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Rationality and Routines as Dynamic Capabilities? The Case of Property Investors

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Abstract

In their decision-making, companies often follow a particular mix of old and new routines. The global commercial property industry exemplifies the combination of long-standing with novel routines. Recently, investors have turned their attention to new, far-away and still opaque market regions. In contrast to traditional property investors these new, more professional investors seek a 'rational' foundation for their decisions based on methodologically confident, systematically calculable procedures. The application of 'rational', 'scientific' models means that actors use algebraic models and procedures based on models of rational choice, which have emerged from neoclassical economic science. We discuss rationality and routines with a specific focus on evolutionary approaches and concentrate on routines, including the concept of dynamic capabilities.

Keywords: decision-making process, novel routines, rational models, evolutionary economic geography

Introduction

In their decision-making, companies often follow a specific mix of old and new routines. Organization science terms this 'dynamic capabilities'. It is assumed that the mix of routines leads to success by helping companies to reconfigure their assets in order to adapt to changing environmental conditions. Such a view especially is helpful when we look at investors' decision-making in situations of new market entry, which is carried out under particular opaque and uncertain conditions. The objective of our paper is to show that the combination of established and novel routines is not only a consequence of practical problem-solving, but at times also an outcome of contradictory paradigms such as rational choice and experience-based knowledge.

The commercial property industry is well placed to illustrate the combination of long-standing with new routines. Recently, institutional investors have turned their attention to new, far-away and still opaque market regions in South East Asia, China, Russia, India, Latin America and the Middle East. In contrast to traditional property investors (e.g., non-property companies such as manufacturing), these new, more professional investors seek a 'rational' foundation for their decisions based on methodologically confident, systematically calculable procedures. As a consequence, they rely on economic models of rational choice for orientation and turn away from practical, experience-based knowledge. At the same time, the new property markets lack transparency. For this reason investors still stick to a range of old routines that stem from experience-based knowledge.

When we speak of ‘rational’ decisions we refer to a very specific kind of rationality (Fuchs and Scharmski 2009). Implied in this is an orientation towards neoclassical equilibrium models. In our example of the commercial property industry, the application of ‘rational’, ‘scientific’ models means that actors use algebraic models and procedures based on models of rational choice, which have emerged from neoclassical economic science and can be systematically calculated. In the following, we discuss rationality and routines with a specific focus on evolutionary approaches. We first concentrate on routines and the concept of dynamic capabilities. After some empirical evidence from the commercial property industry, the paper ends with final conclusions.

Rationality and Routines

Defining ‘rationality’ in economic sciences is no easy feat. A great variety of approaches have emerged over time to overcome the restrictive assumptions imposed by early neoclassical approaches. New models that have appeared in the last decades are much more complex, clearly reaching beyond the assumptions that still characterized neoclassical thinking some decades ago. Although the new approaches still believe in equilibrium, they no longer fit the old and frequently criticized pattern. ‘New growth theory’ stresses the importance of knowledge for companies. Another important new approach is game theory, overcoming the idea that *homo economicus* acts in isolation. In such models, actors’ expectations about reciprocity and fairness play a role. Such models often use insights from psychology and cognitive sciences. Obviously thus, in economic sciences the boundaries between rational choice models including psychology and cognitive sciences on the one hand and behavioural approaches about bounded rationality on the other increasingly erode (Corpataux and Crevoisier 2007). In economic sciences, ‘rationality’ is not as one-dimensional as the opponents of rational-choice models like to assume. Yet, the *ceteris-paribus* postulations often remain restricted. The social respective institutional context of decision-making is underdeveloped in the mathematical modelling done by mainstream economic sciences (Strauss 2008).

In contrast, institutional economics and especially evolutionary approaches focus on routines (Hodgson 1997, Lambooy and Boschma 2001, Martin and Sunley 2006). The common core of the evolutionary approaches is the idea of variation, selection and heredity. Routines – understood as sets of practices – ensure heredity and self-replication respective continuity. Formal and informal routines are “carriers of history” (David 1994: 207-8) and represent a form of “organizational memory” (Nelson and Winter 1982: 99). Firms consist of “bundles of routines” (Foss 1997: 94). Thus, adaptation of a company to the environment does not take place automatically or as a blind reaction, but is the result of routines.

For investors, routines help to save time and resources in times of decision-making under uncertain and complex conditions. However, routines are a theoretical-conceptual problem for economic sciences based on assumptions of rational choice. Routines are also a practical problem for ‘real life’ investors who prefer the application of rational-choice models instead of relying on experiences in their decision-making. This is because routines lead to ‘irrational’ decisions. Despite the opacity in the property industry, modern property investors thus resist decisions based on routines and attempt to introduce novel rules of conduct – new routines – to replace the old, experience-based routines, resulting in a general expansion of ‘rational’ corporate

calculative benchmarking and audit practices (Larner and Le Heron 2004, Leyshon and Thrift 1997). Still, little is known of rational choice, path dependencies and ‘dynamic capabilities’ as combination of both in the property industry (Yang and Lester 2008).

Dynamic Capabilities

The concept of dynamic capabilities developed from the resource-based view (Argyris and Schön 1978). Resource-based concepts emphasize that rather than being directly and immediately influenced by the organization’s environment, internal learning processes are an outcome of the resources which the organization possesses. ‘Capabilities’ are viewed as a central resource. Such capabilities are dispersed across many individuals in the organization and as such embedded within the company that holds them (Pinch et al 2003).

Because the resource-based perspective takes too much of a static view of company and formal assets, the concept of dynamic capabilities and its focus on routines enhances this view. This includes both formal and informal, as well as experience-based and theory-driven routines. Routines are solidifications of practices that help to overcome uncertainties, thus assisting actors in opaque situations of decision-making. They help to organize the company’s resources in line with the company’s targets. The specific architecture of old and new routines leads to dynamic capabilities and will generate a structured mix of knowledge and knowing (Amin and Cohendet 2004).

Dynamic capabilities are the organizational routines which enable the organization to choose the important resources respective competencies adequately and recombine them in a way which solves problems. Dynamic capabilities allow an organization to react to the changing environment (Teece and Pisano 1994). They are not resources in themselves, but ‘architectural routines’ for the creation of competencies (Amin and Cohendet 2004) or the ‘construction plan’ which opens up opportunities to select, recombine, broaden and deepen the existing resources (Eisenhardt and Martin 2000). They enable the organization to solve complicated tasks such as new market entry. Problem-solving architecture means that it is possible to repeatedly access and revitalize former experiences and apply them to a specific problem.

As the following illustrates, we should abandon the idea that such ‘architecture’ of old and new routines is a jigsaw puzzle where one piece fits another and the construction plan has its own, inherent logic. On contrary, some actors fight for specific pieces of the jigsaw (for the new routines), aspiring to create a total picture solely (or primarily) composed of new routines. In this instance, these new routines are the principles of rational choice.

Empirical Evidence

Methodical comment

Since little is known about the new institutional investors in office investments and their kind of decision-making, our method is qualitative-explorative. Based on five selection criteria (see below) the analysis is based on 19 guided interviews with decision-makers of global office investors in 2005 and 2006. We established the following selection criteria to identify relevant cases: 1) institutional property investors; 2) investors with a global investment strategy; 3) investors with more than 5 billion US\$ property assets under management; 4) investors that directly invest in properties; 5) investors with a sectoral focus on office properties. Due to financial and time restrictions the sample is

restricted to institutional investors from North America, for example Pramerica Real Estate Investors, LaSalle Investment Management (both USA), and Europe, such as Henderson Global Investors Ltd. (UK), Union Investment Real Estate and RREEF Real Estate (both Germany). Investors from these countries are counted among the most important players in the cross-border property investment arena.

Particularly in large, multinational companies decision-making processes involve a wide range of persons and are subject to processes of negotiation, coordination and control. The struggle for rationality is not equally pronounced in all departments and at all levels of hierarchy. Conflicts can exist between decision-makers on the board of management and departments tasked with executing specific decisions. Yet, such processes are embedded within the company (Pinch et al 2003). Insofar in our study, we concentrate on the process of decision-making with a view of the property investor as an entire organization, and not on individual persons' processes of learning.

Dynamics of the Property Sector

The extent, intensity and depth of global interconnectedness in the commercial property industry (office, retail, industrial and logistics properties) are all growing apace. Rather than concentrating on their traditional terrain of the core economies, investors increasingly focus on new locations. About 70 per cent of all international investment was made in the Asia-Pacific region, Northern America, Europe and the Middle East (Jones Lang LaSalle 2008). Since 2000, the property industry has been transforming from a locally embedded industry into an internationally oriented one. Despite the overall reduction in transaction volumes due to the global credit crunch, the globalization of the property sector remains a key trend. Correspondingly cross border investment activity accounted for almost 45 per cent of total transaction volumes in 2008 (JLS 2008).

Particularly six driving forces accelerate internationalization, which together influence the expectations and motives for decision-making: 1) Banks, the traditional mediators between supply and demand of financial capital, are less and less relevant. Disintermediation leads to the rise of new institutional investors (such as REITs [Real Estate Investment Trusts], opportunity funds, pension funds and further funds), resulting in growing liquidity on the commercial property markets. 2) As national markets of the core economies are limited, and only investing in national markets becomes too expensive, investors diversify their investments internationally in order to reduce their portfolio risks and to benefit from different market cycles. 3) New vehicles of property financing have been developed in recent years, such as shares of property firms, shares in funds, funds of funds, derivatives and REITs; property investment has been established as an autonomous asset category alongside stocks and bonds. 4) In global cities and other nodes in the global networks, the expansion of multinational manufacturing and service corporations demands first-class office space for management and administration. 5) The creation of virtual proximity by new information and communication technologies encourages commercial property investors to expand into new, so far unknown territories. 6) Certain national markets have now opened up as a result of political and economic reform; political integration such as the European Union and other interstate agreements also strengthens international flows of financial capital (Fuchs and Scharmski 2009).

The Emergence of New Routines

The commercial property industry is a powerful example for the emergence and forceful dissemination of new 'rational' routines based on rational choice. Such process of internationalization leads to dynamics and thus unclear market development. Recently, investors have turned their attention to new, distant and even opaque property markets. At the same time, the competitive environment is changing, with new, more professional investors emerging, who share a common language about the theory and practice of property investment. Whilst traditional commercial property investors are private persons and non-property-companies, such as manufacturing and other companies (which purely own properties but do not use it for making profit as a core activity), new institutional investors like property funds or REITs have appeared that centre on the exchange value or financial investment aspects of property and pursue international investment strategies. Rather than focusing on single buildings, their strategies and management concentrate on the entire portfolio. Furthermore, the passive buy-and-hold strategy is increasingly replaced by an active buy-and-sell strategy, together with concrete schemes of investment, de-investment and portfolio optimisation.

If we take commercial property investors as an example for the implementation of new routines, we find that professional, institutional investors broadly agree that it is necessary to avoid apparently 'old-fashioned' experiential knowledge and the traditional 'bricks and mortar'-thinking. They introduce a reflected, science-based and 'rational' process of decision-making, performing a multilevel procedure of filtering. In this process, considerations about a particular investment – the office building – represent the last link in a decision chain which mainly runs top down:

The first step is the screening of relevant countries. At this stage, locations are excluded that do not match the general principles of investment, are considered imprudent or fail with respect to certain knock-out criteria. The decision-making procedure is based on a set scheme which helps in the systematic search, comparison and evaluation of markets. Thereon locations are evaluated by portfolio analysis. Markowitz developed a model of portfolio selection as early as the 1950s (Markowitz 1952), but it was not until the early twenty-first century that it became widely used in commercial property portfolio management. Now, quantitative arithmetic can be used to check how the pre-selected locations fit into the current portfolio with respect to the risks they entail and property cycles. In the next step of decision-making, the remaining property markets undergo a detailed analysis of market conditions and timing strategy. This requires at least temporary local proximity. Information thus obtained is used in detailed scoring and SWOT models (Strengths, Weaknesses, Opportunities and Threats), with bottom-up strategies influencing the decision-making in the final step. The acquisition department once more cross-references the available project information to the superordinated criteria. Together with this final recommendation a 'due-diligence report' – which is mainly prepared by external consultants – is integrated into the final commercial, legal, fiscal and technical assessment. In case of compliance, the property will be selected and acquired (Figure 1).

	Decision Making Process	Geographic Scale	Selected Methods
top-down	screening	worldwide	scoring models
	portfolio analysis	international comparison	portfolio-selection-theory
	analysis of market conditions and timing strategy	property markets and submarkets	detailed scoring, SWOT models
bottom-up	acquisition	office building x, location y	
	property selection	individual property	surveys, inspections, due diligence

Figure 1: The 'Rational' Decision Process. *Source:* A. Scharmanski

Thus, 'rationality' interpreted by investors is not explicitly and strictly compliant with 'rationality' in recent economic sciences as outlined above. Rather, the new investors pick and choose, using some selected analytical instruments of economic sciences. As Clark and Marshall (2002) put it, rational and non-rational decision-making complement one another like a new turn in a winding. Importantly, such rational instruments do not always represent the latest scientific state of the art. For example, when Markowitz designed his portfolio theory, data bases or data processing had not yet become available to apply and test the assumptions. Today, the theory has proved its worth and is en vogue. Obviously, such a selective patchwork of what investors call 'rationality' is less a homogenous concept than a paradigm or doctrine for how decisions should be made. As such, it is an 'ideal type', and thus it comprises small cracks in which pragmatic, experience-based routines can survive.

The Failure of New Routines in Opaque Markets

The rational decision procedure outlined above presupposes transparency in the property industry. Transparency means maximum availability of information on market-specific fundamentals, structures, regulations, rules of the game, institutions, actors etc. at any point in time. In reality this is hardly given, so that investors' decisions are guided by the opacity of markets. We identified informational, institutional and relational opacity as three categories of opacity which are typical for new market regions and counteract efforts to establish rational decision-making.

Informational opacity refers to information deficits. Market-specific data on investment destinations are often unavailable or at best fragmentary and incorrect. Moreover, calculable variables such as benchmarks for market regions and investment objects have not been fully harmonized, which further contributes to uncertainty. The

absence of reliable data on major market fundamentals and the lack of internationally applied, accepted and understood reporting and valuation standards prevent rational choice models from being used, not least because what is true in one property market is not necessarily true in another. Importantly also, markets are characterized by information asymmetries between local and global property actors. Due to their local embeddedness, local players can directly participate in the 'local buzz', which is created and received through face-to-face contacts and co-location of people and firms within the same industry and place. This buzz consists of rumours, impressions and insider information on the latest market trends, transactions, development pipelines, business opportunities etc. Global players without a local presence or partner are not party to this kind of information.

Institutional opacity spotlights the embeddedness of the property actors within a complex formal and informal institutional setting. In markets where the rules of the game are transparent, robust, stable and familiar, the impact of all variants of the institutional setting on any transaction is relatively predictable. This presumption is unlikely to hold true in new and unfamiliar market regions where clarity and strength of property rights, the enforceability of contracts, the consistent application of taxes, and building and planning codes etc. remain areas of concern. Successful investment demands that international investors should be well informed and familiar with the specific local rules or practices of negotiation, especially where these practices differ from familiar business environments. In opaque markets, the security of legal titles and the enforceability of property rights and contracts tend to be critical issues for investors. Entry in the land register, zoning and building codes are intransparent as well as inconsistent; public authorities usually react extremely slowly and impose high taxes on property acquisition, also charging exalted fees, and corruption is another factor that can push prices for market entry to unacceptable levels. Although the specific rules of the game are familiar to local market participants, they often appear exotic to foreign investors. To complicate matters further, the institutional setting is constantly produced, adjusted and modified within the local context.

Relational opacity results from information asymmetries between property actors, language barriers and unfamiliar practices of negotiation. Local players will know much more about their markets and the place-dependent rules of the game than their foreign partners or competitors. This opens up possibilities for opportunistic behaviour and increases the uncertainty of foreign investors. Far from wishing to encourage perfect competition, many local actors prefer to limit competition and are keen to maintain transaction costs that constrain the market entry of new foreign competitors. Last not least, language barriers and different practices of negotiation complicate cooperation in global-local networks.

Because of informational, institutional and relation opacity, investors cannot rely on 'rational' modelling alone. Instead, they require constant up-to-date knowledge about unknown, new market regions. Such knowledge is dynamic, changeable and dependent on circumstances. It is also inconsistent, erratic and often experience-based, representing exactly the kind of knowledge excluded from neoclassical rational choice models (Amin and Cohendet 2004).

The Survival of Old Routines

Under opacity, systematic and rational decision-making practices can only represent a small and distorted fragment of reality. Although investors do attempt to overcome old

experience-based routines, such routines still survive. In case of experience-based decision-making, we found increasing returns, conformity with routing ideas and organizational proximity as explanations for this.

The first reason for the survival of experience-based routines is increasing returns. 'Rational' behaviour would imply that optimal investment is chosen time and time again from a set of diverse opportunities. However, such continued fresh decision-making is hampered by previous knowledge about locations in a firm, collected in past situations of market entry (Martin and Sunley 2006: 400). Multiplication brings down costs. More generally, we can state that economies of scale generate positive feedback loops. This is true also for financial investments. Wrigley et al. (2003: 384) underline that financial analysts' behaviour is characterized by "considerable sunk costs of social capital bound up in their previous investment advice, they are likely to be hesitant to depart radically from those previously expressed views". Repeated use of a previous market entrance can lead to a reduction of costs in the short term, i.e. by paying less for obtaining information about the market or building up a local office. This leads to the formation of sequences or chains of events (Mahoney 2000): A destination, once chosen, guides future investments. However, such experience-based decision-making can lead to rigidities, because other destinations are ignored in prospective decision-making.

A second reason for the endurance of experience-based routines is conformity with routing ideas. Such conformity reduces the need for the investor to explain himself and seems to justify his decisions. Often, general conformity with the global buzz plays a role (Clark and Marshall 2002). Investors follow popular routing ideas and conform to the global buzz as an originator of impressions, rumours, implicit insider knowledge, interpretations, experiences and shared visions. Rumour is generated in the global centres of financial markets, which act as important nodes of the global networks of management knowledge and loci of business opportunities. Opinion-makers, such as consultants and rating agencies, broaden and deepen the global buzz by conceptualizing city and investment rankings, such as World Winning Cities or Rising Urban Stars. Extreme cases of such decisions are the so-called 'trophy buildings' with their eye-catching architecture and super-regional charisma. Acting as a label for the investment company, their purpose is to improve the image of the investor. Such 'billion-dollar-objects' are mainly found in prestigious global cities, such as New York, London, Paris and San Francisco. Thus, such conformity with routing ideas is linked to prestige and reputation.

The third reason is organizational proximity (Boschma 2005, Torre and Rallet, 2005). Sometimes, investors tend to ignore their own ideal of rational choice as a basis for decision-making because they feel tied to the routines of partners in the company or the company network. In a company and between closely connected partners, a specific set of collective organizational routines grows up, such as commonly shared codes, rules, procedures and benchmarks. Such routines often guide investments in new market regions. An example is a Swedish bank, which expanded into the nearby Baltic States in 2000. As a result, their affiliate, a property investment firm, also intensively focused on the Baltic States in their location research. Another good case is the cooperation of a German open-ended property fund with a Dutch project developer, which was limited to the Netherlands initially and gradually expanded into Portugal, Great Britain and Turkey. The business connections between investors, project developers and tenants replicate themselves in different international locations. Investors interpret such

internationalisation within networks as a reduction of risks because they will already know some important actors in the new locations and trust them.

Thus, we state a – limited – persistency of established routines still guiding the decision-making. Interestingly, such routines do not always originate from the investor company itself. There is an inclination to absorb routines from outside the company (from the global buzz, from consultants and strategic partners) and to adopt them for one's own organization. Partially, such experience-based routines are not irrational in the sense of inefficient, but also contain some economic usefulness: Increasing returns stand for economies of scale. Conformity with routing ideas sometimes leads to benefits in terms of reputation and thus supports the long-term strategic development of a company. And, last not least, organizational proximity seems to minimise risks.

Conclusions

Apparently, new rational routines help to overcome informational, institutional and relational opacity. New routines are en vogue, and investors pursue them as a normative target: If all actors believe in the superiority of rational choice, it seems to be rational for the investors to make decisions along analytical procedures based on economic modelling. As such, empirically-based decision-making has small cracks in which pragmatic, experience-based routines still survive. Looking more closely, we discover different explanations for the resistibility of experience-based routines. We identify increasing returns, conformity with routing ideas and organizational proximity. Such routines do not always originate within the investor company itself; sometimes, they stem from global buzz or local buzz or are adopted from consultants and strategic partners. Although the new investors in the office market try to overcome path dependencies they also stick to them. The result is a combination of rational and path-dependent decision-making, which so far only follows a rough 'construction plan'. However, there is a clear tendency towards analytical decision-making and an unambiguous trend towards rational procedures, which increasingly fill information gaps and thus reduce opaque spaces.

If we focus on the 'architecture' of old and new routines as a central idea in the concept of dynamic capabilities, we could not discover a more detailed 'construction plan'. The pattern, i.e. the relationship of old and new routines, contains contingencies. Apparently, the 'architecture' is quite elementary, simple and frugal and allows broad scope for decision-making. The concept of dynamic capabilities therefore offers a perspective on the mix of formal and informal, 'rational' and experience-based routines. There is no clear evidence of failures or successes under old or under new routines; what we observe is the empirical combination of both. Yet, as experience-based routines are substituted by systematically generated routines, maybe, such dynamic capabilities will dissolve in future.

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