Why has there been a dramatic turning away from product diversification as a strategy by the world’s industrial companies? A move begun during the 1980s away from conglomeration was followed during the 1990s by a broad reduction in diversification, even of “related” diversification, by the majority of the world’s large manufacturing companies.

Table 1 on the next page summarizes this evolution—indeed, revolution—in corporate strategy. It shows that the number of diversified firms (those with 20 percent or more of their sales outside their main industry) among the top 12 US, European, Japanese, and other companies in the major sectors of world industry dropped by half between 1980 and 2000, with most of that drop occurring in the 1990s. (The top 12 in each industry were ranked by dollar sales revenues worldwide.) In contrary motion, the number of focused firms (those with 95 percent or more of their business within their main industry) rose sharply to constitute more than two-thirds of the world’s top 201 firms by the beginning of this century.

Focusing specifically on conglomerate firms and their fate, Table 2 shows that conglomerates have all but disappeared from the population of the world’s leading corporations, accounting for only 5 percent of the total. It also shows that conglomerates, even in their 1980s heyday, were never a large proportion of the world’s leading industrial enterprises, accounting for some 19 percent of the total. The table provides two measures of this history. The first is a count of “true” conglomerates in our corporate universe, meaning firms with multiple, unrelated product

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Conglomerates and highly diversified firms in the corporate universe, 1980–2000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1980</td>
</tr>
<tr>
<td>Conglomerates</td>
<td>34</td>
</tr>
<tr>
<td>Highly diversified</td>
<td>30</td>
</tr>
<tr>
<td>TOTAL</td>
<td>177</td>
</tr>
</tbody>
</table>

The 1990s saw the world’s industrial companies turn away in droves from the strategy of product diversification. The causes for such change include a recognition of the poor performance of highly diversified firms, a trend toward decision frameworks based on market allocation of resources among disparate activities, and the rise of institutional shareholders that demand performance and clarity. These developments will continue to raise the intensity of global industrial competition, requiring managers to cope by thinking more about multinational than multiproduct expansion. Will the few remaining conglomerates and highly diversified corporate holdouts remain strategically viable? And what will happen to firms that persist in diversifying outside their core industries in spite of all the evidence?

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(lawrence.franko@umb.edu)
Table 1
The de-diversification of the world’s largest industrial enterprises (number of companies among world’s Top 12 in industry)

<table>
<thead>
<tr>
<th>Industry</th>
<th>DIVERSIFIED*</th>
<th>FOCUSED†</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Horizons</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Aerospace &amp; defense</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Europe</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Canada</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td><strong>Autos &amp; trucks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Japan</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Europe</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td><strong>Building materials</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Europe</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Chemicals</strong></td>
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<td></td>
</tr>
<tr>
<td>USA</td>
<td>1</td>
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</tr>
<tr>
<td>Japan</td>
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<td>1</td>
</tr>
<tr>
<td>Europe</td>
<td>8</td>
<td>6</td>
</tr>
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<td>TOTAL</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td><strong>Computers &amp; office equipment</strong></td>
<td></td>
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</tr>
<tr>
<td>USA</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Japan</td>
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<tr>
<td>Europe</td>
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<tr>
<td>TOTAL</td>
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<td><strong>Computer software</strong></td>
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<td>Europe</td>
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<td>Korea</td>
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<td>TOTAL</td>
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<tr>
<td><strong>Food, beverages, &amp; tobacco</strong></td>
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<td><strong>Iron &amp; steel</strong></td>
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<td>0</td>
</tr>
<tr>
<td>Europe</td>
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<td>Japan</td>
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<tr>
<td>TOTAL</td>
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<tr>
<td><strong>Non-ferrous metals</strong></td>
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<tr>
<td>Japan</td>
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<td><strong>Pharmaceuticals</strong></td>
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<td>TOTAL</td>
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<td><strong>Textiles &amp; apparel</strong></td>
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<td>Japan</td>
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<td><strong>Tires</strong> (n =9)</td>
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</tr>
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<td>4</td>
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<td>TOTAL</td>
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<tr>
<td><strong>15 sector total</strong></td>
<td>71</td>
<td>60</td>
</tr>
<tr>
<td><strong>17 sector total</strong></td>
<td>64</td>
<td>36</td>
</tr>
</tbody>
</table>

*20% or more of sales outside main industry  †95% or more of sales within main industry

Note: Blank cells indicate no companies headquartered in the country or region ranked among the top 12 in the industry in the year shown.

Sources: Wright Investors Service (www.corporateinformation.com); Japan Company Handbook, various issues; Value Line Investment Survey, various issues; CIFAR 1993; Stopford 1982, 1992; corporate reports and websites.
lines. However, because judgments of the “relatedness” of product lines can be subjective, a second measure is also provided: the number of highly diversified firms in the total, or companies defined as having more than 40 percent of their sales outside their main industry. This second measure suggests that the turn away from extreme diversification, conglomerate or otherwise, started in the 1980s.

The move to focus

In 1980, focused firms did not even constitute the majority of companies in 12 of the 15 industries for which data were available. In 1990, the situation was little different, with focused firms comprising the majority in only three out of 17 industries surveyed. As of 2000, however, half or more of the firms in no fewer than 16 of 17 sectors were focused on their main industry, and three sectors—pharmaceuticals, paper and forest products, and computer software—had their top 12 lists populated only by focused firms.

This rise to dominance of focused firms was particularly pronounced in the pharmaceuticals, chemicals, paper and forest products, and textiles and apparel industries. In pharmaceuticals and paper, the move was primarily the result of restructuring and divestitures by corporations long prominent in the industry. In chemicals, firms spun off pharmaceuticals and energy activities. In the textiles and apparel industry, however, conglomerates and diversified firms, some based in developing countries, were eclipsed and supplanted by focused, largely American “category killers.”

American firms led the way

The decline in the population of diversified firms began to drop first in the United States during the 1980s, as seen in Table 3. The number of US firms in the universe having more than 20 percent of their activity outside their main industry declined by half between 1980 and 1990, especially among those in aerospace, computers and office equipment, electrical and electronics, food and beverages, pharmaceuticals, and tires. This drop was primarily due to the acquisition and/or carve-up of diversified firms such as ITT, RCA, Sperry, CDC, Greyhound, Goodrich, and Uniroyal and their consequent disappearance from, and replacement on, the list of each industry’s top 12. (The top 9 constituted the universe in the case of tires, a highly concentrated industry for which only nine companies could be consistently surveyed over the years.)

Similarly, the number of focused US firms increased from less than half to more than two-thirds of all US firms among the world’s leaders between 1980 and 1990 (see both Table 3 and Figure 1), while the numbers and proportions of European and Japanese focused firms rose much more modestly during that decade.

Although there was some decline in the numbers and proportions of European diversifiers during the 1980s—again, largely due to acquisitions and carve-ups—neither a significant focus-oriented restructuring nor a major replacement by focused companies occurred during that decade. As for the Japanese, the 1980s were the period in which they were rising to prominence—indeed, doubling in number on the list of the world’s top firms—but diversified and focused firms rose in about equal number.

A handful of Australian, Canadian, and emerging market diversifiers and conglomerates also came onto the 1990 list, but their time of prominence faded as they too ended up acquired, carved up, or with slower growth than other firms in their industries and thus were replaced among the top 12 during the subsequent decade.

---

Table 3

Diversified and focused firms among world’s largest industrial enterprises by country of headquarters: 1980, 1990, and 2000

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>29</td>
<td>15</td>
<td>8</td>
<td>39</td>
<td>51</td>
<td>67</td>
</tr>
<tr>
<td>Europe</td>
<td>34</td>
<td>26</td>
<td>12</td>
<td>24</td>
<td>30</td>
<td>44</td>
</tr>
<tr>
<td>Japan</td>
<td>5</td>
<td>14</td>
<td>13</td>
<td>6</td>
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<td>Other</td>
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<td>7</td>
<td>1</td>
<td>3</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>TOTAL</td>
<td>71</td>
<td>62</td>
<td>34</td>
<td>72</td>
<td>99</td>
<td>142</td>
</tr>
</tbody>
</table>

Percentage of companies of indicated nationality among top 12 in each industry

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>USA</td>
<td>36%</td>
<td>20%</td>
<td>10%</td>
<td>46%</td>
<td>68%</td>
<td>84%</td>
</tr>
<tr>
<td>Europe</td>
<td>52%</td>
<td>35%</td>
<td>18%</td>
<td>36%</td>
<td>41%</td>
<td>67%</td>
</tr>
<tr>
<td>Japan</td>
<td>26%</td>
<td>38%</td>
<td>30%</td>
<td>32%</td>
<td>35%</td>
<td>48%</td>
</tr>
<tr>
<td>Other</td>
<td>38%</td>
<td>47%</td>
<td>9%</td>
<td>38%</td>
<td>33%</td>
<td>91%</td>
</tr>
<tr>
<td>ALL FIRMS</td>
<td>40%</td>
<td>31%</td>
<td>17%</td>
<td>41%</td>
<td>49%</td>
<td>71%</td>
</tr>
</tbody>
</table>

Number of companies in universe (15 industries in 1980; 17 in 1990 and 2000)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>USA</td>
<td>84</td>
<td>75</td>
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<tr>
<td>Europe</td>
<td>66</td>
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<tr>
<td>Japan</td>
<td>19</td>
<td>37</td>
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<tr>
<td>Other</td>
<td>8</td>
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<td>11</td>
</tr>
<tr>
<td>TOTAL</td>
<td>177</td>
<td>201</td>
<td>201</td>
</tr>
</tbody>
</table>

Source: Derived from Table 1 and World Market Share database.
In spite of the moribund Japanese economy of the 1990s, Japan’s global company leaders in electronics and automobiles (Canon, Fujitsu, Ricoh, Toyota, and Honda) all gained world market share at the expense of their Western competitors during the decade. All were either focused or had diversified into businesses with a very close relationship to the company “core,” even if some of those businesses were in different industries. An example is Canon combining copiers and printers with optics. Focusing helped them achieve this feat, combined with innovation and multinationalization—the same ingredients that propelled successful global American and European firms. The Japanese had the added challenge of “managing around a black hole” of dismal home market demand, but they succeeded by orienting their product development and marketing increasingly to China, other Asian growth markets, and high-growth North America.

Japanese firms based in such sunset industries as iron & steel and textiles & apparel, however, were and are exceptions to the general worldwide trend—the numbers and proportions of diversified firms in these sectors increased over time. Domestic diversification rather than multinational expansion was the main path chosen by Kobe and NKK from their base in steel, and by Toray and Teijin from textiles & apparel. These firms remained largely domestic and had much lower proportions of foreign sales than did the great Japanese multinational successes. In contrast to America’s Nike and Levi Strauss, whose success in textiles & apparel corresponded to a philosophy of “Find and rejuvenate a niche, and dominate it worldwide,” Japanese firms in mature sectors seemed to be saying that there was no hope in their core, so they should “do something else.”

Focus and performance

Why has this watershed in corporate strategy occurred, and why did it occur primarily in the 1990s? The most tangible factor driving the turn away from diversification was its underperformance as a strategy. With rare exceptions, highly diversified firms have performed more poorly than focused ones, whether measured by accounting returns, total returns to shareholders, ability to reduce risk, gains or losses in world market share, or company survival rates. Despite the publicity, the success of General Electric, United Technologies, and a handful of other conglomerates and “high diversifiers” around the world has not been the norm. More typical has been the fate of such US companies as ITT, RCA, CDC, Uniroyal, and W.R. Grace and the European firms Hanson, BTR, and the like. There is more than a little justification for the coinage of the term “di-worsification” by Peter Lynch (Lynch and Rothchild 1989) of Fidelity’s Magellan Fund fame.

The 1990s: Focus dominates and comes to Europe

During the ’90s, focused companies came even more to dominate the population of US firms among the industry leaders. Eighty-four percent of the 80 US companies among the 201 world leaders in 2000 were focused, up from 68 percent among 1990’s world leaders. What was most striking, however, was the sharp change among European firms, most of which happened during the latter half of the decade. Focused European firms reached two-thirds—the proportion that the US had reached a decade earlier. European chemical firms spun off pharmaceutical activities. Pharmaceutical and food companies divested chemical businesses. Firms such as Germany’s Degussa, which had sprawled across chemicals, non-ferrous metals, and healthcare, reinvented themselves as focused specialty chemical companies. British Aerospace stopped seeking nonexistent synergies between aerospace and autos. And conglomerate dominoes like Britain’s Hanson and BTR fell by dismemberment and acquisition.

A Japanese exception?

Japanese firms are a more complicated case. In the aggregate, Table 3 shows little move toward de-diversification and only a modest one toward focus. A closer inspection of Table 1, however, shows a remarkable bifurcation of Japanese corporate structure between “sunrise” sectors of global success and “sunset” industries under competitive threat.
During the 1980s, evidence accumulated indicating that diversification strategies, especially those of the conglomerate variety, were less successful than strategies based on focus. Montgomery (1994) summed up more than a decade of research on corporate diversification in the US, noting that companies “pursuing strategies of ‘related constrained diversification’—that is, diversification built around a core organizational capability—were, on average, more profitable than single line businesses or highly diversified firms,” but that “profitability decreased as diversification increased.” She noted further, “Narrowly diversified firms, presumably built around more specialized assets, earn higher levels of profit than do widely diversified firms.”

Other studies found that not only did focused firms generate higher accounting profit and other measures of economic return than high diversifiers (controlling for industry effects on profitability), but much of the diversification did not even succeed in terms of a key rationale: that of reducing risk. Managers have often justified unrelated diversification strategies by asserting the desirability of reducing earnings volatility by means of packaging counter-cyclical businesses under one corporate administrative roof. Now the evidence suggests that such hopes typically did not materialize.

This result is not surprising when we examine the typical paths of diversification sector by sector. Aerospace companies that acquired auto parts and other businesses in the area of transportation equipment, or auto and tire companies that acquired aerospace businesses, were not combining activities whose returns were independent of, or highly correlated with, each other. Returns often varied with the same economic or interest rate cycles. Similarly, oil companies that briefly styled themselves “energy companies” and moved into uranium and coal mining in the 1980s found not only that they lacked the managerial resources or aptitudes to produce adequate economic returns but that the returns themselves correlated closely with movements in oil prices.

As a consequence of underperformance, diversifiers’ share prices often dropped to sell at a “conglomerate discount.” Companies became acquisition candidates as they came to be worth, in Wall Street parlance, “more dead than alive.” Thus, during the 1980s, diversified firms were more than three times as likely as focused companies to disappear from the top 12 in their industry as a result of whole or partial acquisition, and twice as likely during the ’90s. Nineteen (27 percent) of the 71 diversified firms of 1980 had exited the top 12 by 1990 because they had been acquired or carved up after some degree or another of corporate failure. In contrast, only six (8 percent) of the 72 focused firms lost their identity by being acquired during the 1980s. In the 1990s, 12 (19 percent) of the 64 diversified firms on the 1990 leaders list lost their identities by acquisition or carve-up, versus only eight (or 8 percent) of the 99 focused firms on that list.

The superiority of focused strategies continued to be manifest during the 1990s, as evidenced by companies’ gains and losses in world market shares. Franko (2002a) documents the resurgence of American firms’ world market shares during that decade. In the sectors where US company gains were most evident—electrical and electronics, pharmaceuticals, and textiles and apparel—the advance was clearly led by focused or refocusing firms. In electrical and electronics, the major gainers of world market share were Motorola and Lucent, both focused firms, while major losers included such European firms as the conglomerate Electrolux and the widely spread ABB, Alcatel CGE, and Philips. In pharmaceuticals, Merck and Pfizer gained share dramatically, while diversified American Home Products lost share (eventually de-diversifying and becoming a pure pharmaceutical firm, renamed Wyeth); Sweden’s conglomerate Procordia was dismembered and its pharmaceutical activities mutated into what is now US-headquartered Pharmacia. In textiles and apparel, focused Nike, VF, and Jones Apparel advanced against European, Japanese, and other diversifiers and conglomerates.

The five new US companies that arrived among the world’s top 12 in computers during the 1990s—Compaq, Dell, Sun, Gateway and EMC—and that collectively raised US firms’ world market share in that sector despite the demise of DEC and the fall of Unisys and NCR were all highly focused. So were all the firms in the newest sector of American global dominance, computer software. The Japanese firms that, even in the face of recession in their home market, gained world market share during the 1990s were similarly focused on activities in their main industry.

**Diversification and the growth of the firm**

Experience with and research on the underperformance of highly diversified firms has resulted in a dramatic shift in management thinking about diversification. Product diversification was long considered the normal, almost inevitable consequence of the growth and development of large, successful companies. Growth led to the accumulation of resources and capabilities, which often led to new opportunities in new product markets. The unchallenged assumption was that those newly accumulated resources and capabilities would be more profitable being allocated by the “visible hand” of management than being sold or traded in the marketplace. Indeed, diversification was celebrated well into the 1980s not only as a description of one of the eventual stages of corporate growth but also as a normative proposition. Goold and Luchs (1993) provide a history of manage-
ment thinking about diversification from the 1950s through the early 1990s.

The conglomerate wave of the '60s and early '70s rationalized first as a way to spread the presumably scarce resource of “professional management” across industries, then as a means to reduce corporate risk by building a portfolio of counter-cyclical businesses. Later, in the '70s and '80s, “growth-share” strategy analysis proposed diversification as a necessary means to corporate renewal. Extra-market resource allocation within the firm was the implicit corporate norm in the long-popular Boston Consulting Group conceptual framework for resource allocation among diverse product activities. Businesses were classified as follows: high-market-share, low-growth cash cows; low-growth, low-share dogs; high-growth, high-share stars; and high-growth, low-share question marks. The “free cash flow” from mature activities, or cash cows, was to be allocated to stars or question marks inside a corporate framework in the assumption that managers knew best how to allocate resources among a portfolio of the various types of businesses.

While this “portfolio planning” approach to diversification was seductive in theory, it began to collapse in practice. As Goold and Luchs explain,

Companies discovered that while certain businesses appeared to meet all the economic requirements of the corporate portfolio, they did not fit easily into the corporate family. It turned out to be extremely difficult, for example, for corporate managers with long experience of managing mature businesses in a particular industry sector to manage effectively their acquired growth businesses in new, dynamic, and unfamiliar sectors.

The rise of incentive-based compensation, and especially the use of stock options, made in-company portfolio management yet more unattractive. After all, why should managers of high-growth businesses wish to have their compensation constrained by a stock price whose upside would be constrained by slower-growth activities in mature and declining sectors huddled under the same corporate umbrella?

Combining a high degree of both product diversification and geographical dispersion proved a particularly daunting circle to square. Like their focused brethren, diversified firms were often pulled into multinationality by market opportunities, or pushed by competitive threats to their foreign markets. The vast majority of the companies in our universe are, and have long been, multinational. The temptation was therefore great to try to be both diversified and multinational. The result was often excessive financial leverage in order to meet demands for both product and geographical expansion, underinvestment in either international expansion or R&D, or both. These factors played a role in the demise of domestically oriented US conglomerates like Uniroyal and RCA.

Some firms succeeded in becoming diversified by both product and geography only to enter into a brave new world of organizational complexity. No longer could they choose between relatively straightforward archetypes such as functional, product, or regional allocations of managerial responsibility. Instead, they were driven into trying to coordinate activities in many products and countries via dual (or more) responsibility and authority-lined matrix, grid, and mixed structures. When these structural solutions to great organizational complexity failed due to their costly multiple reporting lines and the conflicts endemic in managers’ attempts to serve multiple product, nation, and functional masters, salvation was sought in other mechanisms of coordination, such as personnel transfers, cross-national and cross-industry team-building, in-company education programs, and other attempts to change “interpersonal relationships and processes” and “individual attitudes and mentalities,” as Bartlett and Ghoshal (1989) put it.

Few of these attempts at internal “extra-market” solutions to complexity have survived the 1990s. America’s General Electric is so frequently cited as a “successful conglomerate” precisely because it has become the exception to the general rule. The counter-examples are legion. Corning solved its problem of great product/geography complexity by selling and spinning off its consumer products and healthcare service activities in 1998. Volvo’s matrix organization was abandoned and non-vehicle activities were divested some time ago. Swedish-Swiss ABB, once known as Asea Brown Boveri and once an exponent of the productization matrix, has spun off much of its heavy equipment manufacturing activity and simplified its structure. Philips of the Netherlands speaks no more of matrices but of worldwide product divisions and (external) restructuring via a continuing refocus on fewer scale-efficient activities.

Confronted with mounting evidence of the failure of complex diversification and diversification-cum-multinational strategies, strategic management thinkers came to
exhort firms to “stick to their knitting” and focus on their “core competencies.” Still, these injunctions had enough elasticity to allow managers to rationalize the spread of “synergy-based competencies” into diverse industries well into the 1990s.

For their part, finance theorists had already long pointed out that in countries with developed stock markets, shareholders could build portfolios diversified by industry, company, and asset class on their own, without paying for company managements to do it for them. Agency theorists then chimed in, accusing management “agents” of frequently undertaking diversification activities for reasons of self-interested empire-building at the expense of shareholder “principals.” Free cash flow—cash flow net of capital expenditures to sustain core businesses—should not be squandered on corporate empire-building through value-destroying investments in overcapacity, in di-worsification, or on overpriced acquisitions. Rather, it should be returned to shareholders.

Change in the external environment

Still, much as management and finance researchers might like to think that their influence was the primary cause of the great refocusing of the 1990s, other forces were probably much stronger. Why, after all, did the refocusing occur then and not before? Conglomerates and high diversifiers were already recognized to be performing poorly in the 1980s, and organizational complexity had been a problem for diversified (and multinational) firms as far back as the late 1960s. The answer surely lies largely in major changes in the external environment faced by the world’s industrial enterprises: first, the breakdown of the “negotiable environment” of trade protection and the rise of free-trade areas like the EU and NAFTA, culminating in monetary union in Europe; and second, the development of global and institutionally dominated capital markets, or the rise of “fiduciary capitalism.” The first enabled greater specialization of firms competing across borders in world markets; the second forced it.

The opening of world markets

“The division of labour is limited by the extent of the market.” — Adam Smith (The Wealth of Nations, 1776)

With fits and starts, the story of the international business environment from 1970 to 2000 has been a fairly continuous one of the opening of cross-border trade, the creation of regional and world markets, and the arrival of more and more globally oriented competitors. The walls of the “negotiable environment”—a term first used by Van der Haas (1967) to describe the business climate of government-sanctioned trade barriers, currency controls, and tolerated cartels and collusions of the interwar and early post-WW2 years—gradually gave way, then crumbled, at least relative to what they had been. Successive trade rounds led to open markets and a boom in world trade, and the GATT became the WTO. By the early 1990s much of the developing world, up to and including communist China, was convinced that opening up to world markets and trading with them was a much surer route to prosperity than were the old “statist,” closed, or protected economic models. The North American Free Trade Area became a reality in the mid-1990s. The ever-expanding European Community moved from reducing tariff and nontariff barriers to trade during “Europe ’92” and on to monetary union and the euro. Not only is product specialization ever more possible across borders, but a premium is placed on productive efficiency by the fact that the euro facilitates customers’ comparison shopping across borders. With the widening of markets, the number of competitors has multiplied and competition and pressures for efficiency have intensified.

Financial market pressures: The rise of “fiduciary capitalism”

Although corporate managements came under pressure to globalize and focus as a result of the opening of world goods markets, the straw that broke the camel’s back was the change in financial and capital markets. The first tidings became manifest in the 1980s in the United States. Junk-bond financing of corporate raiders led to a boom in the development of the market for corporate control and in the rise of the hostile takeover. The raiders, take-over artists, and leveraged buy-out (LBO) firms were unsentimental about keeping underperforming activities inside firms just because they had always been there, or waiting for internal corporate reorganizations to produce—perhaps, maybe someday—results. Especially in firms subjected to LBOs, the fate of several dismembered conglomerates in our universe, the “sword of debt” forced quick disposals and sales of underperforming assets.

Entrenched managements in many large US firms opposed this threat to their empires, their discretionary powers, and their pocketbooks. They used many means to turn the law into an instrument of corporate incumbent protection. Yet, probably to their great surprise, the Maginot Lines they threw up did not halt capital-market pressures for efficiency and shareholder value. In spite of the roadblocks of poison pills, shark repellants, and raider deterrent laws, the takeovers, carve-ups, and external restructurings continued. To avoid such a fate, somewhat-focused US firms became even more focused. When they did not do the job quickly enough, they were acquired or carved up.

Much of the cause of this continuing pressure on management to become ever more efficiency-oriented was, ironi-
cally, due to the interests of people rarely identified with those of management as a class: teachers, public employees, and oft-unionized workers. They were the beneficiaries of new institutional share-owning fiduciaries with names like CALPERS (California Public Employees Retirement System) and CALSTERS (California State Teachers Retirement System). Their institutions were now the most vigorous advocates of shareholder interests with corporate managers, first in America and then abroad.

The last quarter of the twentieth century has seen the rise of fiduciary capitalism in the United States and a return to concentrated share ownership after a half-century interval of separation of management and shareholders. However, as Stout (2001) says,

This time, share ownership is consolidated not in the hands of wealthy individuals like Henry Ford or Andrew Carnegie, but in the hands of wealthy institutions. In particular, public and private pension funds now hold a sizeable portion of the outstanding equity of the largest US firms. These fiduciary institutions have both the incentive and the ability to throw their weight around in the corporate boardroom that widely dispersed individual investors don't and can't.

Having come to possess fiduciary ownership of almost 60 percent of the 1,000 largest US corporations by 1997, these institutional investors have increasingly used "voice" as well as "exit" in dealing with underperforming companies. They have transformed the principal-agent relationship between shareholders and corporate management.

The pressure of fiduciary capitalism was "born in the USA," then began to spread around the world. Financial markets, especially equity markets, were not globally integrated as recently as the late 1980s. Even many developed countries still had currency and other controls that severely inhibited cross-border stock investments and other financial flows. Not until the late 1980s did US pension and mutual funds begin to do more than dip a toe in the waters of international equity investing. But by the mid-1990s, US institutional investors had a large enough share ownership in non-US firms to begin to exercise the same sort of pressure and influence on managements they had come to place on American firms. And they were not alone. Funded pension plans, the rise of mutual funds now hold a sizeable portion of the outstanding equity of the largest US firms. These fiduciary institutions have both the incentive and the ability to throw their weight around in the corporate boardroom that widely dispersed individual investors don't and can't.

Corporate managements contemplating corporate product diversification strategies are now operating between two scissor blades of globalization. On one side are increasingly competitive international goods markets; on the other are ever more interlinked, ever more institutionalized financial markets. The implication is clear: Discretionary, “outside-the-market” managerial options for allocating resources across industries have been greatly narrowed.

Cross-border competition increasingly limits the amount of time and money managements can burn trying out complex strategies and structures and buttressing them with the information systems, culture-building exercises, management training, and organizational development meetings needed to support them. Institutional investors, when not harassing managers with warnings not to use free cash flow for di-worsifications and value-destroying acquisitions, impose “conglomerate discounts” on the share prices of their firms. These in turn facilitate the takeover and disappearance of firms that resist the dictum that investors can build their own diversified portfolios and do not need high-cost, empire-building managements to diversify for them.

Corporate focus has clearly been a factor in the success of many of the world’s leading corporations during the last two decades of the twentieth century. One implication for managers from that experience is clear: With increasingly rare exceptions, diversification outside one’s home industry, especially conglomerate diversification, doesn’t pay. While GE’s financial and stock market success may still seduce some managers into embarking on or maintaining conglomerate diversification, managers who are ordinary mortals and not Jack Welch may wish to think twice. And a few heretics even wonder whether the house that Jack built will long survive in the form he left it.
It is also not obvious that because some focus is good, more focus is necessarily better. A laser-beam refocusing carries its own risks. Corning, for example, solved a multi-product, multi-nation strategic and structural dilemma by divesting consumer products and healthcare in 1997–98 and focusing on the then super-growth area of optical fiber. It was a great ride while it lasted, and shareholders were indeed able to diversify away firm-specific risk. But the subsequent fall from grace suggests that managers and workers in the firm—even shareholders—can hardly be indifferent to total risk to the firm, including the risk of great financial and human distress.

Will focus be as much of a success factor in the future? A substantial majority of firms have already drawn the conclusion that focus is better. Most have already taken the diversification lead out of their saddlebags. Those who have not are squarely in the line of competitive and financial market fire. But the era of easy, or easier, races for focused firms is changing. Today the majority of firms are "lean and mean," or at least leaner. The result is a ratcheting up of the intensity of global corporate competition.

This is undoubtedly excellent news for customers, for productivity, and for economic growth. Evidence has been around for a while that more focused firms are more productive than diversifiers. And the fact that the United States grew considerably faster than Japan and Europe during the 1990s surely owes something to its having reduced corporate sprawl earlier than its competitors.

But how do managers raise profit and shareholder value in a world where most firms have discarded their di-worsifications? The answer, or part of it, seems implicit in the phrase "global corporate competition." The operative word is "global." Managers can no longer give lip service to internationalizing their operations while in fact allocating resources to proliferating diversifications in familiar domestic markets. If you do not globalize, your newly product-focused competitor will do it for you.

And yet managers still di-worsify…

One can only wonder at the fact that many managers continue to succumb to the siren call of industries other than their own. As recently as 1998, notes Beceren (2003), when the total volume of mergers and acquisitions reached over $1.5 trillion in the United States, more than half of these acquisitions were between firms in different four-digit industries. Tyco, whose explicit goal was to become “another GE,” was one of the most active diversifiers. Enron, before it became a cautionary tale of managerial ethics, was a story of over-ambitious diversification from the humble business of running gas pipelines to trading in energy, coal, steel, paper, pulp, and broadband cable capacity—not to mention power-plant construction in countries where it had no previous experience, say Healy and Palepu (2003).

Companies in Europe not only remain more diversified than their US counterparts, Europe has also continued to spawn new would-be conglomerate empires, such as now troubled (and de-di-worsifying) Vivendi and Invensys. And Japanese steel and textile companies continue to attempt to stave off corporate oblivion by diversifying into theme parks and information technology, usually creating negative shareholder value in the process.

Why do they do it? Governance structures continue to insulate some managers from shareholder interests. Legal inhibitions to markets for corporate control still allow firms to evade capital market discipline. Declining performance in core businesses makes the grass of other industries look ever greener, especially if cash is being generated that companies cannot bear to return to shareholders. Investment bankers, seeking fees for their M&A departments, sell companies on dreams and delusions of grandeur. Sheer managerial hubris takes hold and history-not-learned-from is repeated.

Di-worsification disease is becoming less and less common. But it has not been eradicated. Shareholders and stakeholders should take note, and act accordingly.

References and selected bibliography


