involved in the assessment procedure and the test produces much the same score for a particular individual over and over and over again. However, we now know from research that the Stanford-Binet IQ test predicts only 30 percent of any future outcome about an individual, such as leadership effectiveness or career success. Seventy per cent has nothing to do with IQ. So while it produces a consistent outcome; that is hardly the outcome that we would actually want.

More recently, Daniel Goleman proposed that emotional intelligence (EQ) is a better predictor of leadership effectiveness than IQ, because it incorporates a wider range of capabilities, and so has greater validity. However, the assessment of EQ requires more qualitative judgment, which opens the door to bias and imprecision, which restricts our ability to reproduce a rating of EQ with quite the same high level of reliability associated with IQ scoring. This is the kind of trade-off that pursuit of validity versus reliability produces.

**S&L:** You suggest that executives learn the “language of validity” and designers the “language of reliability” to improve their ability to work effectively with each other. How?

**Martin:** The most important thing is to listen to what each is saying with an ear to understanding why what they are saying is important to their pursuit of either reliability or validity. Executives hire designers to help them with validity, so designers will speak in validity terms, focusing on what great things could be done, not on the analysis that proves what will happen. Executives will speak from a reliability perspective because they know they have to keep the organization stable and profitable. If each appreciates the other’s task orientation, they will learn to listen with a different ear.

**S&L:** At first glance, “design thinking” and “integrative thinking” as you present them, would seem to have quite a lot in common. Are you saying that outstanding leaders think like designers? What exactly do you mean by design thinking and how would you distinguish it from integrative thinking?

**Martin:** Indeed they are related and I don’t think that I would have become as interested in design had it not been for my research on integrative thinking, which showed me that highly successful leaders had the ability to produce a creative resolution of the tensions between opposing models.

Design thinking, a similar creative process, is the productive combination of the inductive and deductive logic of analytical thinking with the abductive logic of intuitive thinking that enables the movement forward of knowledge from Mystery to Heuristic or Heuristic to Algorithm. It’s a process of innovation that analytical thinking doesn’t generate and intuitive thinking can’t deliver with enough consistency to be economically viable.

**S&L:** Can you explain what you mean by abductive logic?

**Martin:** Abduction is the logical process whereby we make sense out of a phenomenon that doesn’t follow an existing deductive rule and hasn’t happened enough to make an inductive finding. In such situations, in the words of the originator of the term, philosopher Charles Saunders Peirce, the individual needs to make an “inference to the best explanation” or a “logical leap of the mind.” That is, in his view, the source of all new ideas. The problem, for an analytically-driven world, is that no new idea can be proven in advance with inductive or deductive logic. For this reason, too many new ideas are sacrificed on the cross of analysis.

**“Shareholder value maximization as the singular goal is not necessary for creating massive levels of shareholder value.”**

**“A firm actually maximizes shareholder value by focusing on customers. If customers are delighted, shareholders will do fine.”**

**S&L:** As you indicated earlier, the perspective that you have developed to characterize the role that design thinking might play in business management involves three stages of knowledge generation and refinement – Mystery, Heuristic and Algorithm. Can you talk us through how managers might use these ideas to help guide their business innovation efforts?

**Martin:** Everything we now know was once a mystery to humanity – from why do things fall when dropped to how to draw a three dimensional object on a two dimensional surface. A mystery exists when we don't know how to think about it. With thinking, research, and study, some mysteries give way to heuristics – a way of thinking about the mystery that provides helpful answers. So from the mystery of why things fall, Newton discovered the heuristic of gravity; a universal force that causes everything to be pulled toward the earth.

For some heuristics, further study produces an algorithm – a formula that can be used to produce a precise answer, such as the gravity formula:  $s(\text{distance}) = 1/2g(\text{acceleration}) \times t(\text{time})^2$ .

The lesson for managers is that knowledge in their business exists at each of these three levels. So if a business can research a mystery – for example, how do women aged 18 to 29 think about their hair shampoo, and reduce it to a heuristic (here are the five things about shampoo that drive their purchasing) – the firm can gain competitive efficiencies. This occurs when a firm focuses its operations on addressing the key things its customers care about. Every competitor still operating at the mystery stage has to cope with inefficient thinking, which likely will result in wrong resource investment decisions.

Going one step further, firms that can refine their understanding of the keys to customer satisfaction and create a process formula by which they can produce successful product after successful product will become increasingly more efficient. Why? Researching and exploring mysteries is time consuming and expensive. Skilled workers who master a particular heuristic are less expensive and more effective. Algorithms can be implemented efficiently by lower skilled employees operating machines or following standardized procedures.

To be a leader, a company drives mysteries to heuristics and heuristics to algorithms before its competitors, gaining efficiency advantages in the process. And, importantly, it invests the gains from efficiency into solving the next mystery before its competitors.

**S&L:** How might this three-stage model help companies to cope with the strategic and organizational challenges of trying to manage new and existing businesses side by side, particularly where the new venture might be disruptive to the legacy business?

**Martin:** It can help companies understand why the imperatives for business units are different at each stage. At the mystery stage, there has to be room for exploration for people working on the complexities of the mystery. At the heuristic stage, the company has to develop skilled experts with the partially tacit knowledge of the heuristic. At the algorithm stage, the company needs to drive for efficiency and scale. And leaders need to understand that identifying the next mystery is likely to render the current algorithm obsolete.

**S&L:** How can traditional firms with a built-in bias for reliability and organizational excellence go about trying to transform themselves into design-thinking organizations?

**Martin:** Established organizations have to come to grips with the limitations of analytical thinking. As long as they think that better analysis is the primary route to better performance, then they won't be able to embrace design thinking.

This is a real dilemma for highly successful organizations. In their past some leader solved a mystery and built a business by developing a heuristic or algorithm. Over time managers

forget how that all happened and think that current success is based on their analytical prowess. So when problems surface, they strive for higher and higher levels of reliability while competitors pursue greater validity by returning to the mystery stage in the search for exciting new value propositions.

#### A (cautionary) tale of two markets

**S&L:** In your new book, *Fixing the Game* (Harvard Business Press) you argue that the current danger to American capitalism “stems directly from the way that we have linked the real world to the expectations world” in ways that have led to quite insidious and corrosive consequences. How does this work in practice?

**Martin:** In the world of business there are two interlinked but quite distinct markets. One is the real market in which companies build real operations that provide real products or services to real customers who pay real money such that the company earns a real profit (or loss). Associated with this market is an expectations market in which investors interpret this real market and determine what price they are willing to pay for the stock of that company.

Prior to approximately 1976, the ties between the real market and the expectations market were quite tenuous. There was almost no stock-based compensation, companies didn’t give “earnings guidance” and CEOs focused their time mainly on performing in the real market and letting the expectations market take care of itself. But in 1976, that all changed with the publication of an exceedingly influential article by Michael Jensen and William Meckling entitled *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* (*Journal of Financial Economics*, 3, 1976). They argued that the interests of executives and shareholders were poorly aligned and needed to be tightly aligned through the mechanism of stock-based compensation – that way if the shareholders did well, so would executives, and vice-versa.

This approach tied together the two markets and encouraged executives to focus more and more of their attention on the expectations market. This has encouraged gamesmanship, practices not in the interests of the customer, market volatility, huge bubbles and devastating crashes as executives attempt to hype expectations, because that is what they are paid directly to do, even though they know that expectations will fall precipitously when investors learn the real market cannot produce what the expectations market is counting on.

The players in the expectations game – executives, equity analysts and hedge funds – are getting more and more expert at manipulating it in ways that are undermining the real game. I believe that if we don’t establish more separation between the expectations game and the real game, we are going to continue to experience bubbles and busts and great damage to our economic prosperity.

**S&L:** Your book’s subtitle intriguingly refers to “what capitalism can learn from the NFL.” How did the US National Football league learn to deal effectively with its own “two markets” challenge and how does this apply to the current model of capitalism?

**Martin:** In the NFL there is a real and expectations structure not unlike in business. But the NFL handles the interplay between the two in the polar opposite way. Associated with the real game is an expectations game – betting on NFL football – in which betters imagine what will happen on the field and bet on the basis of those expectations.

In the NFL, if any person involved in any aspect of the real game – whether player, coach or general manager – is discovered to be betting in the expectations game, he will be banned from the real game for life on the first offense. So while in business, those most important to the real game – executives and board members – are forced to play extensively in the expectations game, in football, they are banned from the expectations game.

Why? It is because the NFL does not want the expectations game to poison the real game. In business, the expectations market is in the process of poisoning the real market. Before it is too late, business should learn from the NFL and delink the real and expectations markets by getting rid of stock-based compensation for executives (and reform board governance and fix pension fund regulation).

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