

# Getting more with less

Applying Pareto's Law and its 80/20 logic can simplify your business and improve profitability.

by Art Raymond  
 araymond@raymondnet.com



People often say, "There's no such thing as a free lunch" or "You get what you pay for." Those clichés lead you to believe that the world is linear — every unit of input will generate equal units of output. Very often, however, the converse is true. The minority of inputs, efforts or causes generates the majority of outputs, results or effects.

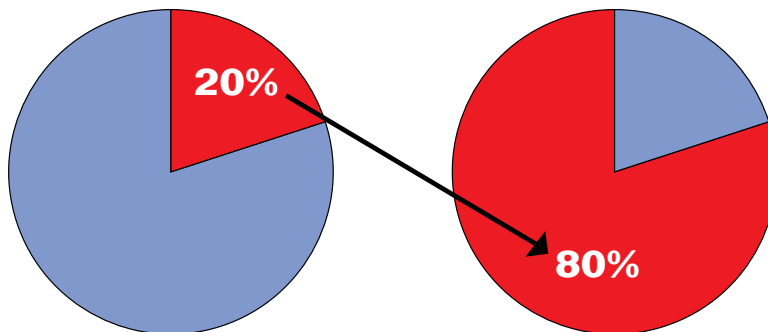
This phenomenon was first documented by Italian economist Vilfredo Pareto back in 1897. Studying the distribution of wealth within various countries, he found that the majority of wealth was in the hands of a minority of the people. Pareto's Law hypothesizes that something like 80 percent of results are generated by 20 percent of the effort. In shorthand, therefore, his law is commonly called the 80/20 Rule.

Proof of Pareto's "predictable imbalance" abounds. Yet we often pay lip service to his 80/20 Rule. In business we regularly treat

all customers equally, ignore the star people in our organizations and continue investing in unprofitable products that don't sell. As a consequence, for example, we add products and customers willy-nilly instead of focusing on those that are already in the top fifth of our rankings. The result is predictable: more products, more processes and more complexity. Complexity means higher cost. And that is bad for your bottom line.

Applying 80/20 logic can help you simplify your business, work smarter and make more money. The first step is completing a Pareto analysis of the critical elements of your business. The goal of such an analysis is to separate the vital few inputs, causes or efforts from the trivial many that add little value. To learn how to conduct such an analysis visit [www.raymondnet.com/pareto.htm](http://www.raymondnet.com/pareto.htm) on the Web.

Businesses should operate in markets and offer products that generate the highest revenues and profits with the



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Art Raymond is a manufacturing consultant specializing in furniture, cabinets, millwork, fixtures, and other secondary wood products. His firm, A. G. Raymond & Co., has developed management and technical solutions for manufacturers around the world. Contact him at 919/831-0070, by email at [araymond@raymondnet.com](mailto:araymond@raymondnet.com), or on the Web at [www.raymondnet.com](http://www.raymondnet.com).

least effort. Applying Pareto can point you to where you are making the most money. Take a look at the profitability of your customers. Segment them as many ways as you can — by distribution channel, by seniority, by size. Then determine, for example, if large customers are more profitable than small ones. Analyze your product line the same way. Which products contribute 80 percent of your profits? With answers to these high-level questions, you can develop ways to leverage these best customers and products into superior profits.

### Thinking strategically

You can also think strategically without conducting a detailed Pareto analysis. Believe it or not, a few industries make the majority of profits. Is your industry one of the moneymakers? If not, learn from industries that are earning top profits. Pareto also tells us that 80 percent of an industry's profits are made by 20 percent of its players. Find out what those most profitable companies are

doing differently. Apply those lessons to your business.

Pareto also theorized that human beings are motivated mainly by sentiment rather than reason and logic. So, like most managers you will not believe the results of what a Pareto analysis tells you. But face it. When 80 percent contribute only 20 percent, huge waste exists. Why make products or serve customers that don't contribute profits? Because not doing so requires radical change — the elimination of four-fifths of what you are doing. Most would say that step is not possible given their assumption that the bulk of the business pays the overhead. But consider that the bulk of your business may be the reason you have overhead.

This conclusion does not mean that size is not valuable. Scale can give you market share and efficiency if you keep complexity from creeping in. Simplicity is the real key.

Once decisions are reached on customers and products, a company must

look at its performance in acquiring those customers and delivering those products. Every manufacturer builds a value chain extending from its suppliers through its plants and on to its sales force. Here again, Pareto can help you think clearly and focus your efforts. At the operational level you should be seeking to provide 80 percent of your product's value for 20 percent of the cost.

### Thinking operationally

Look at what U.S. telephone companies have accomplished. In 1970 421,000 switchboard operators were required to handle 9.8 billion long distance calls. Today, we make 98 billion calls with only 78,000 operators at a fraction of the cost of those 1970 calls. Mass merchants like Home Depot are busy replacing cashiers with automated checkout counters. You can bet these companies looked first at cutting the high-cost elements of their processes before attacking those with

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lower impact on their profits.

A company must identify its best-performing resources and assets. Whether those resources are suppliers, plants, processes or employees, Pareto tells you that 20 percent of each group

contributes 80 percent of your results. As a manager, you should lavish attention on your best performers. Give them more capital, give them more talent. Don't waste time trying to remedy your problem suppliers, plants or people.

Individuals also produce 80 percent of their output with 20 percent of their effort. During that most valuable 20 percent, a worker is performing at many times his/her normal effectiveness. Knowing that, you should organize work to eliminate excessive multitasking where constant interruption inhibits reaching that extraordinary level of performance.

### Better productivity

Industries that use product as a strategy, always introducing more and more SKUs in search of elusive profits, often see their product ranking fall below 80/20. In many furniture companies, 35 percent of their products generate only 70 percent of their revenues. This flattening of Pareto's curve typically means smaller average order quantities, especially when products lack standardization.

The advent of high-tech, fast setup machinery has improved our ability to make those small lot sizes. However, nothing trumps high volume per SKU in the quest for the lowest manufacturing cost. It's a mathematical certainty: the unit setup cost for a lot size of one is always 10 times that for a lot of 10, a thousand times that for an order of 1,000 and so on.

Success requires getting a few

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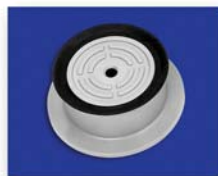
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## Applying Pareto

In addition to products and customers, you can apply the 80/20 Rule to analyze almost anything in business and elsewhere. Here's how:

1. Quality — correcting 80 percent of your defects by concentrating on only 20 percent of the causes.
2. Inventory — allocating investment to support your faster-selling SKUs.
3. Plant layout — streamlining flow by focusing on your primary processes and sequences.

## Need for good data

A constructive Pareto analysis requires accurate and easily accessible data. And you must repeat your analyses regularly. By definition each analysis is a snapshot of history. If you take only one snapshot at the wrong moment, you may draw the wrong conclusions. So decide which 80/20 analyses you need regularly and make certain those data are readily available.

products past the tipping point where the economics are solid and the return on investment is superior. Following Pareto's logic leads you to conclude that most of your products plus the effort and money invested in them are virtually wasted.

What we're talking about here is improving productivity — leveraging your available capital, labor and time for maximum benefit. And improving productivity is how you get competitive and win the game of business.

You have two choices:

**1. Allocate your resources to the most productive uses.** Invest in your most critical activities and man them with your best people. Concentrate on your top customers and products. It's much easier to focus on the vital few customers than chase them all or to concentrate on the most valuable products instead of setting up processes to sup-

port the many that contribute so little.

**2. Create ways to make underutilized resources productive.** Salvaging an underperformer can often prove worthwhile. But do it fast. If you don't get measurable results quickly, kill the effort. Then redeploy your time, talents and cash to support the 20 percent

high-impact activities.

Remember that the latter alternative always requires harder work than the former. And anything else is just a waste of your time.

*Bottom Line:* Stop thinking 50/50. You can get more for less if you direct your efforts in the right places. ▲

**4.** Warehouse design — locating your fastest-selling products to reduce travel cost.

**5.** Sales force — supporting your best salesmen and territories while fixing your weak links.

**6.** Investments — allocating your capital to those assets that generate 80 percent of your returns.

Pareto can help you not only work smart but work smart on the right things.

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