If a business wants to enjoy the benefits of long-term staying power, it must reject theories built on Shareholder Value Theory and replace them with a theory embedded firmly in the real market.

by Roger Martin

UNDERMINING STAYING POWER: THE ROLE OF UNHELPFUL MANAGEMENT THEORIES

WHAT DOES IT TAKE TO HAVE STAYING POWER in today's global economy – to not only survive, but prosper and thrive? It's a question that has grown all the more pressing of late, as we've watched once-mighty companies like **Merrill Lynch** and **AIG** falter and crumble. Indeed, the carnage in the financial sector (and in our own retirement accounts) has lead to much navel gazing, as myriad theories are bandied about to explain the root cause of the crisis.

While examining lending provisions, banking regulations and derivatives structures can provide insight into the specifics of the crash, focusing our attention on the intricacies of the sub-prime mortgage market and asset-backed securities obscures the real lesson. We would do far better to look not just at 2008, but at the recent market swings versus long-term performance. In my view, such a perspective suggests a trend of increasing market volatility: we see a market in which the peaks and valleys are more severe and closer together than ever before. Consider that in under a decade we have witnessed two remarkable bubbles and two subsequent crashes that, in each case, wiped out almost half the value of the S&P.

What is at the root of this extreme volatility? If you ask me, our own management theories are the prime culprit – a triumvirate of well-intentioned theories that are taught in every business school and entrenched in every significant publicly-traded company. Intended to ensure longevity and profitability, they have instead led to the opposite – transience – and contributed mightily to both the technology crash of 2001-02 and the financial-services crash of 2008.

In my view, neither crash would have happened if our business and capital markets theories were as robust as those used to govern America's National Football League (NFL). In 2003, I wrote an editorial for *Barron's* in which I argued that the NFL should serve as a model for the way to think about corporate performance and incentive compensation. This argument is, if anything, more relevant today.

Real vs. Expectations Markets

You may well be asking: what on earth could be the similarities between business and football?

The answer is that both are characterized by the simultaneous presence of a 'real market' and an 'expectations market'. In football, the real market operates when teams take to the field on Sunday and play a 60-minute game, complete with runs, passes and tackles. Real touchdowns and field goals are scored; there is a real winner and a real loser. This is the world that coaches and players *can* and *do* control. In business, the real market is the world in which factories are built, products designed and produced, revenues earned, expenses paid and real dollars of profit show up on the bottom line. This is the world that executives and workers can and do control.

In both football and business, there is also an associated *expectations market* that is driven and governed by expectations about future events. In football, the expectations market is the realm of sports betting. Prior to Sunday's game, bettors place their wagers on its outcome – but it isn't quite as simple as betting on who will win or lose. If the game were played on a neutral site between two equally-matched opponents, we would expect that roughly half of bettors would select one team to win and half the other. Of course, this never happens. One team is playing on the road, one team has a stronger quarterback or one team lacks a rush defense. So the Las Vegas bookmakers dynamically manage a 'point spread' to balance the bets on either side.

If more bettors expect that the Dallas Cowboys will beat the Miami Dolphins, the bookies will 'give points' to the Dolphins. This means that instead of betting on Miami to win the game, you bet that Miami will either win or, importantly, lose by less than the point spread. Imagine that the point spread is 'Dallas by 4.5 points'. If you wager on Dallas to win, Dallas must win by five or more points for the bet to pay off; if you bet on Miami, they must lose by four or fewer points, or win, for the bet to pay off. From the time betting opens until kick-off, the point spread moves according to the bets placed, settling to a point of equilibrium such that roughly half the money is bet on Miami and half on Dallas.

The point spread in football is the moral equivalent of a stock price in business. Again, it isn't as simple as buying the stock of a company you think will do well in the future. The stock price – like the point spread – is a product of people's expectations. In football, the point spread reflects the expectations of all bettors who imagine what might happen on the coming Sunday; and in the capital markets, the price of a stock reflects the expectations of shareholders who imagine how the company might perform in the future.

Let's say a share of 'RLM Inc.' is trading for $100. Why is this the price? Is it because if RLM closed down and sold its assets, they would fetch $100 per share? Typically, not even close: the liquidation case is normally a fraction of the trading price. No, the price is $100 per share because existing and potential shareholders look at RLM Inc., imagine its future prospects, and decide that they would pay $100/share for those future prospects. If any potential investor thought RLM was worth $101/share, that investor would buy shares and drive up the price to $101. So the stock price is a consensus view of a firm's future prospects, representing market participants' best guess – but only a guess – as to the future performance of the company.

The Expectations Trap

While real and expectations markets exist in both football and business, football players and business executives take notably different approaches to these twin markets. In football, the goal is to win the game in the real market. No player in a post-game interview has ever said, "Well, at least we beat the spread." In football, winning isn't everything: it's the only thing. In business, however, the focus of real-market participants – executives and workers – has increasingly shifted to the expectations market. Winning means increasing your stock price, and this is due to the first of our three problematic theories: **Stock-Based Compensation-Alignment Theory.**

In the NFL, athletes are rewarded for their performance on the field. Quarterbacks are paid a set salary with incentives related to their real-market performance – games started, touchdowns scored, passes completed, etc. Performance relative to bettor expectations is never a factor. Executives, on the other hand, are compensated not based on their performance in the real market, but primarily on their performance in the expectations market. Stock price, rather than real 'value created' is the important yardstick, because executives are now granted significant stock-based compensation as a matter of course. Instead of rewarding them for performance in the real market, we give them the opportunity to realize significant gains in the expectations market.

While the trend to stock-based incentives has substantial benefits for executives – sometimes to the tune of hundreds of millions of dollars in bonuses – it creates a new problem for business while failing to solve the problem that it means to address. It turns out that good performance in the real market is *not* correlated directly with good performance in the expectations market, because expectations can – and do – get way ahead of the real market.

For high-performing teams or companies, the expectations market creates a pernicious trap. Imagine that a football team starts winning every game that it plays. With each successive win, expectations for the team grow. Logically, the point spread for each upcoming game will reflect those raised expectations, making it harder and harder for the team to actually beat the spread. Case in point: in 2007, the New England Patriots did not lose a single regular season game. Their record in the real market was an unprecedented 16-0. By late in the season, the betting line for the Patriots against the New York Jets was a historical record high of 24.5 points. The Pats won the game (20-10), but didn't beat the spread. In all, across their glorious undefeated season, they went a modestly favourable 10-6 against the spread. If expectations keep going up, no team – no matter how good – can beat the point spread every Sunday, and the identical trap awaits high-performing companies.

As a firm performs well in the real market, expectations rise and its stock price goes up, and the rise is precipitous, because the new stock price incorporates elevated expectations for the company's future. For example, if **Pfizer** announced tomorrow that it had patented the cure for cancer, its market capitalization would

leap from its current (approximately) $120 billion to $2 trillion (for the sake of argument). The very next day, the brand new shareholders who bought the company at the new $2-trillion-dollar valuation would be asking Pfizer executives, 'what are you going to do for me now?' The reason: these new shareholders cannot make a penny on the stock if all Pfizer does is go out and sell its cure for cancer. The profits from that cure are already built into the price they paid, because expectation changes are instantly reflected in the stock price. It may take years to earn the expected profits, but the stock price shoots up the moment the expectation level rises.

To increase their share price, the only thing executives can do as of a certain point in time is to increase the *expectations* of their company in the minds of would-be shareholders. These prospective shareholders will then attempt to buy shares from existing shareholders at a price consistent with the new, higher expectations, thereby driving up value for existing shareholders. Even if executives somehow managed to double sales and earnings, shareholder value would not increase at this point if the expectations already existed that sales and earnings would double.

Of Principals and Agents

The use of stock-based compensation for executives arose in response to a second concept, **Principal-Agent Theory**, which holds that there is a schism between executive 'agents' and shareholder 'principals' – that the interests of executives are not naturally aligned with those of shareholders. Given that human beings are inclined to perform in their own self-interest, the theory goes, executives will inevitably put their own interests ahead of shareholders' interests. To solve this, we needed a way to align these interests, and we settled on Stock-Based Compensation Alignment Theory, which holds that using executive compensation in the form of stock-based instruments aligns the interests of executives/agents with shareholders/principals. But this also gives executives based in the real market a significant stake in their firm's performance in the expectations market.

Why should we care so much about the schism between executives and shareholders? Surely, if executives are properly incented in the real market, the company will perform well and we will all be better off. Why mix in the expectations market at all? The answer lies with the third and most insidious of the three theories: **Shareholder Value Theory**. This theory holds that the primary job of the executives of publicly-traded companies is to maximize shareholder value, measured as appreciation in the market price of the stock plus dividends – i.e. a combination of expectations market (appreciation) and real market (dividends) measures.

Shareholder Value Theory presents two very thorny issues. First, executives have limited leverage over the only thing that has the potential to create shareholder value – an increase in expectations about the future in the minds of potential investors. Executives don't run or control the expectations market; the only control they have is in the real market, where the activities have only a tenuous and imperfect relationship with what goes on in the expectations market. This is why in 2008, real activity decreased only fractionally, while expectations as measured by stock prices decreased 50 per cent. In making it the job of executives to increase shareholder value, we are giving them a job that they are not even close to being equipped to do.

> If expectations keep going up, no team – no matter how good – can beat the point spread every Sunday, and the identical trap awaits high-performing companies.

Second, as the Pfizer example shows, the very instant expectations rise, the base for new shareholders is a price consistent with the newly heightened expectation level. This immediately makes executives a prisoner of the heightened expectations, having to execute perfectly against the new expectation level – i.e. Pfizer would have to sell cancer-curing drugs to every cancer patient worldwide, and in addition, accomplish things in the real market that would cause expectations to rise yet again.

It has not yet been possible for any executive team to do this continuously for a lengthy period, because in due course, expectations get ratcheted up too high and nothing can be done to raise them to still-greater heights. Hence, even fabulously successful companies like **GE**, **Microsoft** and **Cisco** were trading at a fraction of their historic highs even before the recent market crash; and **Google** struggles to imagine, while it is dominating its market, how it can return to the expectation level of all those investors who purchased shares at $400. Notionally, these companies' managers destroyed huge quanta of shareholder value because, despite being consistently-highly profitable, they couldn't raise expectations further than they were at the height of expectations. Like the magnificent 2007 New England Patriots, they couldn't beat the proverbial 'point spread' every week.

A New Role for Executives

Despite these thorny issues, Shareholder Value Theory has taken hold throughout the business world. By the mid-1980s, executives found themselves on the receiving end of large dollops of stock-based compensation, whether options, restricted stock or outright stock grants, in order to encourage them to focus their attention on increasing shareholder value. Executives no longer had to think of themselves as working for anonymous shareholders; they were now working for themselves. If they increased shareholder value, they would get rich. But to get rich, they had to overcome two challenges.

First, they had to keep raising expectations, which, as we've noted, is impossible; but they soon realized that they didn't actually have to produce perpetually-rising expectations. All that a

Those who have come to make the most money in this economy are not those who build real companies or talented workforces. Instead, the most highly rewarded are those who can influence expectations.

crafty executive needed to do was produce one spurt of expectations-raising, and he would be rich – as long as he sold out before expectations came tumbling down. And who would have the best insight into likely falls in expectations? If they had any brains, the senior executives of the company would.

The second challenge was that their authority and expertise lay in the real market, while shareholder value is created and destroyed entirely in the expectations market; but they soon engineered around this, too. Executives came to understand that the hardest way to raise expectations was to improve actual performance in the real market. That required hard work, effort and investments that might make expectations fall in the short term, lowering the value of their stock-based compensation. It was much easier to go to Wall Street and simply hype expectations. During this period, giving positive 'earnings guidance' became an almost universal practice. It was also easier to perform a series of acquisitions that gave the appearance of rapid growth; or to use aggressive-if-not-illegal accounting tricks to make real performance look better than it was. CEOs quickly learned that investing in expectations-raising worked better than doubling down in effectiveness in real market activities. And pump expectations they did.

This triple-threat of unhelpful theories got us to a world utterly obsessed with expectations rather than real markets. Corporations became vehicles for CEOs to juice expectations and get out before expectations fell, leaving the job of juicing fallen expectations to their successor. Even this wasn't a disaster for the successor, because as soon as expectations cratered and the stock price followed, the successor received stock options at the bargain-basement value, and he or she could then rebuild expectations from a low base and start the cycle again. Boards increasingly looked for CEOs who could raise shareholder value, loaded up said-CEOs with massive stock-based compensation and then looked for a fast run-up of expectations. In this context, the hiring of **Carly Fiorina** by **Hewlett-Packard** or **Bob Nardelli** by **Home Depot** made perfect sense.

Waiting in the Lurch: Hedge Funds

The environment described above created a fertile environment for the explosive growth of hedge funds. Expectations that shift slowly and methodically are bad for hedge funds; big swings – whether up or down – make for great opportunities. For these funds, having CEOs obsessed with jerking-around expectations was a recipe for success. Smart hedge funds could watch a CEO drive expectations up to an unrealistic level and ride up the stock by going long, and then ready themselves for the inevitable collapse of expectations by shorting the stock, making huge gains with the fall.

Even more so than CEOs – who still have obligations to pay some attention to improving performance in the real market – hedge fund managers can and do focus exclusively on understanding the expectations market. But *understanding* the expectations market is only the first step. Like CEOs, hedge-fund managers quickly realized that *influencing* the expectations market was their most powerful money-making tool. If that meant getting together with other hedge funds to organize a concerted attack on a target company to drive down its stock, why not? If it meant spreading false rumors about the prospects of a company in order to drive down expectations, why not?

The extreme form of payoff that drives this behaviour is itself a function of the nexus of the three unhelpful theories. Hedge-fund managers argue that on the basis of Stock-Based Compensation Alignment Theory, they should have an incentive structure that allows them to share in the upside of their investors. Hence the famous hedge-fund formula whereby the general partner (i.e. manager) is paid two per cent of assets-under-management plus 20 per cent of any gain produced for the limited partners (i.e. the investors) – the '2 & 20 formula' – was born. This formula notionally aligns the interests of investors and managers.

But does it? Imagine a relatively typical $1-billion hedge fund operating for five years. The hedge-fund manager automatically earns $100 million in fees. If the fund is worth $2 billion after five years, the gain is $1 billion and the manager gets another $200 million. Investors are happy, having earned a 70 per cent return (after total fees of $300 million). However, if the manager loses 100 per cent of the investment, he still makes $100 million in fees, while the investor loses the entire principal. Rather than creating alignment, this provides an incentive for the hedge fund manager to swing for the fences – to take huge risks to attempt to earn a big upside on the 20 per cent sharing formula – and accept as much risk of a bad downside as necessary, because the downside still means $100 million in fees. Even more perniciously, many hedge-fund managers get paid the 20 per cent sharing upside on a quarterly or annual basis; so as long as there is a short-term uptick in the portfolio, the manager receives an upside-sharing cheque; even if after five years, he goes on to lose all the investors' capital.

As a consequence, those who have come to make the most money in this economy are not those who build real companies or talented workforces. Instead, the most highly rewarded are those who can influence expectations and exploit vacillations in them: hedge-fund managers. Consumers are now looking at companies and workers are looking at their employers and asking, where do I fit in? And the answer is: "Nowhere. You are a side show. At centre stage is the job of exploiting the expectations market to the hilt. And if that means sacrificing your interests, we won't hesitate for a second."

The Way Forward

Consumers and workers no longer trust the corporations with whom they deal, and for good reason. As I have indicated, the causal trail of logic goes straight back through craven hedge-fund managers, to manipulative executives, to deluded boards, to Stock-Based Compensation Alignment Theory to Principal-Agent Theory, and finally to the resting place of Shareholder Value Theory.

If we want executives to focus on building value in the real market, hedge funds to wither away, and to restore faith in corporations, what must happen? The answer is not that complicated: we must become more like the NFL and widen the divide between the real and the expectations markets.

In the NFL, participants in the real market are strictly forbidden from playing in the expectations market. If a player, coach or referee is caught betting on an NFL game, they are banned for life. Why? Because the league's owners and commissioners realize just how powerful the incentives to alter performance can be – whether purposely winning by less than the point spread ('point shaving') or playing badly to lose this week so as to lower the point spread for the next week to enable you to bet on your team and win handily ('tanking').

If NFL players were allowed to bet for or against their own teams, it would destroy the integrity of both the real market and the expectations market. The result is that football players are not playing for the bettors; they are aware of but entirely-removed from them. If we follow this logic through to the corporate world, the answer becomes clear: we need to scrap Shareholder Value Theory entirely. When it expires, so will stock-based compensation, and in due course, we will get back to rewarding *builders* more than *traders*.

I am not saying that business should not pay attention to shareholders. Whereas Shareholder Value Theory holds that the primary responsibility of executives is to maximize shareholder value as measured by stock market results – i.e. the expectations market – a more productive theory holds that executives should care about shareholders only with respect to the real market. The goal should be to earn a return on *book equity* – i.e. the real dollars given to the company by real shareholders – which compensates the equity investors for putting their capital at risk. The higher the risk, the higher the return required.

A firm's leaders should consider the return to equity holders to be in the form of dividends paid and appreciation of the book value of the equity (i.e. paid-in equity plus retained earnings); and they should strive to ensure that any shareholder who provides a dollar of paid-in equity at any point in time would earn a minimum of the risk-weighted cost of equity return, as measured by the dividends plus appreciation in book value. The only concern management should have with its stock price is if the firm needs more equity capital and the stock price is higher than current book value per share; then it will have to be able to earn a real return on the higher-valued real equity infusion. Only if management believes that it can earn a real return on that real money should it issue new equity.

In short, the only shareholders to whom management should feel it owes loyalty or responsibility are those who buy treasury shares from them. Management should not, and in fact cannot, protect the interests of those who buy shares on the open market at prices that are purely a function of expectations. Such shareholders are on their own to the extent that they pay more than book value for their shares.

Lastly, the goal of executives should be to maximize the return measured by dividends plus appreciation of book value of equity, but only in the long run. The goal should be sustainability of earnings more so than short-term maximization – to ensure that over the long term, the firm earns an acceptable return on equity capital so that it always has access to such capital. This is more important than earning a maximum return in the short run if that is at odds with long-term prosperity.

In closing

The true key to long-term sustainability is building customer and employee bases that enable long-term profitability. If we are to emerge from the current mess, executives must switch their focus entirely to the real market and completely ignore the expectations market. This entails building skills and experience in building real products, developing real consumers and earning real profits. It also means never giving earnings guidance and not attempting to meet any expectation placed on the firm by any shareholder.

In addition, executive compensation should have no component of stock-based compensation at all. Compensation should be based entirely on real-market measures such as revenues, profits, and return on book equity. Incentives should also be aligned to real market performance.

While these proposals might seem draconian, they are absolutely necessary to save corporations from themselves. Customers and employees will only accept the legitimacy of a business if its executives put customers and employees ahead of shareholders who buy shares from existing shareholders; businesses will only become skilled at creating real value if they don't spend their time on the expectations market; and the negative impact of hedge funds will only diminish if executives stop spending their time jerking-around expectations.

In the end, if a business wants to enjoy staying power, it must utterly reject the troika of theories described herein and replace them with a theory divorced from the expectations market and embedded firmly in the real market. **R**

Roger Martin is Dean and professor of Strategic Management at the Rotman School of Management, and director of the School's AIC Institute for Corporate Citizenship. His third book, *The Design of Business*, will be published by Harvard Business Publishing in 2009.