Opinion **US**

Managers must be judged on the real score

Roger Martin MAY 11 2009

Myriad theories have been bandied about to explain the recent carnage in the financial sector. While examining lending provisions, banking regulation and derivatives structures can provide some insight, focusing our attention on these areas obscures the real lesson.

The prime culprit for the increasing market volatility that has brought the economy to its knees is a triumvirate of management theories taught in every business school and entrenched in every significant publicly traded company. Intended to ensure longevity and profitability, these theories instead contributed mightily to the technology crash of 2001-02 and the financial services crash of 2008.

Neither would have happened if our business and capital markets theories had been as robust as those used to govern America's National Football League (NFL). You read that right. In the NFL, definitions of and rewards for success are grounded in the "real market" – the touchdowns and field goals scored during a 60-minute game that determine who wins. Football also has an associated "expectations market": betting on the outcome of games.

In business, the real market is the world in which products are produced, revenues earned, expenses paid and dollars of profit logged. But, increasingly, that is not where business looks to determine its success or make decisions regarding rewards. For that, it turns to the expectations market, reflected in a company's stock price.

A stock price in business is the moral equivalent of a point spread in football betting. However, NFL players are strictly forbidden from betting on any game, including their own; 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 slide down the slippery slope began with shareholder value theory. This holds that the primary job of executives is to maximise shareholder value – a combination of measures from the expectations market (appreciation) and the real market (dividends).

Next came principal-agent theory: the notion that the interests of executive "agents" are not naturally aligned with those of shareholder "principals" because executives, as human beings, inevitably put their own interests first.

That in turn led to stock-based compensation alignment theory, which argues that in order to realign management agents with shareholder principals, one has to make executive compensation significantly stock-based.

As a result, unlike NFL players, business executives are compensated primarily on their performance in the expectations market. Only if they increase expectations will their incentives pay off; real market performance is secondary.

This creates a pernicious trap. The instant expectations rise, the base for new shareholders is a price consistent with the new level. This is why Cisco, trading at around $18.60 a share as it dominates its market, struggles to imagine how it can satisfy the expectations of those who bought at $80.

Increasingly, executives have understood the structure and strictures of the game they are playing. Their rewards depend on raising expectations; however, they understand that expectations will eventually outstrip reality and then come crashing down.

Improving performance is the hardest way to increase expectations. Easier ways include engineering a series of acquisitions to give the appearance of rapid growth or employing aggressive accounting to give the appearance of higher profitability. The effect is twofold: enormous expectations-market volatility and flaccid real-market performance; or, more simply, a volatile and poorly performing economy.

The biggest friends of these volatility-driven executives are hedge funds. If they bet correctly on a big expectations swing they make gigabucks; if they bet wrongly, they hand the remaining money back to investors and start another fund. Like executives, hedge fund managers quickly realised that influencing the expectations market was their most powerful money-making tool. If that meant getting together with other hedge funds to organise concerted attacks on target companies to drive down their stock, why not?

It is time to scrap shareholder value theory. Executives should care about shareholders with respect only 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 book value per share.

We also need to 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 may seem draconian, they are necessary to save corporations from themselves. Business 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.

The writer is dean at the Rotman School of Management and director of the School's AIC Institute for Corporate Citizenship. His third book, The Design of Business, is published in October