

Why are CEOs compensated differently than quarterbacks?

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Modern capitalism dictates that the job of executive leadership is to maximize shareholder value, as measured by the market value of the company's stock. To that end, the CEO should always be working to increase the stock price, to raise expectations about the company's prospects ad infinitum. And just how does that play out?

To see, let's look at how expectations play out in professional football. In 2007, the New England Patriots had a remarkable year; the team went unbeaten in the regular season, racking up a stellar 16-0 record. Eight of its starters went to the Pro Bowl. Quarterback Tom Brady was named the league's most valuable player, and head coach Bill Belichick earned coach of the year honors. The team scored more points that season than any team in history. It was, in short, a superlative performance. In terms of the real

market, the Patriots were perfect.

But the Patriots' performance in the expectations game was mediocre in comparison. In betting vernacular, a favored team covers the spread when it wins the game by more than the point spread. In their sixteen-win regular season, the Patriots covered the point spread only ten times. Why? Because expectations ran away to unattainable levels. The Patriots had started the season with sensible expectations and played, admittedly, exceptionally well. The average point spread for the first eight weeks was 10.5, and the Patriots were able to cover the spread in every game, winning by an average of 20.5 points. But as they continued to perform very well, expectations rose; bettors expected the Patriots to continue to be more and more exceptional each week. The point spreads widened, and soon the Patriots were facing the largest spreads in the history of the NFL.

They played very well in the second half of the season, though less exceptionally than in the first half of the season. They still won each game, but in the final eight weeks, the Patriots beat opponents by a comfortable but somewhat lower 12.5 points on average, while point spreads had risen to an average of 16.5. Against these heightened expectations, the Patriots covered the point spread in only two of their games in the second half of the season. Brady's Patriots thrashed the Dolphins 28-7 in the second-to-last game of the season, but still couldn't meet bettors' expectations for a win by 22 points or more.

The lesson is that no matter how good you are, you cannot beat expectations forever. Expectations will get ahead of you. Patriots quarterback Tom Brady had perhaps the finest season of any quarterback in NFL history, but he couldn't beat expectations more than ten of sixteen times. And that is why quarterbacks aren't compensated on the basis of how they perform against the point spread. While Tom Brady was leading his team to a perfect record but only beating expectations ten times out of sixteen, his young counterpart on the Cleveland Browns, Derek Anderson, was leading his team to a decent but unspectacular 10-6 record on the field, but a superb 12-4 record against the spread. If the point spread mattered more than the real game, Anderson, whose team missed the playoffs, would have out-earned Brady, who took his team to the Super Bowl championship game and set records doing so.

The problem is, in American capitalism, CEOs are compensated directly and explicitly on how they perform against the point spread; that is, against expectations. Imagine the following scenario: a company decides to pay its CEO \$10 million in total compensation for the year. It could pay that CEO \$10 million in salary or, alternatively, it could pay him \$2 million in salary and \$8 million worth of phantom stock units (say 100,000 units with the stock at \$80 per share). The simple \$10 million salary embodies no incentive to increase shareholder value, while the \$2 million salary plus stock embodies a large incentive to do so. If the CEO can double the price of the stock by the time he retires, he will have earned \$18 million in that year rather than \$10 million.

The company's stock price is \$80 per share today because expectations of the company's future performance have coalesced there. Any existing shareholder who had a more doubtful view of future expectations would sell the stock, cease to be a shareholder, and in the process drive the stock price lower. If anyone had a more optimistic view of future expectations, that person would offer to buy the stock at more than \$80 per share and drive the price up. The CEO's phantom stock units are valued at \$80 per share because, in aggregate, current expectations suggest that is exactly what the stock is worth.

The CEO now has a clear and simple incentive: to raise expectations of future performance from the current level. There is no other way to increase the value of his incentive compensation. One might imagine that improving performance in the real market would increase the stock price, but this just isn't the case. The dot-com bubble taught us that stock price and real market performance are not as closely linked as we would like to believe. Even setting that fact aside, consider that investors already tend to believe that a company will improve its performance in the real market over time and therefore build that belief into the stock price. And if investors already believe that real performance will improve over time, actually improving real performance doesn't exceed their expectations, it merely meets them. Sadly, improving real performance doesn't help much in creating shareholder value.

Microsoft provides a good illustration of this conundrum. Over the past decade, Microsoft has performed quite spectacularly in the real market. It has nearly tripled its revenue and profit. However, with a few brief exceptions, Microsoft stock (adjusted properly for splits) has traded in a narrow range between \$20 and \$30 a share for the entire decade of spectacular real-market performance. The market expects Microsoft to perform pretty much spectacularly in the real market, and so doesn't reward it in the stock price for doing so.

Next, we'll explore the implications of this dynamic for our economy.