

## A critique of Porter's cost leadership and differentiation strategies\*

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**Abstract:** Porter identifies high market share with cost leadership, citing GM as a successful practitioner of this strategy. However, GM became a market share leader in the American automobile industry due to a strategy of market segmentation, differentiation and a broad scope shaped during the 1920s. Porter argues that cost leadership and differentiation offer an equally viable path to competitive success. Nevertheless, a differentiation strategy based on superior quality compared to competition is more profitable than cost leadership strategy. It can lead a business to become a market share leader, and consequently even a low-cost leader. Research indicates that differentiation and cost leadership can co-exist. However, Porter insists that each generic strategy requires a different culture and a totally different philosophy. The problem is that Porter's generic strategies are too broad. It is not his logic that is flawed, but his basic premise that prescribes cost leadership strategy as the only route to market share leadership, and presents a narrow view of differentiation with a unique product—sold at a premium price—on the one hand, and a “standard, or no-frills” product on the other. Mintzberg (1988) says Porter's cost leadership strategy should be called “price differentiation”: a strategy that is based on a lower price than that of the competition. He suggests that business strategy has two dimensions: differentiation and scope. Thus, setting scope aside, competitive strategy has only one component: differentiation. So, the key question is not whether to differentiate, but how? First, make customer-perceived quality as the foundation of competitive strategy because it is far more critical to long-term success than any other factor. Second, serve the middle class by competing in the mid-price segment, offering better quality than the competition at a somewhat higher price. It is this path that can lead to market share leadership—a strategy that can be both profitable—and sustainable.

**Key words:** Michael Porter; cost leadership strategy; differentiation strategy; customer-perceived quality; market segmentation; price-quality segmentation; outpacing strategies

### 1. Introduction

A scholarly work that has received widespread recognition is Porter's (1980, 1985) typology of generic strategies: cost leadership, differentiation and focus. These three fall into two basic categories. The focus strategy requires concentration on a niche or a narrow segment. But, Porter says that success in this strategy can be achieved either via cost leadership or differentiation. Thus, cost leadership and differentiation are the two basic strategies in Porter's typology. These two then are the subject of discussion in this paper. Here our purpose is to offer a critique of Porter's work, and a synthesis of the vast literature centered on it.

Thompson, Strickland, and Gamble (2008) have expanded Porter's generic strategies from three to five.<sup>1</sup> So,

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<sup>1</sup> Overall low-cost provider strategy, broad differentiation strategy, best-cost provider strategy, focused low-cost strategy and focused differentiation strategy.

the author will also briefly examine their work.<sup>2</sup>

## 2. Cost leadership strategy

The cost leadership strategy requires the sale of a “standard, or no-frills” product (Porter, 1985, p.13) combined with “aggressive pricing” (Porter, 1980, p.36). Also, the firm should have a broad scope serving multiple industry segments to gain a low cost advantage (Porter, 1985, p.12). Porter (1980, p.35) describes the core philosophy of this strategy as follows:

“Cost leadership requires aggressive construction of efficient-scale facilities, vigorous pursuit of cost from experience, tight cost and overhead control, avoidance of marginal customer accounts, and cost minimization in areas like R&D, service, sales force, advertising, and so on. A great deal of managerial attention to cost control is necessary to achieve these aims. *Low cost relative to competitors becomes the theme running through the entire strategy, though quality, service and other areas cannot be ignored*” (*italics added*).

Thus, the strategy involves making a “fairly standardized product and underpricing everybody else” (Kiechel, 1981b, p.181).

### 2.1 Major reliance on modern capital equipment

The cost leadership strategy requires “heavy up-front capital investment in state-of-the-art equipment” (Porter, 1980, p.36). So, Kiechel (1981a, p.140) says that in order to maintain cost leadership, a firm should therefore “buy the largest, most modern plant in the industry”. In basic industrial commodities—such as pulp, paper, and steel—“knocking a couple of percentage points off production costs has far more strategic impact than all the weapons the marketer could employ in these industries” (Bennett & Cooper, 1979, p.82). Porter (1980, p.43), also, points out that in many bulk commodities “it’s solely a cost game”. So, cost leadership strategy makes a lot of sense in such industries (Mintzberg, 1988, p.15). However, we shouldn’t forget Levitt’s (1980) dictum, discussed later, that even a so-called commodity can be differentiated.

In most other markets, differentiation is much more critical. So, investing a big fortune in state-of-the-art equipment in the absence of some advantage in the market means putting too many eggs in the low-cost basket.

### 2.2 Relying on experience curve to underprice competition risky

According to this theory, the market-share leader can underprice competition because of its lower costs due to its cumulative experience, “thereby further hastening its drive down the curve” (Kiechel, 1981a, p.140).

A frequent result of such an aggressive strategy can be a “kick-’em, punch-’em, wrestle-’em-to-the-ground price war” (Kiechel, 1981a, p.140). Wars like these are quite bloody and often end without winners. Because price cuts are easy to imitate, they may not result in a long-term advantage (Wensley, 1981). Since price is the primary competitive weapon of such a strategy, this approach implicitly assumes that most products are commodities (Giddens-Emig, 1983). Texas Instruments’ sad experience in the consumer watch market is a good case in point (Peters & Waterman, 1982; Porter, 1985, p.13). Dupont’s adventure in the nylon market may be one more example of a similar failure (Kiechel).

Another disadvantage of competing on price is that it can lead to a “cut rate” or “discount” image that may be hard to overcome. One example is Sharp which tried to compete on the basis of price even though it was offering quality products that were favorably rated (Rachman & Mescon, 1979, p.218; Porter, 1980, pp.45-46). Also it is far easier to cut prices in order to gain market share, but it is much more difficult to try to do the opposite, i.e., to

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<sup>2</sup> Except their two focus strategies.

raise prices in order to make some money, as Du Pont found out in its nylon business (Kiechel, 1981a).

### **2.3 No such thing as a “commodity”: Everything can be differentiated**

Levitt (1980) points out that everything can be differentiated—even a commodity. Peters and Austin (1985, p.61) declare that they just despise this word. They argue that if we put the label of commodity on a product it becomes a self-fulfilling prophecy. Buzzell and Gale (1987, p.113), too, warn that “if you think of your product/service offering as a commodity, that’s what it will be—a commodity”.

In consumer markets, even simple products, such as chicken, bananas, potatoes, oranges, etc. are now differentiated through branding (Levitt, 1980). This trend toward branding also includes ingredients. For example: DuPont’s Lycra, Teflon and Stainmaster; G. D. Searle’s Nutrasweet and 3M’s Scotchgard (Norris, 1992).

Caves (1987, p.22) argues that with the exception of industrial markets, most manufacturing industries that sell to other manufacturers are “nearly free of differentiation”. He adds that these so-called undifferentiated commodities are sensitive to price. However, Levitt (1980, p.84) says that this belief in high sensitivity of undifferentiated commodities to price is “seldom true except in the imagined world of economics textbooks”. For example, he states that when Detroit (the auto-industry) buys sheet metal it stipulates exceedingly tight technical specifications, various delivery schedules, responsiveness in reordering, and the like. In addition, Detroit has an elaborate rating system for evaluating supplier performance. Thus, Detroit does not regard sheet metal as just a “commodity”.

Interestingly, Porter (1985, p.121), too, agrees with Levitt’s position.

In price-sensitive markets where prices tend to be uniform a business can gain competitive advantage by achieving differentiation based on service (D’Aveni, 1994, p.48; Friedman, 1983, p.54; Gale & Buzzell, 1989; Hambrick, 1983). Even Caves (1987, p.22) admits that undifferentiated commodities may achieve *some* differentiation due to a seller’s reputation for reliable delivery, or the supporting services provided. Lawless (1991) suggests that sellers often use commodity *bundling*—combining the physical product with service—to differentiate themselves in the market.

### **2.4 Porter identifies high market share with cost leadership strategy**

Porter (1980, p.36) maintains that achieving “a low overall cost position *often* requires a high relative market share or other advantages, such as favorable access to raw materials” (*italics added*). But, how does one acquire high market share in the first place? The answer is that market share leaders accomplish this distinction via a strategy of differentiation—higher quality—rather than through cost leadership (Hambrick, 1983; Gale, 1992).

#### **2.4.1 Porter—GM successful follower of cost leadership strategy**

Porter (1980, p.43) cites General Motors (GM) as a successful practitioner of cost leadership strategy. But, GM’s past success raises an important question. How did GM become a low-cost leader? Was it because of a pursuit of cost leadership strategy, or was low cost mainly the result of the high market share GM was able to achieve due to differentiation?

### **2.5 Differentiation the genesis of GM’s past success**

It was GM’s CEO Sloan who pioneered the strategy of “a car for every purse and purpose” (Cray, 1980, p.243). In 1921 he rationalized GM’s cars into five<sup>3</sup> price-quality segments—from a Chevrolet, to a Pontiac, to an Oldsmobile, to a Buick, to a Cadillac. In order to differentiate GM brands from their competition, he positioned each car line at the *top* of the price scale within its price-quality segment (Sloan, 1972, pp. 73-74; Datta, 1996).

GM’s broad scope in serving multiple segments in the auto industry provided it an advantage that such a

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<sup>3</sup> Originally, Sloan offered GM’s cars in six price-quality segments.

strategy can bring about in gaining a low cost position, as Porter (1985, p.12) has indicated earlier.

The most revolutionary development in the American automobile market then was the popularity of the closed-body cars (Sloan, 1972, pp.183-184). At that time Ford was following a classic cost leadership strategy with the low-price model T (Porter, 1980, p.45). With a single-minded focus on improving manufacturing efficiency, he strongly believed in producing a standard product at the lowest price. He said the customer can have a car in any color so long as it is black (Datta, 1997).

The sharp rise in demand for the closed-body cars made it impossible for Ford to sustain his market share leadership. This is because Ford had "frozen his policy in model T" which was essentially an open-car design; with its light chassis, it was ill-equipped for the heavier closed-body car (Sloan, 1972, p.186).

In 1921, Ford had 60% of the car and truck market in units, while Chevrolet had only 4% (Sloan, 1972, p.76). So, in 1925, GM came out with a plan of attacking Ford with a closed-body Chevrolet (with a self-starter) that offered more value at a somewhat higher price—a move that was a "resounding success" (Cray, 1980, pp.230-231; Datta, 1997).

Following the success of Chevrolet, Sloan (1972, p.186) made the comment that the "old master had failed to master change" (also Porter, 1980, p.45).

The 1920's decade was an era of increasing affluence (Cray, 1980, p.218). Then customers demanded cars that provided "comfort, convenience, power and style" (Sloan, 1972, pp.187-188). Yet, Ford stubbornly clung to his belief that a new car was supposed to meet the need for basic transportation. However, after 1923, this demand was being met primarily by the *used* car market (*ibid*). As customers bought more new cars, they traded-in their old ones, and so the used car became the chief rival of Ford's model T (Cray, 1980, p.220).

Following the above developments the sales of model T declined precipitously. In response, Henry Ford closed his River Rouge plant for nearly a whole year to retool. However, he could not recover from this calamity, and finally lost the market share lead to Chevrolet for good (Sloan, 1972, p.187).

Although, the closed-body design with which GM attacked Ford was ground-breaking, Sloan adopted a rather cautious approach to differentiation. According to this policy, GM cars were to be "at-least equal in design to the best of our competitors in a grade, so that it was not necessary to lead in design or run the risk of untried experiments" (Sloan, 1972, p.72). This reference by Sloan to "untried experiments" was a fearful reaction to GM's failure to develop an innovative air-cooled engine for Chevrolet. So this mind-set became ingrained into general policy that would later dominate corporate thinking: "don't innovate" (Cray, 1980, p.198).

Another innovation that can be attributed to Sloan is incorporating the economies of scope in GM's strategy. Sloan decided to use Chevrolet parts for "Pontiac which was essentially a lengthened Chevrolet" (Cray, 1980, p.248). This was in contradiction to the conventional wisdom at that time that mass production required a uniform product. However, Sloan showed that mass production and product variety could both be pursued together (Sloan, 1972, p.181).

The Japanese conquered the U. S. small car segment during the seventies, as reported later. So, how did GM non-luxury mid-size and large cars compare in quality with Ford and Chrysler before the Japanese entered these segments? Based on *Consumer Reports* data from 1976-1982, GM clearly outperformed both companies in these two segments.<sup>4</sup>

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<sup>4</sup> The data in this analysis was taken from the annual guides. From the model years 1976 through 1982, GM full-sized non-luxury cars scored first and second in every year except Ford's second place for 1981 (no data reported for second place for 1982). Similarly, GM also made a clean sweep of the domestic midsize/compact category for the same period except for Dodge's first and second showing for 1982 and 1977 respectively. These two categories of cars probably represented the biggest and most profitable segments of cars in the U.S. for that period.

GM dominated the U.S. auto industry like a colossus for half a century with a market share as high as 54% in 1954 (retrieved from <http://seekingalpha.com/article/122761-as-gm-goes-so-goes-the-nation-part-1>) which made it the low-cost leader in the industry. However, as pointed out above, this cost leadership was primarily the result of two strategies: differentiation and broad scope.

#### 2.5.1 The decline of General Motors

During the earliest years in the U.S. automobile industry, most improvements were mechanical in character. But, by the end of 1920 the industry saw fewer and fewer mechanical improvements. The “new and improved” models the American public expected from Detroit were “new and improved” only by the “addition of convenience and the dint of advertising” (Cray, 1980, p.246).

So, Sloan (1972, p.188) instituted a policy of annual model change that became standard industry practice. This policy—that later came to be known as “planned obsolescence”—was instituted to increase demand by inducing customers to buy new cars frequently, because the new models made the older ones *look* unfashionable and therefore undesirable (Cray, 1980, p.235).

Sloan also masterminded another strategy with far-reaching implications. He became convinced that future sale of GM cars “rested not on technology, but on their “looks”: “body design, the paint schemes, the richness of the interiors... to differentiate them from their mechanically identical competitors” (Cray, 1980, p.245).

Thus, the policy of “planned obsolescence”, a focus on cosmetics rather than technology, and the attitude of “don’t innovate” had sown the seeds of GM’s decline. For too long GM had pursued a notion of quality that was literally *skin* deep. GM’s dominance of the auto industry allowed it to set the rules of the game that were anchored in *style*—an area GM had made a part of its core competence. GM was clearly the king when the competition consisted solely of the much weaker rivals Ford and Chrysler. However, GM found it was in a different league when the Japanese and the Germans joined the competitive arena. Also, while multiple brands might have been a good strategy for GM in the past, it is not so in today’s global competition in which successful firms like Toyota concentrate on a limited number of car lines (Womack, 2006).

So, it is sad to see that GM, an American icon, had to file for Chapter 11 bankruptcy. Now that it has emerged out of bankruptcy, we hope the new GM will have a bright future.

#### 2.6 Mintzberg: Cost leadership is “price differentiation” strategy

Porter (1985, p.13) says that “a cost leader cannot ignore the bases of differentiation,” and “if its product is not perceived as comparable or acceptable by buyers, a cost leader will be forced to discount prices well below competitors’ to gain sales,” and this “may nullify the benefits of its favorable cost position”. Mintzberg (1988, p.15) argues that the implication of the above statement by Porter is that “price differentiation *may* have to follow cost leadership, implied almost as a necessary evil” (*italics* in the original).

Porter (1985, p.13) suggests that a cost leader “must achieve *parity* or *proximity* in the bases of differentiation relative to its competitors” (*italics* in the original). A cost leader cannot be an “above-average performer” unless it can “command prices at or near the industry average”. But, asks Mintzberg (*ibid*): “What would enable it to command such prices?”

As already stated, the essence of cost leadership strategy (Porter,1980, p.35; 1985, p.13), includes producing a “standard, or no-frills” product, “tight cost and overhead control, avoidance of marginal customer accounts, and cost minimization in areas like R&D, service, sales force, advertising”, etc. Mintzberg (1988, p.15) says that is “all good for the cost side of the ledger”, but “hardly the basis for attracting customers”. He adds:

“The differentiation likely to result from cost leadership is *negative*: less service, lower quality, fewer features, fewer options. Price differentiation then becomes *not* the fallback position, *not* even the derivative strategy, but the very *raison d'être* for the overall generic strategy. What attracts the customers is the *price*: cost reductions simply make(s) low pricing a *viable* strategy. The customers pay less, they get less, and the firm hopefully makes more money” (p.16; *italics added*).

So, following his foregoing argument, Mintzberg (1988, p.16) makes an intriguing statement: he calls cost leadership a strategy of “price differentiation” based on a price lower than that of the competition.

This characterization by Mintzberg is radically different from Porter's (1980, 1985) definition of differentiation. Porter (1980, p.37; 1985, p.14) defines product differentiation rather narrowly and equates it with uniqueness and premium price. On the other hand, Mintzberg's (1988, fn.9) view of differentiation is more in conformity with its usage in marketing. A differentiated product is one that customers perceive being different from its competition on any product characteristic including price (Datta, 1996). So, Mintzberg sees cost leadership as price differentiation strategy in which the basis of differentiation is lower price.

Speed (1989, p.11) says cost leadership “is not a strategy at all, since operated alone it has no value”. Partridge and Perren (1994) also argue that cost leadership is not a separate strategy.

Miller (1992b) and Miller and Dess (1993) also argue that Porter's model does not represent a set of generic strategies, but rather dimensions along which an individual business could fashion a strategy of its own. However, as we shall later see, Porter strongly disagrees with this characterization of his theory.

### **2.7 Thompson, Strickland, and Gamble's low-cost provider strategy**

Thomson, Strickland and Gamble (2008) cite Motel 6 as a follower of what they call a “low-cost provider” strategy. However, we argue that Motel 6 is pursuing a *low-price* strategy by competing in the economy segment of the hotel/motel industry. Then within this segment it has differentiated itself by positioning the brand with a claim of offering “the *lowest* price of any national chain” (Crowell, 2009; *italics added*).

## **3. Differentiation strategy**

Porter's (1980, p.37; 1985, p.14; 1990, p.37) differentiation strategy calls for a product that is “perceived *industrywide* as being unique” for which it is rewarded with a “premium price” (*italics in the original*).

Porter (1980, p.38) further suggests that because of its need for exclusivity differentiation strategy and high market share do not generally go together.

Similarly, Porter (1985, pp.127-28; 1990, p.38) emphasizes that differentiation is also generally incompatible with cost leadership.

### **3.1 Porter's idea of “premium price” ambiguous**

Most markets can be visualized into three basic price-quality segments: premium, mid-price and economy (Datta, 1996). However, Porter seems to have used the term “premium price” rather loosely, and it is not clear what it really means. Generally, a business competing in the “premium” segment is unlikely to gain high market share because of its high prices. So, Porter's position that differentiation and high market share do not generally belong together implies that his reference to the term “premium price” means the “premium” *segment*.

Porter (1980, p.37) has provided eight<sup>5</sup> examples of differentiation. All except Coleman and Crown Cork & Seal clearly belong to the “premium” segment. However, Coleman had become an “icon of the middle class” and

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<sup>5</sup> Fieldcrest, Mercedes, Hyster, Macintosh, Coleman, Jenn-Air, Crown Cork & Seal and Caterpillar.

has been competing in the mid-price segment (Cole, 1989; Sterngold, 1997; Coleman Co., 1999). Likewise, as a producer of an industrial commodity one can hardly regard Crown Cork & Seal as a member of the "premium" segment.

Thus, Porter's examples of firms that command a "premium price" fail to answer the question of how he has defined the term "premium price". The problem lies in realizing a subtle but vital difference: "premium price" vs. "price premium".

### **3.2 Need for recognizing an important distinction: Segmentation vs. differentiation**

A key question that needs answering is: "premium price" in relation to what? Porter (1985, p.127) says differentiation "is usually costly". But, elsewhere (1985, p.163) he says "differentiation is inherently relative", and so a "firm's value chain must be compared to those of competitors". Thus, first, a firm must determine what its competition is?

#### **3.2.1 "Premium price" or "price premium"?**

Many authors, including Porter, have cited Mercedes as an example of a company pursuing differentiation strategy (Datta, 1996). As reported in the April 1996 issue of *Consumer Reports* (pp. 22, 30, 38), the luxury Mercedes E-class, the luxury BMW 5-series, and the mid-price Ford Taurus—all medium-sized cars—had a sticker price range, respectively, of \$39,900-\$49,900, \$37, 900-\$49,900, and \$17,995-\$22,000. It is clear from the above example that the primary competition of Mercedes E-class then was (and still is) BMW 5-series, not Ford Taurus.

However, we cannot reflect on differentiation separately from price-quality segmentation. So, when we consider them together, differentiation can be visualized two ways: (1) differentiation across or between segments, and (2) differentiation within segments. The comparison between Mercedes E-class and Ford Taurus is an example of differentiation *between* segments. But the comparison between Mercedes E-class and BMW 5-series is a case of differentiation *within* a segment. Clearly, one would find far more competition within rather than between segments. Thus, the distinction between market segmentation and differentiation is more a matter of degree than of kind (Datta, 1996).

Let us examine the implications of Porter's statement that a firm pursuing a differentiation strategy can charge a "premium price". Clearly, Mercedes E-class did not compete directly with Ford Taurus. Thus, it is not very meaningful to say that the Mercedes commanded a "price premium" over the Ford. Rather, it is much more appropriate to observe that they belonged to two distinct neighborhoods—luxury or "premium" segment for one, versus a much more modest "mid-price" segment for the other.

The next step is to compare Mercedes E-class with its direct competitor, the BMW 5-series. Based on the above price data, it seems the Mercedes did not command a "price premium" over the BMW. Now let us compare Mercedes E-class with another competitor in the luxury segment: Lincoln Continental. While the Mercedes had a price range of \$39,900-\$49,900, as mentioned earlier, the Lincoln had a price tag of \$41,800 (*Consumer Reports*, April 1996, p.36). Thus, if we take the high end or even the mid-point of the Mercedes' price range, we can say that the Mercedes was getting a "price premium" over the Lincoln.

*To sum up:* Instead of saying that Mercedes was following a differentiation strategy, it is more fitting to state that it was competing in the "premium" *segment*. So, the upshot of the above discussion is that while the term "premium price" implies competing in the "premium" segment (e.g., Mercedes), the phrase "price premium" means getting a higher price over a competitor within the same segment (e.g., Mercedes over Lincoln).

### **3.3 Porter: Differentiation synonymous with being unique**

Porter (1980, p.37) cites Mercedes as an example of a unique product. In a later work, he observes that both Mercedes and BMW “emphasize high performance cars” (1990, p.39).

Unique means “being the only *one* of its kind; without an equal or equivalent; unparalleled”<sup>6</sup> (*italics added*). Since BMW, too, was (and is) pursuing the path of “high performance,” Mercedes could no longer be considered unique. Even Cadillac began to compete with Mercedes and BMW with Catera in 1996 (*Consumer Reports*, April 1999, p.35). Later, Lincoln LS began challenging the Germans in this segment. In its October 1999 issue *Consumer Reports* says that the Lincoln LS is the “best American car we’ve ever driven” (p.24). According to *Consumer Reports* (April 2009, p.41) Cadillac CTS compact sports sedan is “as capable as its German rivals”.<sup>7</sup>

As Porter (1990, pp.578, 580) has observed, there “are few competitive advantages that cannot be imitated”, and that competitive advantage primarily grows out of “improvement, innovation, and change”.

### 3.3.1 Superior quality—not uniqueness—more sustainable

In the past first-movers were able to gain competitive advantage that lasted for decades (Porter, 1990, p.47). But, we have now entered an era of hypercompetition (D’Aveni, 1994). So, competitive advantage, once gained, is unlikely to last very long if a business rests on its laurels. Thus, while uniqueness might be a viable goal in a static economy, it is no longer so in today’s dynamic global environment. A much more viable option is to offer superior quality vs. the “principal competitors”: a standard employed in the PIMS database (Buzzell, 2010, p.480).

More and more product markets today resemble competitive sports. In individual sports the best athletes usually are not head-and-shoulders above their nearest rivals, but just a little better. Many times the winner in tennis is decided after one or more tie-breaks. In championship soccer one goal winning margin is quite typical. But, what separates champions from also-rans is this: they somehow manage to rise to the top again and again.

### 3.4 Customer-perceived quality central to long-term success

Porter (1980, p.35) suggests that the “generic strategies are approaches to outperforming competitors”, implying that cost leadership and differentiation strategies offer an equally viable path to success. However, as the following evidence shows differentiation strategies are more profitable than cost leadership strategy.

Peters and Waterman (1982, p.186) say that the high-performing companies in different industries lean toward customer value as opposed to the “cost side of the profitability equation”. Such companies “tend to be more driven by close-to-the-customer attributes than by either technology or cost”.

According to the PIMS database research customer-perceived quality is far more fundamental to competitive position and profitability than any other factor: including market share, low cost, position on the “learning curve”, and so on (Gale, 1992; Buzzell & Gale, 1987, p.7). Other researchers using this database have also reported the importance of quality. These include Prescott, Kohli and Venkatraman (1986), Luchs (1986) and Jacobson and Aaker (1987).

Outstanding reliability, quality of fits and finishes, a “flawless paint job”, “plus high gas mileage” enabled the Japanese to capture the small car market in the U.S. during the 1970s. Technologically, however, most Japanese cars were fairly ordinary (Peters & Waterman, 1982, p.37).

Lower quality and lack of innovation played a key role in the virtual disappearance of U.S. companies from the consumer electronics industry, and their loss of world dominance in such markets as automobiles, steel and tires (Dertouzos, et al., 1989, pp.1-2, 166; Kotter, 1995).

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<sup>6</sup> *The American Heritage Dictionary of the English Language (3rd ed.)*. (1992), Boston: Houghton Mifflin, p.1953.

<sup>7</sup> In this report Infiniti had the highest overall road test score of 95, followed by 84 each for Cadillac and Lexus, and 77 each for BMW and Mercedes (*Consumer Reports*, April 2009, p.29).



### **3.5 Differentiation compatible with high market share—even cost leadership**

Porter's critics argue that cost leadership and differentiation are not a dichotomy, but part of a broad continuum (Hambrick, 1983; Jones & Butler, 1988; Karnani, 1984). Contrary to his thinking, high market share can be achieved by pursuing a strategy of differentiation. A differentiation strategy can often lead to a low-cost position: due to increase in sales volume, the learning curve, economies of scale and scope (Hill, 1988; Murray, 1988; Jones & Butler, 1988; Dess & Rasheed, 1992; Dess, Gupta, Hennert & Hill, 1995; Pitelis & Taylor, 1996). Research, based on the PIMS database, by Phillips, Chang and Buzzell (1983) and Gale and Buzzell (1989) also supports this view. The authors found a positive relationship between higher quality and market share. Higher market share then led to lower unit cost.

Porter has attributed GM's past success in the American auto industry to cost leadership strategy, as mentioned earlier. However, as we have argued, the foundation of GM's success was laid in the 1920s by Sloan's revolutionary strategy of market segmentation, differentiation and broad competitive scope. It is this strategy that led to GM's dominant market share, which, in turn, made GM the low-cost leader.

Empirical research also supports the notion that some businesses can excel both at differentiation and low cost. One example is the global TV set industry in which Japanese firms were able to achieve higher quality and lower cost: both at the same time (Magaziner & Reich, 1982). Studies by Hall (1980), White (1986), Wright, Kroll, Tu and Helms (1991) also report a similar conclusion. Miller (1992b, p.403) found that "vigorous pursuit of any one generic strategy does not seem to preclude the pursuit of another". In their study based on the PIMS database, Miller and Dess (1993) found "hybrid" strategies both feasible and profitable.

Toyota Camry, a mid-price car, has been the best-selling car in America for nine of the last ten years (*Wired 2 The World*, Nov. 15, 2007). Toyota is also the leading low-cost producer in the global automobile industry (Thomson, Strickland & Gamble, 2008, p.152).

Even Porter (1980, p.44) realizes that "low overall cost position may not be incompatible with differentiation".

### **3.6 Even higher quality may lead to lower cost**

A product design aimed at ease of manufacturing can reduce production cost (Deming, 1986; Miller, 1992a). Simplifying product design by reducing the number of parts can also result in lower cost (Porter, 1985, p.105). It may even improve quality. For example, the 1997 Toyota Camry had seven fewer parts than its 1996 counterpart. Yet, it was able to withstand a 5-mile an-hour impact, unlike the earlier model (Krebs, 1996).

An innovative process technology can also lead to lower cost (Porter, 1985, p.105). Sometimes, it may even produce higher quality simultaneously with lower cost. One example is the introduction of solid state technology in the TV set industry which resulted in higher reliability, and lower cost (Porter, 1983, pp.482-503). Another instance is the mobile telephone industry in which process technology not only drove cost down, it raised performance level as well (Oskarsson & Sjoberg, 1994).

Quality assurance can be a major contributor to raising conformance quality--doing it right the first time. But such a process can also reduce overall costs by decreasing waste and increasing productivity (Deming, 1986), and by eliminating the "need for inspection, rework, expediting, fire fighting or the hidden plant (Flynn & Flynn, 1996, p.372; Porter, 1985, pp.44-45). Reducing product defects can also lower service costs (Porter, 1985, p.155).

### **3.7 Thompson, Strickland and Gamble's alternative to Porter's typology**

In what they call a "broad differentiation" strategy, Thompson, Strickland, and Gamble's (2008) view of differentiation is far more inclusive than Porter's, because they do not make a distinction between the premium

segment (e.g., Mercedes and BMW) and the mid-price segment (e.g., Toyota and Honda).

Another strategy they offer is “best-cost provider strategy”: a hybrid version that adopts a middle ground between low cost and differentiation. One example they cite is Lexus (*ibid*). They suggest that relying on its prowess as a low-cost producer, Toyota used the “classic best-cost provider strategy” when they launched Lexus.

However, Hamel and Prahalad (1994, p.89) offer a different perspective. “Toyota set itself outrageously ambitious goals in the development of the Lexus”. It put a specific price target that allowed Toyota to undercut the price of German luxury cars and “then worked backward from that to reinvent the very idea of a luxury car”.

Stalk and Webber (1993, pp.97-98) report the holistic process Toyota followed to launch Lexus. Toyota had collected a massive array of information on what upper-income customers value in a car, and then reverse-engineered Lexus to hit the bulls-eye on the very first launch. For Toyota, the “Lexus was not just a new car, it represented a whole new way of doing business”.

Toyota's success as a low-cost producer did not come from a relentless pursuit of cost reduction, as prescribed by Porter's cost leadership strategy. Rather, it came from its revolutionary lean production system which was based on a philosophy of persistent customer focus, and an unflinching dedication to quality (Nayak & Ketteringham, 1994).

#### **4. Two conflicting views of cost leadership**

Our previous discussion has shown that there are two opposing views of cost leadership. One is from Porter who insists that cost leadership and differentiation cannot co-exist. The other is that they can be combined.

##### **4.1 Critics: Cost leadership compatible with differentiation strategy**

As already reported, Porter's critics argue that cost leadership and differentiation are not a dichotomy, but part of a broad continuum, and that cost leadership and differentiation can be combined to gain competitive edge.

##### **4.2 Porter: Cost leadership and differentiation embody different philosophies**

Porter (1985, p.11) has steadfastly maintained that each generic strategy represents a “fundamentally different route to competitive advantage”. Thus, a firm must make a choice among generic strategies, otherwise it will become “stuck in the middle” (Porter, 1980, p.41).

Porter (1980, pp.35, 41-42; 1985, pp.24, 99) emphasizes that each generic strategy requires a different culture: different resources, different organizational structures, different management styles and radically different philosophies. He says that the “strategic logic of cost leadership usually requires that a firm be *the* cost leader” (1985, p.13; *italics* in the original).

As mentioned earlier, Miller (1992b) and Miller and Dess (1993) have suggested that Porter's typology merely represents dimensions along which a business could create a strategy of its own. However, we agree with Porter's assertion that the two strategies are fundamentally different; that both embody a coherent and logically consistent whole rather than mere “dimensions” that could be mixed or matched to concoct a strategy.

##### **4.3 Cost leadership vs. differentiation: A false choice**

Porter is right in insisting that cost leadership and differentiation strategies—as he has defined them—are generally incompatible. However, the underlying problem is that Porter's generic strategies are coarse-grained (Hambrick, 1983). The flaw is not in his logic, but in his basic premise that: (1) designates cost leadership strategy as the sole path to market share leadership, and (2) presents a restricted view of differentiation grounded in uniqueness and premium price.

Porter has specified that a business needs to pursue cost leadership strategy to achieve market share leadership. Since this strategy is based on a price that is lower than that of the competition, as already discussed, low cost becomes critical to its success. So, it is vital to grasp the logic of this strategy: (1) that the firm be “*the* cost leader” and (2) that “low cost relative to competitors becomes the theme running through the entire strategy” (Porter, 1985, p.13; 1980, p.35).

On the other hand, Porter's differentiation strategy calls for a unique product that commands a “premium price”: a strategy not generally compatible with high market share. Clearly, the two strategies are poles apart: each with a diametrically opposite goal. No wonder Porter affirms that the two cannot be blended into a common mix.

Nevertheless, the way the two strategies are portrayed above offers us a false choice. As already discussed, a differentiation strategy based on superior quality relative to competition can lead a business to become a market share leader and, as a result, even a low-cost leader. So, under such a scenario a business does *not* have to follow the rigid regimen prescribed by Porter's cost leadership strategy to be a low-cost leader.

#### **4.4 Internal orientation of cost leadership strategy**

According to Mathur (1986, p.93), Porter (1985) “seems more concerned with the internal configuration of activities, customer perceptions seem to play a lesser role”. Cost leadership strategy has clearly an internal orientation. Yet, customer, rather than cost, should be the starting point of strategy.

Organizational culture can play an important role in shaping firm behavior. So, Porter (1980, pp.45-46) has cautioned against the pitfalls of cost leadership strategy. A potential danger from this strategy is that its single-minded pursuit can leave a business vulnerable to a critical fault (Miller, 1992a). For example, it may create a low-cost mentality that can lead to a major disaster. Notable examples are: Ford's model T (already cited), Schlitz (Buzzell & Gale, 1987, pp.115-116), and Food Lion (Dess & Picken, 1999).

### **5. A proposed framework of competition**

Based on the foregoing discussion, we present below a framework of competition that is quite different from Porter's work we have examined in this paper.

#### **5.1 Differentiation the cornerstone of competitive strategy**

We agree with Mintzberg (1988, p.16) that business strategy has just two dimensions: differentiation and scope. So, if we temporarily set scope aside, differentiation is the only game in town. This position also fits in with the notion, espoused by Levitt (1980)—and others, including Porter—that even a so-called commodity can be differentiated. So, the critical question is *not* whether to differentiate, but *how*?

#### **5.2 Customer-perceived quality the centerpiece of competition**

Earlier we have presented considerable evidence showing how critical quality is to the long-term success of a business. In a review of the long history of PIMS-based research, Buzzell (2004, p.480) states that it has “consistently shown a strong, positive association between *quality* and profitability” (*italics* added). Total quality management (TQM) supporters also consider customer-driven quality central to competitive strategy (Dean & Bowen, 1994). So, customer-perceived quality should be the cornerstone of competitive strategy because it is so vital to business success.

#### **5.3 Road to market share leadership: Differentiation at moderate prices**

Several authors have noted that Porter's typology of generic strategies ignores market segmentation (Chrisman, Hofer & Boulton, 1988; Sandberg, 1986; Wind & Robertson, 1983). The most critical idea missing

from his typology is the concept of price-quality segmentation (Datta, 1978; Datta, 1996).

We suggest that the best vehicle for seeking market share leadership in most consumer markets is to cater to the middle class by competing in the mid-price segment. This is the socio-economic segment that represents about 40% of households in America (Datta, 2010a). It is also the customer group that P&G—one of the leading global consumer products companies—has successfully served in the past (Datta, 2010b). But, to become a market share leader a business must also distinguish itself by offering—relative to competition—a higher customer-perceived quality at a somewhat higher price. This is necessary for two reasons: (1) to maintain an image of quality, and (2) to ensure that the strategy is profitable and sustainable (*ibid*).

#### **5.4 The crucial role of “outpacing” strategies**

Just as low-cost leaders cannot ignore differentiation, leaders in differentiation, too, cannot ignore costs.

Gilbert and Strebel (1989) state that the product life cycle theory has strongly influenced traditional approaches to strategy. This theory assumes “as if the product life cycle was a given to which strategy should respond, rather than a process that the strategy should shape” (*ibid*; also see Datta, 1998).

Gilbert and Strebel (1987) argue that in evolving markets success does not come from a single-minded pursuit of either cost leadership (process cost reduction), or differentiation (perceived product value) strategy. Rather, it comes from an “outpacing” strategy to outdistance the competition. An outpacing strategy involves an explicitly-developed ability to add one strategy to the other as a market goes through a back-and-forth transition between standardization and rejuvenation.

Porter (1985, p.194), too, has recognized this innovation-efficiency dilemma, because product innovation is the enemy of efficiency. Abernathy and Wayne (1974) suggest that to achieve a successful evolution of the learning curve, a manufacturer needs a standard product. Instead of introducing a stream of products continually, a follower of this strategy relies instead on setting the industry pace through major periodic model changes. The time between such periodic innovations is then used to attain the lowest possible cost in a relatively stable environment. IBM practiced this strategy successfully in the computer industry (Levitt, 1986, pp.10-14).

#### **5.5 A subtle shift in Porter's thinking**

A major criticism of Porter (1980, 1985) is that his framework is static, and is applicable under stable conditions (Moran & Ghoshal, 1999; Datta, 1998; Ghoshal & Bartlett, 1997, pp.275-276; D'Aveni, 1994, pp.13-14; Hamel & Prahalad, 1994, p.xiii; Mintzberg, 1990). Nevertheless, Porter (1990, pp.578-584) has recognized the importance of innovation in creating and sustaining competitive advantage; so he has proposed a dynamic theory of strategic management (Porter, 1991).

It seems Porter's views on differentiation and cost leadership strategies have also undergone a subtle, but remarkable change. In *The competitive advantage of nations*, Porter (1990, pp.49-51, 581-582) says a differentiation-based competitive strategy offers higher-order advantages because they are more sustainable. In contrast, a competitive position based on low cost provides lower-order advantages because they can be easily imitated.

Bolstering differentiation further, Porter (1990, p.578) suggests that competitive advantage grows primarily out of “improvement, innovation, and change”. But perhaps the most notable clue to this change in his views is this statement: that “most products are *differentiated*” (p. 13; *italics added*). As we have mentioned before, Porter had earlier recognized that even a commodity can be differentiated.

This process of change seems to have started much earlier. The following comments from Porter (1985, p.38) further reinforce the notion that a major shift seems to have occurred in his thinking toward the superiority of

differentiation over cost leadership:

“[Customer] *value*, instead of cost must be used in analyzing competitive position since firms often deliberately raise their cost in order to command a premium price via *differentiation*” (*italics added*).

## 6. Conclusion

An extensive review of Porter's cost leadership and differentiation strategies has revealed four major themes. First, he identifies high market share with cost leadership, citing GM as a successful practitioner of this strategy. But GM became a market share leader in the U.S. auto industry mainly because of a strategy of market segmentation, differentiation and a broad scope devised during the 1920s.

Second, he suggests that cost leadership and differentiation strategies are an equally viable path to outperform the competition. However, a differentiation strategy based on superior quality relative to competition is more profitable than cost leadership strategy. It can lead a business to become a market share leader and therefore even a low-cost leader.

Third, Porter's generic strategies are overly broad and present a narrow view of differentiation with a unique product—sold at a premium price—on the one hand, and a “standard, or no-frills” product on the other.

Fourth, Porter affirms that cost leadership and differentiation strategies—as he has defined them—are not just dimensions that could be mixed or matched to formulate a strategy. Rather, each strategy requires a different culture and a different philosophy. Nonetheless, research indicates that differentiation and cost leadership can actually go together.

Mintzberg (1988) suggests that Porter's cost leadership should be called “price differentiation” strategy because it relies on a price that is lower than that of the competition. He also says that business strategy has two dimensions: differentiation and scope. So, setting scope aside competitive strategy has only one component: differentiation. The important question is not whether to differentiate, but how?

First, customer-perceived quality should be the cornerstone of competition, because it is far more critical to long-term success than any other factor. Second, in consumer markets the best road to market share leadership is serving the middle class by competing in the mid-price segment, and offering superior quality compared to the competition, at a somewhat higher price. This is essential for two reasons: (1) to maintain an image of quality; and (2) to ensure the strategy is both profitable and sustainable.

Finally, cost leadership strategy is internally rather than customer oriented. However, this deficiency represents a more general problem. The “word *customer* rarely appears in management journal article titles, management textbook indexes, or session titles at the Academy of Management meetings” (Dean & Bowen, 1994, p.408; *italics added*). No wonder “customer” represents a big gap in management theory (Datta, 1997).

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