Running risks on scoreboard and big board; Judging managers by a firm's stock price has been a recipe for volatility and stagnation

Roger Martin
Dean and professor of Strategic Management at the Rotman School of Management
June 5 2009
The Toronto Star

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 has led to much navel-gazing as theories are bandied about to explain the root cause of the crisis.
The prime culprit is a triumvirate of management theories intended to ensure longevity and profitability that have instead contributed mightily to the technology crash of 2001-02 and the financial services crash of 2008.

Neither would have happened if business and capital markets theories were as robust as those used to govern the National Football League. You read that right. In the NFL, success is grounded in the "real market" - the real touchdowns and field goals scored during a 60-minute game. Football also has an associated "expectations market": betting on the point spread.

In business, the real market is the world in which products are produced, revenues earned, expenses paid and real dollars of profit hit the bottom line. But increasingly that's not where business bases its definition of success. For that, business turns to the expectations market - driven entirely by expectations about future events - and reflected in a firm's stock price.

A stock price is the moral equivalent of a point spread in football. However, NFL players are not rewarded for beating the point spread; their incentives are based on how they do on the field. In stark contrast, business executives are encouraged if not required to play in the expectations market.

The first theory that begins executives' slide down that slippery slope is "shareholder value theory," which holds that the primary job of executives of publicly traded companies is to maximize shareholder value - a combination of expectations market (appreciation) and real market (dividends) measures.

The existence of that theory led to the creation of the second theory - "principal-agent theory" - which held that the interests of executive "agents" are not naturally aligned with those of shareholder "principals" because executives inevitably put their own interests ahead of shareholders'. So the agents are inclined to undermine the first theory and not maximize shareholder value.

That in turn led to "stock-based compensation alignment theory," which held that in order to realign management agents with shareholder principals, one has to make executive compensation significantly stock-based so that they would feather the nest of shareholders in order to feather their own.

As a result, unlike NFL players, business executives are compensated primarily on their expectations-market performance, through significant stock-based compensation. The theorists missed the logical connection that this makes their primary incentive not to enhance real results but rather to increase expectations.

This creates a pernicious trap. Imagine a football team starts winning every game it plays - like the 2007 New England Patriots. With each win, expectations for the team grow. If expectations keep rising, no

team - no matter how good - can beat the point spread every Sunday - like the record 24.5-point spread the Patriots faced in a late-season game against the New York Jets. They clobbered the Jets but didn't cover the spread, disappointing their bettors.
The identical trap awaits high-performing companies. The very instant expectations rise, the base for new shareholders is a price consistent with the new heightened expectations level. This is why Google struggles, while dominating its market, to return to the expectation level of all those investors who purchased shares at $400.

Increasingly, executives have understood the structure and strictures of the game they are playing. They get compensated highly to the extent they can raise expectations. However, it is impossible to keep expectations rising continuously. They understand that expectations will eventually exceed reality, then come crashing down.

So they increasingly define their job as increasing expectations - not increasing real performance because improving performance is the hardest way to increase expectations. Easier ways include going to Wall Street to hype expectations or engineering a series of acquisitions to give the appearance of rapid growth or employing aggressive accounting to give the appearance of higher profitability. But because these techniques are impossible to sustain, the crafty executive concentrates on producing one spurt of expectations-raising before cashing in and getting rich - before expectations come tumbling down.
The effect is twofold: enormous expectations-market volatility and flaccid real-market performance; or more simply a volatile and crappy economy.

The time has come to scrap shareholder value theory. Executives should care about shareholders only with respect to the real market. The goal should be to earn a return on the real dollars given to the company by real shareholders, compensating equity investors in proportion to the degree of risk at which they put their capital. Managers should feel zero responsibility to earn a return on any value other than the book value per share.

As well, we should scrap stock-based compensation alignment theory. Executive compensation should be based entirely on real-market measures such as revenue growth, market share, profits and book equity return. Incentives should be aligned solely to real market performance.

While these proposals might seem draconian, they are necessary to save corporations from themselves. If a business wants to enjoy staying power, it must become more like the NFL, replacing the troika of current management theories with a theory divorced from the expectations market and embedded in the real market.

Roger Martin's third book, The Design of Business, is forthcoming from Harvard Business School Press.
This article is adapted from a longer version that will appear in Rotman magazine.