

EDITORIAL COMMENTARY

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The Wrong Incentive

Executives taking stock will behave like athletes placing bets

Every Sunday in the season, hundreds of National Football League players put on their cleats, shoulder pads and helmets and head out on the field to compete. The teams wage an intense battle of strategy, will, experience and muscle. Offensive coordinator against defensive coordinator. Quarterback against secondary. Running

back against linebackers. Wide receiver against cornerback. It is a very real game in which real touchdowns and field goals are scored. And after 60 gruelling minutes of official time there is a real winner and a real loser.

Billions of dollars are earned on television contracts and billions are spent on player salaries. But Sunday is also the culmination of an even bigger dollar game: betting on the NFL. Because much of it is done illegally, nobody really knows just how big a game betting on the NFL is, but it is probably bigger than the real game.

During the week, bettors make predictions about what will happen when the teams take the field and place their bets. Clever bookmakers continuously adjust the point spread—the number of points the bettor must give the underdog if betting on the favorite—to even the betting on each team. The magnitude of the spread is entirely based on expectations of a future event—what really will happen on Sunday. Point spreads change with the news. An injury to a key player can stretch the odds or even reverse them.

In football, there is a rigid separation of the real market—the games played on Sundays—from the expectations market, or the betting that takes place prior to the game. No participant in the real mar-

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ket is permitted to participate in any way in the expectations market. If they do, they risk a lifetime ban for even one infraction.

Why wouldn't you want your star quarterback to be even more motivated to win on Sunday afternoon by having placed a big bet on his team? Trying harder on Sunday is one way to score in the expectations market, but another is to manipulate expectations in order to improve betting chances. Going in the tank in Week Three could pay off in Week Four if other gamblers underestimate the team's true ability. Shaving points to score less than would otherwise be possible can lead a gambling player to throw the game and win a bet on the opposing team using the betting spread.

These second-order incentives to manipulate the expectations and real markets for personal benefit are what caused football and the other major professional sports to ban participation in the expectations market.

Vulnerable Market

There is an even bigger game in which players in the real market not only are allowed, but are strongly encouraged to play in the related expectations market—even though exactly the same incentive problems exist.

That game consists of the markets in which publicly traded corporations compete. Here, real companies spend real

money to make and sell real products and earn real profits if they play with skill. This market also requires strategy, will, and experience.

Linked to this are expectations markets—the stock markets, the biggest of which is the New York Stock Exchange. Like point spreads in the NFL, prices on the NYSE aren't set by real things like sales, margins or profits, but by the collective expectations of investors concerning future sales, margins and profits. Stock prices go up only when expectations of investors rise, not necessarily when sales, margins or profits rise.

Senior executives, arguably the most critical players in the real market, are strongly encouraged and often compelled to participate in the expectations market. They are given massive stock-based compensation under the misguided theory that stock-based compensation aligns their interests with the interests of shareholders.

Stock-based compensation does nothing of the sort. Like encouraging NFL players to bet on football, it encourages executives to manipulate the expectations market and the real market to benefit themselves at the expense of outside shareholders.

There is only simplistic logic in assuming that powerful stock-based compensation incentives will cause executives to work hard in the real market to improve performance, which then will increase the stock price and make investors rich.

As in the NFL, it isn't that simple. There are much easier paths to personal riches than working hard to improve performance in the real market, then waiting and hoping that improved performance will result in higher stock prices.

Motive to Manipulate

Stock-based compensation is an incentive to increase expectations, not performance. The easiest way to do that is to hype the stock by talking up the company's prospects on TV and in newspapers and magazines. Alternatively, a hungry executive can use extremely aggressive accounting to inflate performance in the real market in an attempt to raise expectations. Or he can make a bunch of acquisitions that appear to produce profitable growth in the short run but hurt the firm in the long run. Better still: Combine all three, like Tyco International!

As NFL officials know all too well, simple exaggeration of expectations isn't the worst result. Tanking and point shaving are more nefarious and a key feature of senior executive behavior. Tanking helps reset expectations to a low level and provides a big upside potential for stock compensation that was given at the low price level. Point shaving, known in the stock market by the more popular term "earnings management," can ensure that results don't rise too high, too fast, pushing expectations to unsustainable levels.

The greatest incentive for stock-compensated managers is to create as big a gap as possible between expectations and reality—in either direction—then utilize their superior knowledge either to sell or buy stock for personal profit.

In the numerous stock-market scandals of the recent years—Enron, Worldcom, Global Crossing, Qwest, Tyco, Adelphia, etc.—observers seemed shocked that senior managers appeared so misaligned with the interests of outside shareholders, despite high levels of stock-based compensation.

There should have been no shock. Senior managers were completely misaligned with the interests of outsider shareholders because of their high levels of stock-based compensation. They had a powerful incentive to hype expectations on their stock well in excess of reality, then cash in on sales of stocks and options before outside investors understood the true picture.

Blaming the Tool

The reaction has been to blame the problem on stock options, but the real culprit is stock-based compensation of any kind. Overemphasizing any form of equity compensation provides executives with the incentive to focus on and manipulate the expectations market.

How, then, should incentive compensation be structured? It should be based

exclusively on features of the real market—sales, costs, investments, margins, profits. These are items over which management and employees have some control and their actions can be directly linked to such items. Compensation plans should look more like royalty streams than annual bonuses.

If there is any great utility to employee stock ownership, it is not as an incentive for enhancing performance, but rather as a vehicle for creating a feeling of warmth and togetherness in the corporation. Employees like to feel that they are all in the enterprise together and stock ownership is conducive to the warmth of feeling.

In the end, the corporate market needs to take as sophisticated an approach to the fundamentals of compensation as the NFL.

Imagine what play in the NFL would be like if Brett Favre's or Peyton Manning's compensation depended more on the number of point spreads they beat than on the number of wins they produce.

Actually, imagination isn't required. We need only look at the behavior of senior executives over the last ten years, as their compensation based on the expectations market has dwarfed compensation based on the real market.

We will see more distortion until we recognize what professional sports have long realized: You shouldn't mix the real and expectations markets. ■