Co-Creating Strategic Risk-Return Management

Companies no longer create value and wealth just by themselves. Customers, suppliers, investors, and others play an active role in the process.

By Mark L. Frigo and Venkat Ramaswamy

CFOs are on the front line in navigating the turbulent waters of today's business environment. The global economic crisis of 2008 and continuing challenges in 2009 have revealed serious limitations and dangers of many of the traditional ways of managing risk. In recent years, there seems to have been too much unbridled focus on "returns" (return on investment) and not enough attention paid to the "risk" underlying that ROI. Some critics argue that because returns on certain strategic initiatives were so great, risks that were present were either unknown or ignored. (For example, see the Jan. 4, 2009, article in *The New York Times* titled "Risk Mis-Management" that was highly critical of the shortcomings of the risk oversight processes at many of the failed financial services institutions.)

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Numerous calls have now arisen for drastic improvements in risk management, particularly for more formal risk considerations in managing an organization's deployment of specific strategic initiatives. The pendulum quickly swung in this direction, focusing management's attention on damage control and a risk-aversion mindset. After seeing massive losses, organizations now face the challenge of balancing risk and limited growth opportunities in the short run, and they need new approaches and tools to strategically manage risk and generate sustainable returns in the future.

We believe that *sustainable wealth creation* requires *balanced risk taking* by focusing on *co-creation opportunities* that can generate *superior returns* while simultaneously reducing risks for companies and their stakeholders. One of the major forces driving the need for a new approach to value creation is the activism in today's business environment. Besides customer and employee activism, increased shareholder/investor activism and government intervention are driving greater expectations for better strategic management of risk and return together. Multi-stakeholder engagement platforms and processes are needed for this.

A New Paradigm

There's a new approach to strategically managing risk-return that is linked to the "Win More—Win More" philosophy of Value Co-Creation through engagement platforms to co-create wealth moving forward. This framework is derived from two powerful streams of research on high-performance companies: Return Driven Strategy, developed by Mark Frigo and Joel Litman (with which readers of *Strategic Finance* are familiar), and Value Co-Creation.

Value Co-Creation is a new paradigm of value creation expounded by Venkat Ramaswamy and Francis Gouillart in their forthcoming 2009 book, *Co-Creating the Future*. As they discuss, co-creative interactions among individuals everywhere in the value-creation system have exploded on an unprecedented scale, thanks to the Internet, the structural forces of ubiquitous connectivity, globalization, and new communications and information modes (everything from blogs to videos, wikis, podcasts, message boards, online forums, chat rooms, text messaging, and a plethora of new "social interaction" technologies). This is most visible in examples such as Digg, Wikipedia, YouTube, Flickr, and Facebook. Perhaps less visible is the silent and emerging shift in co-creative interactions as the very locus of value creation in all spheres of the economy. Providers of products and services are challenged by the fact that their recipients are increasingly informed, connected, empowered, and active and are demanding a deeper engagement in the firm's value-creation processes. All stakeholders at large expect a higher-quality engagement experience.

Value Co-Creation rests on the four key building blocks of Dialogue, Access, Risk-reward understanding, and Transparency (DART) that enable interactions among individuals and with processes to be more co-creative. Through engagement platforms that are DART enabled, organizations can:

- Engage all stakeholders in the co-creation of organizational purpose and decision making, thereby focusing on what stakeholders truly value and going beyond the conventional firm-centric view of product-service strategy;
- Reduce investment risk by leveraging the knowledge and skills of all stakeholders—both individually and as communities; and
- Incorporate a more broad-based experience-centric view of value into their operations.

Figure 1 shows a framework for managing risk-return through Value Co-Creation that is based on:

- Co-creating Return Driven Strategy and risk management with all stakeholders (the top and bottom parts of Figure 1) and, most important,
- Expanding value creation through the paradigm of Value Co-Creation (the central portion of Figure 1).

This framework is designed to achieve the following benefits:

- New experiences of value to co-creators plus
- Lower risk and cost to stakeholders (co-creators) and, simultaneously,
- Increased strategic capital and returns for the company plus
- Lower risk and cost for the company.

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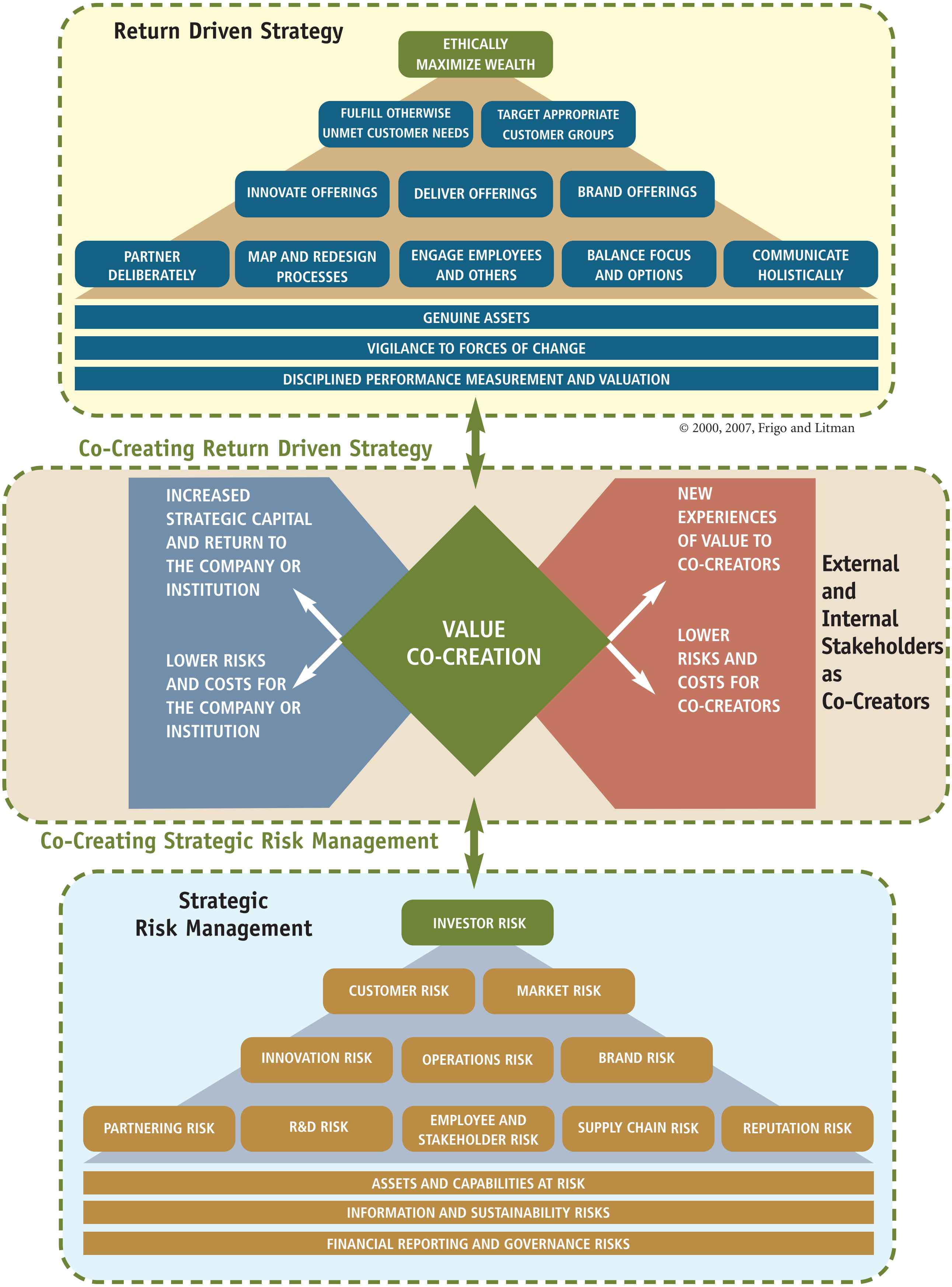
The Return Driven Strategy framework describes the hierarchy of strategic activities of the best-performing companies in terms of financial impact and shareholder value creation. In other words, it provides a pathway that can lead to greater returns and growth. At the same time, the framework is based on the philosophy or premise that the pathway to shareholder wealth creation is through creating value for others (customers, employees, suppliers, and other stakeholders).

Figure 1: A Framework for Strategically Managing Risk-Return through Value Co-Creation



Executive teams have used Return Driven Strategy as a holistic framework to set, evaluate, refine, and execute strategy. It also has been integrated into strategic planning processes and has been used as a way to evaluate the impact of events and scenarios, including merger-and-acquisition scenarios, on a strategy's performance. As directors and management teams have used the framework to evaluate business strategy and strategic initiatives, they have been able to hone in on key risks that could destroy shareholder value while considering the upside of risk in terms of the opportunities, thereby using it as a framework for strategic risk management. Further, applications of the Return Driven Strategy framework for enterprise risk management (ERM) and for risk assessment have been vetted by boards, executive teams, and risk management thought leaders.

All this has led to the formal Strategic Risk Management framework (see Mark Frigo, "When Strategy and ERM Meet," *Strategic Finance*, January 2008), which mirrors and reflects the tenets and foundations of the Return Driven Strategy framework (see Figure 1, bottom framework section).

Management teams and boards can use this framework to systematically assess risk within business strategy and to incorporate strategic risk management into their strategic planning and strategy execution processes. The framework includes a broad spectrum of risk areas that form a hierarchy of interconnected risks that drive investor risk.

Investor risk: At the top of the pyramid is "investor" risk, which provides a high-level overview of risk associated with the different types and roles of investors and is driven by the ability to generate future growth and return on investment as reflected in the plans of a company and the company's capabilities to execute against them. Anything that will impede business success, including the risk of unethical activities, needs to be considered in assessing investor risk using the top tenet of Return Driven Strategy through Co-Creation: *to ethically maximize wealth*.

Customer and market risks are what many companies face now. Customer risk is driven by the ability to fulfill otherwise unmet needs. The more "unmet" needs that are fulfilled, the less the customer risk. The more commoditized the offering, the greater the customer risk. Customer risk is reduced by the enhanced quality of customer communication and customer information. Market risk is driven by the underlying trends of the groups of customers served, including events that could adversely affect the ability of customers to buy the offerings (products, services) of a company.

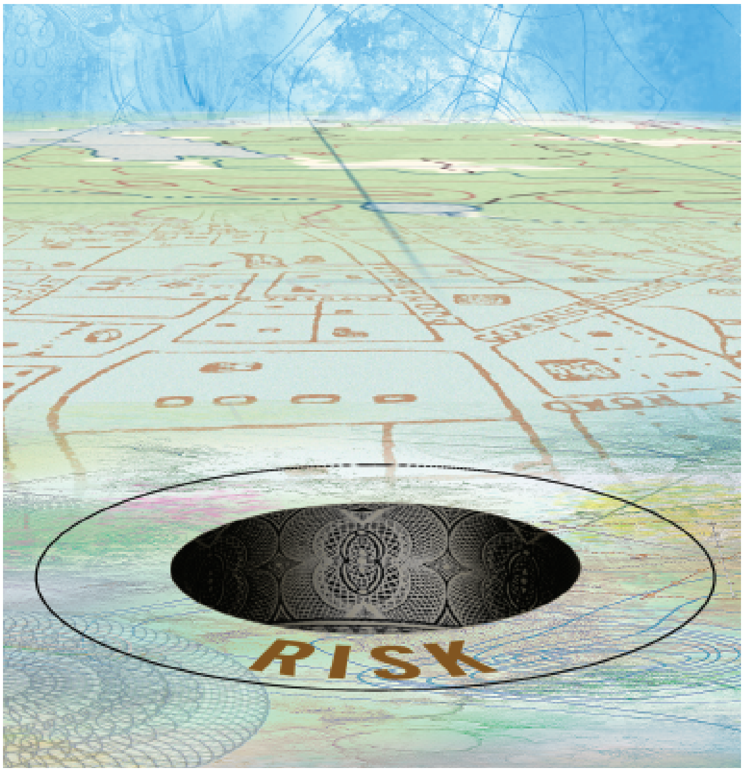
Innovation risk arises from the inability to change or create new offerings or to fulfill unmet needs better than competitors. For instance, Apple continues to roll out new models, sometimes killing successful products to soar to even greater heights, as it has done with various successful models of its iPod line-up. It has also demonstrated how to mitigate innovation risk by linking it to Value Co-Creation. Apple opened up its iPhone platform to anyone—not just traditional software developers—by making its internal Software Development Kit (SDK) available online at no cost and inviting applications to be developed. The App Store achieved an impressive 100 million downloads just two months after its introduction and continued its blistering pace with more than 800 million downloads in eight months, exceeding even the speed with which iTunes took off. This caught the attention of thousands of developers who offer their wares on the iPhone, making it a cauldron of exciting new applications appearing every day and driving a huge buzz around the device. Apple sold 13.7 million iPhones in the first year (exceeding its publicly announced goal of 10 million phones).

Operations risk is driven by anything that would damage the ability of the organization to deliver its offerings to customers.

Brand risk includes the risk of brand erosion and damage to the company's reputation. Starbucks CEO Howard Schultz has begun to engage customers in co-creating the brand experience to reduce brand risk. The Starbucks website MyStarbucksIdea.com invites anyone, especially customers, to submit ideas that are, in turn, voted on by the community. Starbucks management then indicates which ideas they have decided to pursue after reviewing them in light of their strategy development and execution.

Partnering risk arises from the activities of a multitude of partners, from vendors to joint ventures and other alliances. The problem for managers is that there are simply too many moving parts with no set patterns of relationships around which they can easily organize structurally. Co-creation of value cuts across a larger number of global suppliers, partners, customers, and communities than ever before.

Supply chain risk: Companies must learn to manage supply chain risk as Cisco has done. CEO John Chambers recognized that both demand volatility and the newfound customer power had arrived to stay, so Cisco built flexibility into its IT systems and into the entire supply chain,



manufacturing, and logistics infrastructure. One of the main challenges in co-creation is the growing complexity of supply chain and logistical networks. Genentech, a market leader in biotech, has developed an effective approach to supply chain risk management as part of its overall enterprise risk management system by engaging its stakeholders.

Employee engagement risk: Co-creating employee experiences can reduce employee engagement risk and attrition issues, a challenge for many companies with an increasingly global talent base. For instance, Starbucks constantly encourages employees to come up with ideas about products, services, and experiences and participate in enhancing the in-store experience. Its employees are also engaged through MyStarbucksIdea.com in general and through store-specific customer conversations.

R&D risk is driven by the pipeline of options and processes for innovating new offerings and solutions for future growth. As companies engage in outsourcing and collaborative research and development (R&D) relationships to innovate new offerings, the result can be greater efficiency but also increased R&D risk. Co-creation can mitigate this risk.

Reputation risk is driven by how well the company communicates and engages internally and externally with all stakeholders. Co-creating with stakeholders, especially NGOs (nongovernmental organizations) and civic organizations, to "do well by doing good" can mitigate this risk.

Managing risk-return through Value Co-Creation requires strong leadership capabilities that are driven from the top but are also guided by the bottom. The foundational risks of global *assets and capabilities, sustainability and information risks, and the financial, reporting and governance risks* mirror the risks associated with the foundations of co-creating Return Driven Strategy. For instance, there is more risk exposure to assets, such as when companies engage in open innovation and mass collaboration as in the case of Apple and its iPhone. But building innovation co-creation capabilities can help organizations mitigate these foundational risks and reap the disproportionately higher benefits of co-creation as Apple has shown with the fast growth of the iPhone.

Similarly, sustainability and information risks can be mitigated through co-creative decision-making systems and designing an effective enterprise IT architecture. (For more details, see the chapter "Co-Creating Innovation and Enterprise Architecture" in *Co-Creating the Future*). Further, co-creation can help companies better manage the internal risk function "pillars" of governance, risk, and compliance (GRC) in terms of achieving better risk mitigation and lower cost. (See Mark Frigo and Richard Anderson, "A Strategic Framework for Governance, Risk, and Compliance," *Strategic Finance*, February 2009). Co-creating strategic risk management means co-creating across the legal, internal audit, compliance, safety, finance, and even IT functions by building engagement platforms for identifying and leveraging shared risk identification, assessment, monitoring, and control. The key is to (re)design processes through the co-creative interactions of the various functions. Information risk is based on the fundamental idea that lack of information can create more risk and that risk is often a very expensive substitute for information. Co-creating strategic risk management can reduce information risk.

Redefining the "investor": The traditional risk-return investment theory makes a clear division between investors and other stakeholders. But Value Co-Creation recognizes that these roles are morphing. For instance, following the example of Harley-Davidson (see "How Harley-Davidson Co-Creates Success," p.), are consumer communities that facilitate the spread of a brand investing in the firm and its success? What about suppliers who share their accumulated knowledge with the firm? The world needs an expanded definition of an investor. Defining an investor solely as someone who provides financial capital underestimates the complex mosaic of roles in Value Co-Creation.

All co-creators of value will increasingly demand to

How Harley-Davidson Co-Creates Success

In studying high-performance companies, we've found a handful of companies that have *instinctively engaged in Value Co-Creation in the past* while demonstrating adherence to the tenets of Return Driven Strategy. One of them is Harley-Davidson, which has "kept on cruisin'" through the years by co-creating brand experiences with its customers, thereby engaging them as a community. Harley achieved superior performance in terms of ROI, growth, and shareholder returns over a 20-year period beginning in 1986. During this time, the company created wealth ethically by co-creating value.

The Goal Tenets: Since the mid-1980s, Harley-Davidson has focused on serving *otherwise unmet needs* (i.e., lifestyle, freedom, adventure, community, and a whole new culture) while pursuing a growing customer group (the Baby Boomer generation).

The Competency Tenets: The company's innovation, delivery, and branding of its offerings were all centered on a unique Harley experience. As Harley rider Jose Escalante put it, "When I get on the bike, all of a sudden I'm thinking about the road and nothing else. It shifts you from one life to another." And Harley's brand has shifted from a youthful countercultural persona to middle-aged nostalgia.

The Supporting Tenets: The company enabled owners to co-create their unique experience with other Harley fans by involving them as a community, in addition to personalized parts and paraphernalia. Harley owners are notorious for trying to express their own personalities. Owning a Harley is both a personal and social statement. Connoisseurs spend as much time cleaning and admiring their bikes as riding them.

In 1983, Harley formed the Harley Owners Group (HOG) to encourage owners to become more actively involved in the sport of motorcycling and the Harley experience. More than one million Harley owners now belong to HOG, and they regularly turn up to compare their bikes at rallies and shows. (In contrast, Honda's Gold Wing Road Riders Association is less than a tenth the size of HOG, which is more than an "association"—it's an engaged community.) About half the company's sales are to new customers, and the other half are to committed and loyal Harley riders. While many companies wish they had such an engaged customer base, interaction technologies today are facilitating many individuals to indeed engage their customers in Harley-like fashion.

Engaged Customers and Employees: As former Harley CEO James Ziemer (he retired at the end of April) said, "You're not going to change the bike you ride when you've got its name tattooed on your shoulder." Even more amazing, some of the salespeople and Harley executives have those tattoos, just like their customers. Through its unique organizational design, Harley has engaged its own employees as much as it has its biker community over the years. The center of gravity of the Return Driven Strategy pyramid is the supporting tenet of *employee and stakeholder engagement*. In Harley's model, the company communicates holistically because its own employees are involved in the process. This is in contrast to the typical disconnects between the brand promise, the customer experience, and the employee experience of many companies.

Employee conversations and discussions among Harley owners create shared contextual meaning, a basis for dialogue that generates unique experiences for individuals. Harley's employees and managers have immersed themselves with the Harley customer community. For example, Harley's salespeople are so mentally intertwined with their customers that it can be difficult to tell them apart. Not surprisingly, Harley co-creates insights through its salespeople and managers on a daily basis. For instance, the salespeople's customer discussions are part of the strategy development and execution process. Harley is able to map and design its sales processes through the lens of experience-based interactions. Its salespeople can literally feel the customer's pain points and aspirations. At Harley-Davidson, the customer and company converge.

Engaged Partners: This convergence extends up Harley's business network. Its capacity for co-creation reaches all the way through its tightly knit $1 billion-plus supply chain with more than 300 suppliers. Key suppliers have access not only to Harley's facilities but also to its internal management system, dubbed "Ride." They have access to minutes of meetings, plans, schedules, and other internal processes, facilitating dialogue with Harley managers and employees in product design and manufacturing. In the spirit of openness and full disclosure, there's a detailed contract among key suppliers that spells out expectations and obligations on both sides of the company-supplier dialogue. For instance, when developing the electronic fuel-injected (EFI) engine for the V-ROD bike, Harley engineers and managers had to collaborate with key supplier Delphi Automotive and with European firms, including Porsche and Magneti Marelli. Later, when Delphi's initial attempts to adapt an automotive-based system to a motorcycle failed, the team had to redesign the system from the ground up, which meant trusting the development of a critical component to an outsider.

Balance Focus and Options: Through co-creation, Harley attempts to *balance focus and flexibility*. The development of the EFI engine for the Harley V-ROD certainly called for experimentation. Engineers inside and outside the firm had real-time access to plans, files, pictures, and audio and video clips, as well as the ability to create new knowledge continuously. But the co-experimentation process and the positive experiences it generated produced a new level of trust that in turn catalyzed new efficiencies in product development. The dialogue increased dramatically as the development of the project unfolded. Moreover, Harley also has an underlying process of engaging customers in co-creating the product and engaging the community at large if there are significant changes to its brand. A case in point is getting the approval of the community when Harley sought to partner with Ford on its Special Edition Harley F-150 truck. Harley owners were involved in this strategic decision.

Partner Deliberately: In short, Harley acts as a nodal company, *partnering deliberately with both suppliers and customers in end-to-end fashion*, letting insights flow from the community all the way up the supply chain and back.

The Road Ahead

Between the 1980s and early 2000s, the company commanded as much as a 30% price premium on its motorcycles while generating a phenomenal 20-year run of superior return on investment, with continued growth and a total shareholder return as much as 25 times the S&P 500 index.

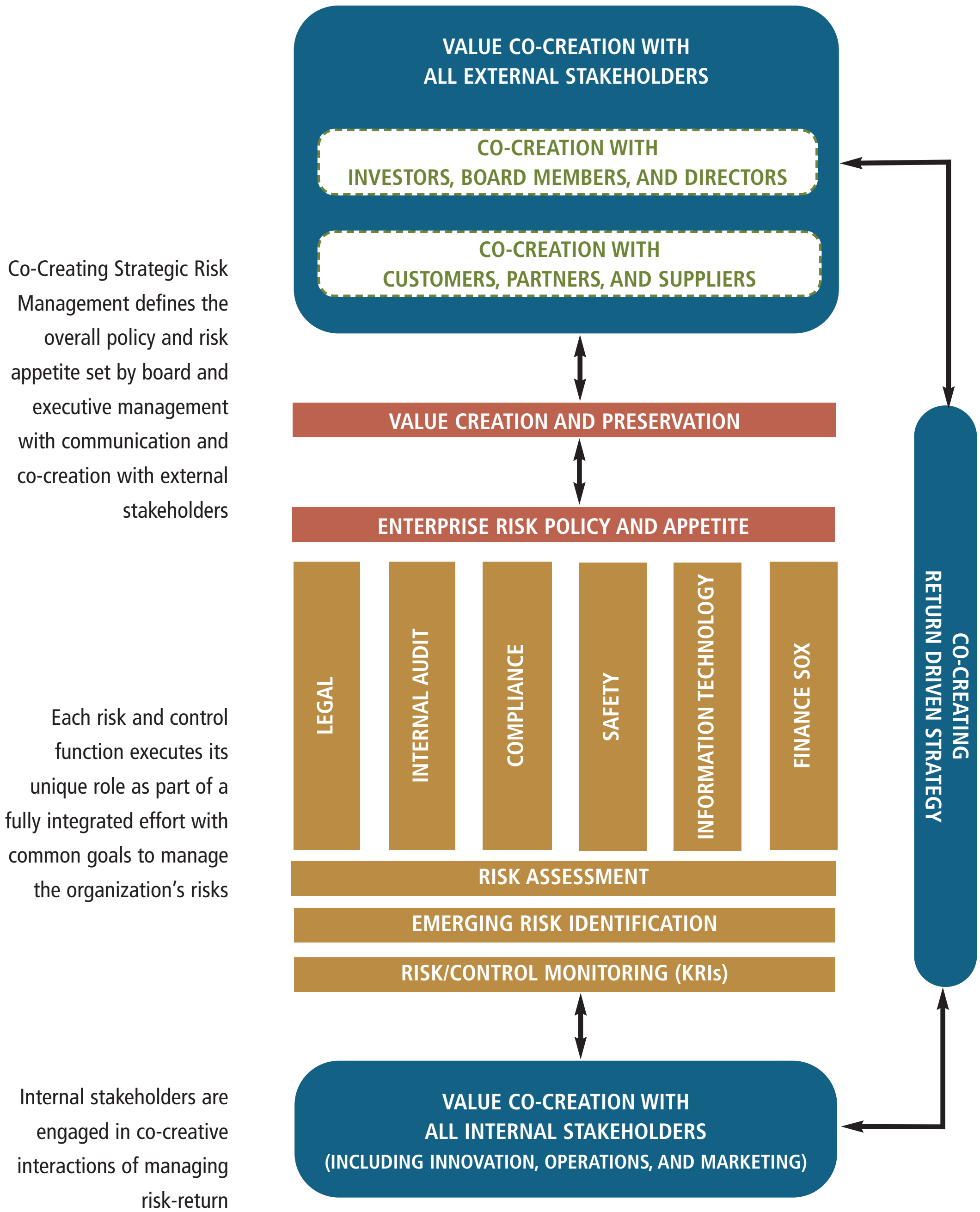
The median age of a Harley buyer has shot up from 45 to 48 in the last five years, so Harley faces the challenge of a somewhat saturated segment of Baby Boomers in the U.S. as it also pursues rising foreign sales. James Ziemer saw no reason to battle the youth-conscious imports head on, saying that "The type of customer who chases the latest race-winning, forward-pitched sport bike is hardly brand-loyal." Genevieve Schmitt, founding editor of the e-zine WomenRidersNow.com, notes: "[Harley has] responded to the needs of smaller, less muscular riders by offering motorcycles with lower motors. They realize women are an up-and-coming segment and that they need to accommodate them. They don't market to a specific gender, but are gender-neutral. They market a lifestyle, with daughters and moms, dads and sons."

Naturally, the current economic crisis hasn't been kind to Harley. But amid all the troubling economic news and challenges, the company's one millionth motorcycle (a Harley Sportster®) rolled off its Kansas City plant on Jan. 13, 2009, after more than 11 years in production. Only time will tell if Harley can continue to grow its business and maintain superior returns. We believe that if Harley can continue to leverage its Return Driven Strategy to co-create value in new ways, while judiciously managing its business risk through co-creation, it can continue to keep its motor, and the Harley lifestyle, running strong.

know more about the inner workings of companies because of the Internet and the associated structural shifts in society. Today, few industries and firms volunteer to disclose risks and debate them with value co-creators. Yet co-creators are increasingly assigning a greater responsibility to managers to make transparent and discuss with them the company's risk elements, including personal risk and societal risk. Co-creators must trust the firms with which they engage in co-creation. Shouldn't investors be informed about risks in jargon-free language? Should firms go so far as to adopt a "co-creator bill of rights"? After all, employees, corporate activists, ratings agencies, regulators, and other "investors" have already raised their expectations for organizations around how risk is managed following the dramatic failures in risk management in financial services and other industries and subsequent government intervention.

"No silos": Using the Strategic Risk Management framework with co-creation can lead to better risk management. Most traditional risk management is performed by internal silos (such as finance, internal audit, legal, HR, IT, and operations) working in parallel but with little or no engagement. This is a major barrier and problem in risk management and is the antithesis of a co-creative organization and co-creative management systems. One of the main challenges is breaking down the silos and avoiding creating new ones. This is where co-creation can provide the *pathway*.

Figure 2: A Framework for Co-Creating Strategic Risk Management



We believe that, ultimately, ERM processes must be co-created within the overall policy and risk appetite of the enterprise. Engaging in co-creation across the governance, risk, and compliance functions will enable the various entities to participate without any hidden (re)organization agendas and build *internal* trust, a precondition for becoming a co-creative organization. This reflects the concept of co-creating risk management with internal and external stakeholders, including investors, boards, directors, and other stakeholders.

Figure 2 shows a framework for co-creating strategic risk management (which is adapted from the Frigo and Anderson article in the February 2009 issue) that engages internal and external stakeholders.

The key point of Figure 2 is this: *Value Co-Creation with both external and internal stakeholders helps balance risk-return by mitigating different types of risks while enhancing return* through an expanded engagement model that cuts across silos through engagement platforms that facilitate more co-creative interactions.

Co-creating Return Driven Strategy and Strategic Risk Management are two sides of the same coin (pyramid). They are about taking a *balanced* approach to risk-return management by engaging in Value Co-Creation with customers, employees, and other key stakeholders in one or more of the Return Driven Strategy tenets, which reflect strategic choices made by the company to maximize wealth ethically through co-creation. The Return Driven Strategy framework provides a guide or road map about where to create value, and co-creation provides the process.

Strategically Managing Risk-Return through Value Co-Creation

Every organization has a great opportunity to co-create wealth using the approach and frameworks we've described. As we mentioned earlier, CFOs are in a position to lead this effort and to achieve greater returns and growth while reducing risk and cost. The "return on co-creation," with its focus on balancing risk and rewards, can help organizations rebound from the current economic environment. To achieve sustainable high performance, companies will have to co-create wealth by consistently executing the strategic activities in the Return Driven Strategy framework while concomitantly co-creating value through engagement platforms. This will require collaborative organizational capabilities and building co-creative management systems. Transformational change for any company must begin with confronting the root causes of failure to protect and create shareholder value. We believe the approach described in this article provides a valuable guide for organizations to co-create risk-return management and thereby co-create wealth.

To get started, here are some questions to consider:

◆ With whom do you want to co-create value? While the key to creating value and wealth is through co-creation (collaboration) with customers, employees, partners, suppliers, investors, and other stakeholders, it's important to identify the locus of co-creation opportunities.

◆ Where do you want (need) to co-create value? Co-creating Return Driven Strategy can be used to assess where an organization is performing well and where it needs to improve. Value Co-Creation can then help in identifying the new opportunities for co-creating mutual value and how to migrate the organization through co-creation with internal and external stakeholders.

◆ Where do you need to co-create risk management? The Strategic Risk Management framework can be used to assess and manage risk and to identify the engagement platforms to strategically manage risk-return through co-creation. **SF**

FURTHER READING

In addition to the publications mentioned in the article, here's a short list of additional material about Value Co-Creation and Return Driven Strategy.

For a further discussion of the convergence of the Value Co-Creation paradigm and management of risk-return that forms the basis of the new Wealth Co-Creation framework, see the forthcoming 2009 book by Mark L. Frigo and Venkat Ramaswamy titled *Co-Creating Strategic Risk-Return Management*.

Also see:

Mark L. Frigo and Richard J. Anderson, *Strategic Risk Management: A Primer for Directors and Management*, forthcoming 2009.

Mark L. Frigo, "Return Driven: Lessons from High-Performance Companies" *Strategic Finance*, July 2008.

Mark Beasley and Mark L. Frigo, "Strategic Risk Management: Creating and Protecting Value" *Strategic Finance*, May 2007.

Mark L. Frigo, "Strategic Risk Management: The New Core Competency" *Balanced Scorecard Report*, Harvard Business Publishing, January-February 2009.

Venkat Ramaswamy, "Co-Creating Value through Customers' Experiences: The Nike Case," *Strategy + Leadership*, Vol. 36, No. 5, 2008.

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Mark L. Frigo is a speaker at IMA's Annual Conference, June 6-10, 2009, in Denver, Colo. For information, visit www.imaconference.org.