

# Organizational Portfolio Analysis: Focusing on Risk *Inside* the Corporation

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This article presents a new application of Organizational Portfolio Analysis (OPA) and applies it to some leading corporations to reveal how their corporate risk arises from the risks of their individual business units. OPA offers an insightful method of analysis that can aid executives in their corporate strategic decision-making. OPA models the corporation as a portfolio of business units. It provides a graphical representation of the organizational portfolio and the role of the different business units within it. The contribution of a business unit to the reduction of corporate risk is captured in variables representing risk, synchronization and weight.

In a corporation, each business unit has a particular risk that is the magnitude of the fluctuation of its profits over time, which may be expressed relative to the fluctuations in the overall corporate profit. A business unit accentuates or dampens corporate profit fluctuations, thereby shaping corporate risk. Three types of business units are distinguished by their risks relative to corporate risk: Amplifiers, Conformers and Stabilizers. Business unit profit can also fluctuate in synchronization with, or against, corporate profit fluctuations. Therefore, Weak Countercyclical and Strong Countercyclical business units are also distinguished. The composition of the organizational portfolio in terms of these five business unit types shapes corporate risk.

Executives who wish to change the risk of their corporation can use OPA to see the ways in which they must alter their business units to attain their desired level of corporate risk. The action options include changing the portfolio of business units versus making changes within the business units and changes that can be made in the short-term versus changes that can be made in the longer term.

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## Introduction

Today, many of us are concerned with risk. With organizations going bankrupt or requiring embarrassing government bailouts, CEOs are seeking to avoid catastrophic downturns in the fortunes of their corporations. The issue is organizational risk, the upturns and downturns in the corporation's financial performance over time. Corporate performance is composed of the separate performances of its business units and how they fluctuate and interact together to shape corporate financial outcome. Each business unit has a risk, which is the fluctuation in its financial performance. Taken together, the business units of a corporation form the "organizational portfolio" that determines corporate risk.

We are used to thinking of investments — either personal or corporate — as forming a portfolio (Tucker et al., 1994). Downturns in one stock can be compensated by upturns in another, reducing the risk of the overall portfolio and cushioning us from failure. The organization itself can also be thought of as being a portfolio, in which the risks of any one business unit can be offset by the risk of another business unit. We can thus incorporate some of the ideas and tools from finance within the organizational context to shed new light on how corporate risk can be reduced. This may be of interest to corporate managers and directors, other organizational stakeholders and government policymakers.

Taking the concept of "organizational portfolio" as the starting point (Donaldson, 1999), a new approach developed here is Organizational Portfolio Analysis (OPA). The innovation of this technique is to take existing ideas about portfolio management in finance and apply them within corporations themselves. In a corporation, the components of the portfolio under analysis can be units of various levels, e.g., business segments, business divisions, or product lines. In this paper, we will refer to these components generically as business units.

Risk is treated herein as the fluctuation in profit over time. Greater profit fluctuation means more uncertainty faced by managers as they make decisions about a business unit or an entire corporation. Greater profit fluctuation also signals a greater likelihood of profit downturns, which can lead to the insolvency of the corporation.

A major way for a corporation to avoid risk is by diversification. This has long been understood but has become less popular as managers were beseeched to "stick to the knitting". The argument has often been made that diversified portfolios are for the investor rather than for the corporation (Lubatkin and Chatterjee, 1994). Nevertheless, corporate diversification strategy, if implemented appropriately, is a powerful tool to reduce risk: a downturn in the performance of one business unit of a corporation may be compensated by the upturn in another business unit (as will be illustrated by the case of *IBM*). However, diversification may not always reduce risk (as will be illustrated by the case of *CSR*).

To deploy a diversification strategy that effectively reduces corporate risk, executives need to open the "black box" of their organizational portfolio and analyze the separate roles of and interaction between its business units. OPA offers an insightful, yet succinct, method of such an analysis. A business unit's effect on corporate risk is conveniently summarized by three variables: the risk of the business unit relative to corporate risk, the synchronization between the fluctuations in business unit profit and in corporate profit, and the weight of the business unit (i.e., its profit relative to corporate profit). The position of all the business units on these three variables provides a graphical pictorial representation of the organizational portfolio of a corporation. Hence, OPA offers a readily comprehensible overview.

We will begin by motivating the discussion, showing quantitatively the reduction in corporate risk that can occur due to the organizational portfolio. To do so, we will examine an example where corporate risk is less than the combined risks of the business units that make up the corporation, illustrating the importance of the interaction between the risks of the business units. We consider the separate risks of the constituent business units as possible factors reducing corporate risk. Next, we present a typology of five different types of business units, each with a distinctive role in the organizational portfolio. Subsequently, we discuss the options available to executives wishing to

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