

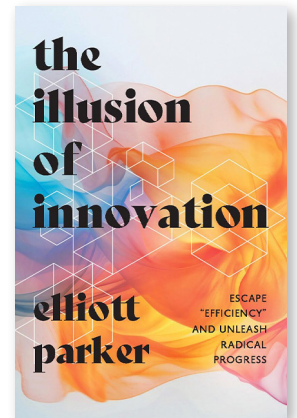


Executive Book Summaries[®]

The Illusion of Innovation

Escape “Efficiency” and Unleash Radical Progress

by **Elliott Parker**



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THE SUMMARY IN BRIEF

We are living in a time of innovation crisis. Corporations are better managed than ever, but they’re less capable of delivering the breakthroughs that change our world for the better. They’re optimized for safety and predictability, for maintenance of the status quo. Their focus on capital efficiency leads them to engage in an *illusion of innovation*: activity that feels like innovation but leads to value destruction, not progress.

The Illusion of Innovation: Escape “Efficiency” and Unleash Radical Progress is designed to allow the reader to question received ideas and to rethink their approach to innovation from scratch.

Author Elliott Parker provides a practical, how-to guide for making innovation more tangible inside of large organizations. He seeks to inspire people to see things differently, or to try to do so, and to then take the action necessary to make things better. The book relies on enduring principles, drawing from examples of the history of invention and creativity, and includes a few business stories when relevant.

IN THIS SUMMARY, YOU WILL LEARN:

- Traditional corporations are optimized for efficiency, not resilience.
- Large organizations should prioritize experimentation over efficiency.
- Collaboration with external startups is a better path for innovation than internal R&D for most large companies.
- Long-term thinking and a focus on societal benefit are essential for building enduring companies.

Part One: The Illusion of Innovation

We've spent decades optimizing our institutions to root out the kind of variability, volatility, and risk that produce surprise successes. Our institutions are too sterile. And this is a big problem.

The reality is that the innovator's dilemma is a very tricky problem to solve. To address it, companies must choose to accept some capital inefficiency in their operations. The optimal amount of capital inefficiency, contrary to popular belief, is not zero. The problem is that large corporations are organized to eradicate capital inefficiency.

There are three types of innovation that corporations can pursue:

Performance-improving innovations, or replacing old products with new models.

Efficiency innovations, or lowering operating costs.

Empowering innovations, or transforming products so radically that they create new classes of consumers, expand or create markets, and generate jobs for their originators and the economy.

Financial metrics prioritize the first two types of innovation at the expense of the third.

Managers and investors are trained to believe the efficient use of capital is a virtue because of its perceived scarcity.

All of this makes empowering innovations seem like poor investments in comparison with other forms of innovation that produce better efficiency metrics. Empowering innovations take years to pay off, if they pay off at all, while efficiency innovations can generate impact within a quarter or two.

Empowering innovations require capital investment, while efficiency innovations free up capital in the near term. Empowering innovations require bets on new customers and markets, while efficiency innovations seem safer because they address markets and customers that already exist and are well understood.

Here is the dilemma: the first two types of innovation, while necessary, do not create enduring, resilient enterprises. The pursuit of safety and efficiency at the expense of new market creation is incredibly risky over the long run. But asking executives to act in opposition to incentives, personal interest, or short-term gains is impractical.

Doing the right thing for long-term prosperity seems at

odds with what investors want, according to the metrics, tools, and timelines commonly used to guide investments.

At this moment in history, capital, in aggregate, is no longer scarce, and we should be using different tools to measure success, including performance over much longer time horizons.

The question to ask of any corporation is: Is the company optimized for near-term safety and efficiency or long-term resilience? Or both?

Political scientist Francis Fukuyama coined the term "vetocracy" to describe an environment in which many more people are empowered to say no than to say yes. Corporations are—by design—vetocracies because vetocracies preserve the status quo.

Resilient organizations not only permit people to challenge the status quo; their organizational structure, incentives, and governance attract and enable innovators to thrive.

Large corporations are designed to be safe, to propagate the status quo and to make results predictable. This is why collaboration with external assets and resources in the form of nimble startups is now a more viable path for most large companies than centralization of innovation.

Over the long run, resilience beats efficiency and is therefore a more productive objective for scaled organizations. Innovation can (and should) be directed at both efficiency and resilience.

The challenge is that our scaled organizations are optimized for the preservation of what already exists, not for building the new. They are organized for seeking efficiency, for risk eradication, for removal of variance, and for enhancement of predictability.

Fortunately, there are options for dealing with the challenge of innovation. There are practical—if counterintuitive—steps that large organizations can take to innovate effectively.

Jack Welch, former CEO of General Electric, once proclaimed, "Variation is evil." The idea that variation, or volatility, must be removed from companies for effective operation is unsound because it constrains ingenuity; it seeks to turn people into machines. Companies should be efficient, but efficiency can be taken too far.

Contrast Welch's approach with the management philosophy of Reed Hastings, founder and CEO of Netflix, who declared in a podcast interview, "Most companies over-optimize for efficiency. . . . The non intuitive thing is that it is better to

Radical innovation requires learning, making mistakes, and messiness.

be managing chaotically if it's productive and fertile.

Our model is messy, chaotic, and fertile. In the long term, fertile will beat sterile." Netflix's acceptance of a degree of messiness (read: capital inefficiency to try new things) has enabled the company to thrive.

Organizations wanting to adopt a similar degree of "messiness" through process and metrics alone will find failure if culture is not part of the equation. Strong and rigid organizational designs create fewer errors, less messiness, and fewer insights.

The trick in transformative innovation is to remember that it is the magnitude of correctness that matters, not the frequency. This means you can be wrong a lot in the pursuit of transformative innovation, because on the occasion when you are right, you are likely to achieve dramatic results.

Conversely, in the operation of a scaled business, the frequency of correctness matters more than the magnitude—leaders try hard to avoid anything that looks like a mistake. That tension is what makes innovation so hard.

In the face of an unknown future, the best strategy for maximizing returns and minimizing risk is to run as many experiments as possible, at the lowest possible cost per experiment. Radical innovation requires learning, making mistakes, and messiness.

Projection models built by innovation teams operating in a realm of assumptions, not knowledge, are always wrong because prediction is not possible. In the operating business, where assumptions are low, and the level of knowledge is high, the opposite is true: financial projections can be relied upon with much more confidence. In a state of uncertainty, rapid experimentation to convert assumptions into knowledge is required. Action creates data for better decision-making. However, action taken beyond the level of confidence is more likely to result in failure at scale.

Empowering innovation—often requiring a radical departure from the core business—typically requires an "emergent strategy," which allows for agility, experimentation,

and pivots. Emergent strategy works best when the future is ambiguous or hard to predict. Emergent strategy is optimized for learning, which is why startups deploy it so well.

Corporations can learn from the world of venture capital and venture-backed startups, where the fortress walls haven't been built and the processes of discovery and research are decentralized across many firms and investors. Venture capitalists are willing to be wrong a lot if they believe that when they are right, the payoff will be enormous.

By decentralizing their innovation through external startups and small teams, corporations can focus more of their innovation efforts on resilience instead of efficiency, on market creation instead of performance improvement. Corporations already know how to be efficient and how to improve performance; they are not very good at new market creation.

If the objective of innovation is resilience—not just efficiency—then innovation's success should be measured in terms of the learning and optionality it provides to the core organization. Learning can be measured by the pace at which organizational assumptions about the future are converted to knowledge.

In the 1930s, economist Ronald Coase set out to understand why corporations exist, why some transactions happen in the open market, and why other transactions are managed within corporations. He won a Nobel Prize in economics for explaining that firms exist to achieve lower transaction costs, taking advantage of inefficiencies in markets to do things better inside the corporation.

But the apex of the centralized corporation is likely over—at least the corporation as we've always conceived of it. The signs that this is true are abundant, but few seem to recognize that a shift has occurred. If it's now less expensive to access information, technology, or capital outside the corporation than within, the game completely changes. Why do corporations exist at all when transaction costs are now more likely to be lower outside the firm than within?

In 1776, Adam Smith published *The Wealth of Nations*, which explained that the economic pie was not actually

fixed but could expand infinitely through specialization and cooperation. This was (and still is!) a revolutionary idea. Smith believed that competition between producers was essential to spur economic development and opportunity.

Once one understands that corporations exist to seek lower transaction costs, their structures, their governance, and the processes they use to get things done all make sense. Slow decision-making, for example, can be viewed as a feature, not a bug, for protecting the status quo, which has served the corporation well and enabled it to grow.

For many decades, corporations used internal R&D to create seemingly magical product and business model innovations. However, in a world where individuals and small teams have inexpensive access to information, technology, and capital that only corporations previously could claim, the old corporate approaches are no longer as effective.

In our current era, R&D and M&A remain the primary tools for driving innovation and growth for large companies. But as primary drivers of breakthrough growth, these approaches are becoming less impactful. They are both harder to execute and less financially rewarding than they were in the past, partly because they work best in a theory of the firm that thrives on centralization.

That does not mean R&D and M&A should not be an essential part of every large company's innovation toolkit—they remain essential. It just means they should not be the only tools, and expectations about their effectiveness should be adjusted down.

Over the last three decades, the average cost of an acquisition has roughly tripled. We are seeing a trend where the number of acquisitions remains relatively flat, while valuations increase, signaling that good deals may be harder to achieve. Acquisitions are a more difficult way to unlock innovation than they once were.

Globalization was a primary driver of efficiency gains for many decades, and the era of globalization is not over—yet—but many of its cost savings have already been realized.

With these powerful headwinds, the narrative about business over the coming decades will be one of reinvention and disaggregation of the firm.

There are, of course, exceptions to the decentralization trend. The internet, while fostering access to information and expertise on an unprecedented scale, also centralizes power in some instances.

Scaled corporations need a new approach and may need to consider a redefinition of the firm itself.

Part Two: Recapturing Progress

Small teams, including small teams in the form of startups, will be the changemakers. “Startups operate on the principle you need to work with other people to get stuff done, but you also need to stay small enough so that you actually can,” noted investor Peter Thiel in his book *Zero to One*.

For big companies, the recipe for victory has changed from centralized, hierarchical control of owned assets to coordination of decentralized, “borrowed” assets.

Nimble startups that can learn and grow quickly are poised to thrive, while traditional, scaled firms feel intense disaggregation pressure.

A growing stack of innovative economic research says startups are the key to economic revival.

The new, decentralized world order requires a faster pace. Only startups with well-incentivized entrepreneurs can reimagine the existing world and deploy resources quickly enough to learn, discover new products, and coordinate talent effectively in this environment. Corporations produce incremental returns. Startups produce exponential returns—when they are successful.

For incumbent firms in many industries, a more expansive reimagining of R&D, M&A, corporate venture capital, and even the boundaries of the firm is required.

Resilience is developed and maintained through learning, optionality, and redundancy. Resilience is never the result of top-down, hierarchical management. It is always the result of organic, messy experimentation. Resilience requires a certain degree of inefficiency, randomness, and exploration.

Fragility, on the other hand, results from too much focus on efficiency and is often the output of a top-down, hierarchical organizational structure over time.

Companies that want to limit fragility and increase their resilience must develop a means for rapid, organic, and “cheap” experimentation.

Resilient companies can withstand failure, crises, and changes in context and turn these dangers into opportunities to gather information, learn, and become smarter.

Novelty is achieved simply by moving away from where you've been already.

What lessons can we learn from resilient ecosystems about how large corporations can better adapt and thrive?

1. There are no objectives
2. Experimentation happens at the margins
3. Knowledge compounds

When it comes to innovation, variability is your friend. You can't get the gains without putting the system under tension and stress. You have to be willing to risk failure. Startups are actually optimized for both inefficiency and learning.

The primary job of the innovator is to convert assumptions into knowledge by gathering insights. The best innovators do this systematically, through rapid and cheap experiments that poke holes in status quo beliefs.

Novelty is achieved simply by moving away from where you've been already. Seeking out novelty is the fastest way to accumulate data about the future. So, take action to create data, and pursue novelty.

You can increase your variance by focusing on horizontal, not vertical, learning. Vertical learning is when you go deeper into things you already know, searching for data to confirm beliefs you already have. Horizontal learning is when you go outside your organization's sphere of knowledge to learn things that may challenge status quo beliefs.

The implications for an organization that wants to innovate are obvious: create and take more high-quality shots on goal. The solution to organizational sclerosis is more experimentation: faster, cheaper, and weirder. Experimentation, when done right, is chaotic, natural, and messy—not hierarchical, planned, or objective driven.

Innovation is unlikely to succeed if the strategic bounds are not established and agreed upon. An organization's leaders must determine where the organization will play and how it will win. All good strategies are controversial because they represent real choices. Hard choices.

When considering which experiments to pursue, it is better to consider the value of experiments as options: relative

value is more important than real value. The most valuable experiments are those that are likely to create findings that lead to more experiments, that generate findings that challenge the status quo—within strategic constraints.

The level of investment in experiments and the proper forum and structure for those experiments depend on how much innovation an organization needs and how soon it needs it.

When experiments are aligned with strategy, producing sufficient insights to deliver on objectives, and being executed efficiently, an organization's experiment engine is working. Metrics can be used to monitor the effectiveness of experiments in all three dimensions: alignment, sufficiency, and efficiency. Changes can be made along all three dimensions to better tune the program.

Innovation is best funded as an operating expense when the ideas are close to the core business. On the other hand, innovation is better funded from the balance sheet when it challenges or looks very different from the core business.

If there's a single piece of advice large companies should consider when launching external ventures, it's this: Don't constrain a new venture's strategic or financial options.

The takeaway? Run more experiments: fast, cheap, and weird.

Business schools teach students that profitability, or ROIC, is the most important measure of a company's success, while underemphasizing the time dimension that must be factored into that measure to understand it correctly. Profitability is usually measured in quarterly or annual increments, for no reason other than such timing aligns with attention spans and regulatory requirements. Think how differently the world would operate if profitability were measured over ten- or one-hundred-year increments. Durability should matter when accounting for an institution's success.

Long-lived institutions create more than they consume. Contrary to popular wisdom, they don't seek to maximize profitability in the short term, and they don't pursue or achieve monopoly status. Instead, they earn "enough" to maintain their presence in a market and to remain hard to

kill as a result; they are not greedy. In fact, most of the long-lived institutions founded before the eighteenth century have never grown larger than three hundred employees.

The important lesson? If you're building a company, make sure your mission matters and has a link to societal benefit that is obvious. Companies persist at society's pleasure.

All enduring institutions are successful at preserving and retelling stories to reinforce culture, mission, and devotion. Enduring institutions do this proactively and deliberately. Every successful and enduring company has a mission that benefits the society in which it operates. Companies that endure have a clear sense of what must never change, but they are very good at reinventing everything else, all the time.

Long-term orientation is inseparable from customer obsession; it is born out of a deep care for customers.

Organizations that focus on their customers avoid crowds; they more easily move into unexplored spaces where competition is not so cutthroat. More importantly, a focus on customers enables organizations to learn to adapt through constant experimentation. Build products and a culture that people want.

Part Three: Winning the Future

There are two primary factors that determine the pace of innovation:

Prevalence of technology building blocks: access to inventions makes it easier for people to mash together ideas and create more inventions.

Ease of idea exchange: increased connectivity leads to

an increased exchange of ideas and therefore more and better ideas.

Optimistic views, on average, over time, have proven more correct than pessimistic views. Civilization depends on optimism, on the hope and trust that people will generally behave in ways that are predictable. Civilization needs optimists to create the future!

The data tells us we should be optimistic. There is an amazing opportunity in front of all of us who are optimistic about the future. Optimism is understanding the good news that our capacity to solve problems can increase. In the coming age of abundance—an age that we are arguably already living in—when communications, computing, and power are free, innovation will move incredibly quickly.

Large organizations will rise and die much faster, at incredible cost, if they do not learn how to take advantage of the trends and manufacture serendipity through faster cycles of experimentation.

Large corporations are optimized for efficiency but not resilience. This stifles innovation and makes them vulnerable to disruption. The key to success lies in experimentation, adaptability, and a long-term focus on societal benefit.



Elliott Parker is founder and CEO of High Alpha Innovation, a venture builder that partners with corporations, universities, and entrepreneurs to co-create startups that solve compelling problems. He built his career in strategy consulting at Innosight, the firm founded by Clayton Christensen, in corporate venturing, and as an entrepreneur bringing new ideas to market. To date, he has launched over 40 venture-backed startups. Originally from California, Elliott currently resides with his family in Indiana. He earned a B.S. in Finance from BYU and an M.B.A. from the UCLA Anderson School of Management.

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