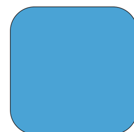


IF WHAT GETS MEASURED GETS MANAGED, MEASURING THE WRONG THING MATTERS

What gets measured gets managed — even when it's pointless to measure and manage it, and even if it harms the purpose of the organization to do so.

PAUL BARNETT

Management guru Peter Drucker is credited with the much-used phrase: "What gets measured gets managed" — a truncated version of the full and much more powerful quote: "What gets measured gets managed — even when it's pointless to measure and manage it, and even if it harms the purpose of the organization to do so."

These words can be read as a warning that was ignored. What we have measured, and continue to measure, is not just pointless, but also dangerous — and played a part in causing the global economic crisis of 2007–2008. But we have not yet learned the lesson. We continue to use pointless measures of the performance of businesses.

Economist Martin Wolf of the *Financial Times* said:

> Almost nothing in economics is more important than thinking through how companies should be managed and for what ends. Unfortunately, we have made a mess of this. That mess has a name. It is shareholder value maximization.[1]

The term, often expressed as maximizing shareholder value, or MSV, was the brainchild of economist Milton Friedman, espoused in his book *Capitalism and Freedom* in 1962.

As the authors of a recent report note, the mantra that the purpose of a company is maximizing shareholder value "became ever more pervasive, taught as an article of faith in the world's business schools," and has been "asserted in

PAUL BARNETT *is founder and CEO of the Strategic Management Forum, a membership organization that exists to advance the professional practice of strategic management across all sectors, all functions, and all levels. Additional information is available at:* http://www.strategicmanagementforum.org.

corporate boardrooms as a non-negotiable."[2]

Previously, CEOs typically managed companies for the benefit of their stakeholders — not just shareholders. The Johnson & Johnson credo, written by its chairman in 1943, is an articulation of the previous approach. It even listed shareholders last in the list of stakeholders whose interests should be served. After serving customers, employees, and communities first, it said:

> Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed and mistakes paid for. New equipment must be purchased, new facilities provided and new products launched. Reserves must be created to provide for adverse times. When we operate according to these principles, the stockholders should realize a fair return.[3]

Robert Wood Johnson II recognized the primacy of customer value as the first priority of a business. He recognized that delivering value depends on employees and that business cannot be independent of the community it serves. These are key points that I hope the reader will consider. Also consider this: He thought shareholders should receive a "fair return." He did not believe that the business should exist to maximize shareholder returns.

OPERATING COMPANIES WITH THE AIM OF MAXIMIZING SHAREHOLDER VALUE LEADS TO WHAT MARTIN WOLF CALLED MISBEHAVIOR.

The Johnson & Johnson credo no doubt determined what measures the business used to assess its performance, and we might expect that indicators of customer satisfaction would be high on the list. Since businesses don't survive without them, putting customer interests first, and making customer satisfaction the first measure of performance, would make common sense, but research by KPMG found that only 7 percent of companies provided performance data on customer focus or satisfaction in a survey of annual reports.[4] It does not mean that they do not collect the data, but I suggest that it does reflect the level of importance they attach to it since they do not consider it to be worth sharing with investors.

The point to be stressed is this: Maximizing shareholder value as a measure of the performance of a business is, as its past champion Jack Welch (former chief executive of General Electric) later said, "the dumbest idea in the world." But, as Michael Skapinker of the *Financial Times* said, it is "likely to endure as a powerful idea" because "it gives managers something against which they can be measured. Other managerial responsibilities — to employees, customers or the community — are numerically less precise."[5]

Operating companies with the aim of maximizing shareholder value leads to what Martin Wolf called misbehavior. It does so by determining priorities and what gets managed. By effectively reversing the order in which stakeholder interests are considered in the Johnson & Johnson credo, the maximizing shareholder value concept pushes management to focus on the wrong priorities. This is in itself bad enough, but the damage is amplified by stock-based compensation for CEOs, designed to align their interests with shareholders.

As Roger Martin explains in the October 2014 issue of *Harvard Business Review*, "After 1980 it seemingly became essential to motivate people financially to exercise their talent,"[6] and skilled leaders saw a major boost to their income as tax policy shifted dramatically, meaning they kept more of their money and they began to be paid in stock and profits. These shifts were the result of the publication of Michael Jensen and William Meckling's article in the *Journal of Financial Economics*. It argued that corporations needed to align the interests of management and shareholders to keep agency costs from causing damage to shareholders and the economy in general.[7] But as Martin has shown, returns to shareholders have actually declined since maximizing shareholder value became the dominant paradigm. As a measure of performance it is "tragically flawed," as Martin comments.[8]

If stock-based compensation for management amplified the problems caused by maximizing shareholder value, the 2 and 20 Formula turbocharged them. The formula sees fund managers charge a 2 percent management fee and take a 20 percent cut of the profits they gener-

ate. It was adopted in venture capital and private equity first, "but the biggest beneficiary was the hedge fund industry, which grew to immense size and applied the 2 and 20 Formula to ever larger and more lucrative pools of limited partner capital."[9]

Research by Steven Kaplan of the University of Chicago and Joshua Rauh of Stanford shows that the top 25 hedge fund managers in 2010 raked in four times the earnings of all the CEOs of the Fortune 500 combined.[10] This is not a problem in itself. It is a problem because the business of a hedge fund is to trade, not invest. "Five minutes is a long holding period" for a hedge fund, as Martin points out, adding:

> Hedge fund managers don't care whether companies in their portfolios do well or badly — they just want stock prices to be volatile. What's more, they want volatility to be extreme. They aren't like their investment manager predecessors, long-term investors who wanted companies to succeed.[11]

It's not surprising then that market volatility has increased dramatically as the hedge fund industry has grown. But less understood is the fact that stock-based compensation also means executives have an incentive to promote volatility too.

Martin explains how this element works, saying:

> A stock price is nothing more than the shared expectations of investors as to a company's future prospects. If expectations for performance rise, the stock price rises, and vice versa. Thus, stock-based compensation motivates executives to focus on managing the expectations of market participants, not on enhancing the value of the company. What's more, because stock-based compensation is generally conferred annually at the prevailing stock price, managers have an interest in volatile expectations for their company. If expectations fall during a given year, the options for deferred stock granted a year later will be priced low. To reap a big reward all managers have to do is help expectations recover to the prior level.[12]

The stupidity of this system may seem hard to believe, but Martin illustrates his point so that it cannot be disbelieved. He notes that the global financial crisis was not at all bad for John Chambers, CEO of Cisco Systems. Owners of shares in 2007 that retained their shares as of the end of June 2014 would have suffered a decline in their stock price of 27 percent and two 60 percent drops along the way. But for Chambers, "those two big dips were handy for picking up attractively priced stock-based compensation." His $53 million in stock-based compensation from five grants appreciated by 18 percent through to June 2014. If, instead of exposing shareholders to massive volatility, Chambers had overseen a steady decline in the share price over the period, "his stock-based compensation would have lost about 20 percent of its value rather than gaining 18 percent."

Martin adds:

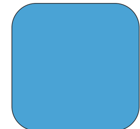
> The effect of modern stock-based compensation is to drive volatility, not appreciation. Of course, the providers of capital are constantly pressing executives to deliver better returns. What the executives do in response is fairly simple. They cut back on labor, the variable they can most easily squeeze in order to signal that they are addressing performance. Such creative destruction can be a good thing for the company and the economy — but it can also compromise the company's long-term capabilities. And managers' incentives to create large changes in the market's expectations suggest that cuts in labour are more likely to be overdone than underdone.[13]

A report into the misrepresentation of earnings published in January 2014 was based on a survey of CFOs. It found that:

> CFOs believe that in any given period a remarkable 20 percent of firms intentionally distort earnings, even when they are adhering to generally accepted accounting principles... The economic magnitude of the misrepresentation is large, averaging about 10 percent of reported earnings. Whilst most misrepresentation involves earnings overstatements, interestingly, one third of firms that are misrepresenting performance are low-balling their earnings or reversing a prior intentional overstatement.[14]

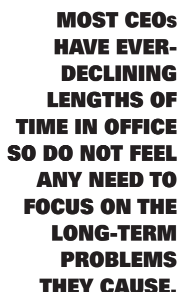
These findings seem to support the notion that the reporting of earnings is used to stimulate managed volatility.

Before looking at a case that is currently in the news, let me summarize the key points. Maximizing shareholder value is the "dumbest idea in the world." It encourages the use of false measures of success, a problem made worse by the alignment of CEO incentives with those of shareholders using stock-based compensation. This combined problem is turbocharged by the 2 and 20 Formula,



THE BUSINESS OF A HEDGE FUND IS TO TRADE, NOT INVEST.

providing both hedge fund managers and CEOs with a strong incentive to stimulate managed volatility from which they can reap massive gains, as illustrated by the Cisco Systems example.



MOST CEOs HAVE EVER-DECLINING LENGTHS OF TIME IN OFFICE SO DO NOT FEEL ANY NEED TO FOCUS ON THE LONG-TERM PROBLEMS THEY CAUSE.

The retail supermarket giant Tesco is currently in the news after announcing it had overstated its anticipated profits by 250 million. As one journalist rightly commented, "If analysts had focused more on corporate culture and less on predicted numbers, they might have had a better understanding of the dynamics of the business." The same journalist goes on to note that "there have long been things in Tesco's behaviour and business model that did not seem sustainable, and were possibly even toxic," adding that:

> Companies are about people, not numbers, and the clues to these now-obvious problems could be found in the company's reputation. This was stellar in the City because analysts will tell you the foundation of a great corporate reputation is the ability to grow market share and profits year after year. But the customers, suppliers and communities where the company operates had a different perspective. Tesco's reputation with these stakeholders was sometimes rather a contrast.[15]

I am going to add further quotes from this same journalist because they illustrate the point between what I will refer to as "growth at any price" and "values driven value creation," or what you might like to call "quality growth."

He made the point that:

> Expansion was crucial to the business. What set Tesco apart was not its offer to the customers, the range of its products or the price at which they were offered. It grew remorselessly because it had a machine that could build more stores in better locations than any of its competitors. Then the internet turned this plus into a minus almost overnight.

With the pressure it was under, the author notes that Tesco's treatment of its suppliers was also causing increasing concern.

In his damning criticism of the City and "investors," he says:

> A visitor from Mars would have looked at these signs of alienation in communities, of customers and of suppliers and think that Tesco had a problem — that this was not a sustainable model and that sooner or later these issues would come together to undermine the business. But not so the City; it could not see past the numbers.

He notes that the reason for this was "perhaps because most fund managers tend to hold shares for a relatively short time, less than a year, and therefore feel no particular need to focus on a potential long-term problem." To this last comment he could have added that most CEOs have ever-declining lengths of time in office so do not feel any need to focus on the long-term problems they cause either.

In his final attacks on the role of the City the journalist said:

> The City asks how this could happen when it should ask how it missed or failed to heed the warnings implicit in all the other signals, because this [the overstatement of anticipated profits] is simply the most extreme manifestation of behavior patterns that have been visible for years. When the pressure to perform becomes intolerable, good people will often do bad things. It is the culture which is bad, not the people. But it is high time investment managers, who charge the public for their expertise and judgement, paid more attention to that culture.

I take this to mean that he believes they should focus on indicators (measures) that matter.

These comments, written in September 2014, may seem overly harsh to some readers, but not when you consider that Lord MacLaurin, former chairman of the supermarket, publicly attacked the performance of Sir Terry Leahy as CEO. He did so at the company's annual general meeting in 2013. This followed an annual fall in profits of 50 percent, growing problems in a number of its markets, and a write-down in property investments of €804 million, according to a report in *The Guardian* in June 2013.[16] On the day that Warren Buffett, one of the largest stakeholders in Tesco, admitted he had made a huge mistake,[17] Tesco's share price was down nearly 50 percent on the year, and Buffett was looking at a $700 million loss.

The journalist whose comments on the Tesco saga I quoted extensively talked about customers, employees, and the community as being the victims of a "machine" that was focused on growth at any price as a means of satisfying the demands of the City. By the City what do

we really mean — not share*holders*, but share*traders*, not *investors* but *speculators*?

Could it be argued that maximizing shareholder returns would be fine if it were made clear that this really did mean share*holders* not share*traders*? And perhaps if stock-based compensation were rethought or redesigned? Certainly these would be improvements. But I would also argue that shareholders should only ever get a "fair return," as proposed in the Johnson & Johnson credo. I say this because to me other stakeholders are also either invested in the business in various ways or, in the case of society at large, grant it a license to operate for the purpose of producing social value, not only private profit.

To those such as Peter Drucker and Charles Handy, and a growing number of entrepreneurs today, the wisdom of combining profit and purpose is just common sense. And it is reassuring to know that the "fundamental question of the purpose of businesses is, once again, up for debate," according to a study by Cranfield University School of Management, which was commissioned by Coca-Cola Enterprises.[18]

The report compared the opinions of current business leaders with those of future business leaders (an international group of recent MBA graduates) and found that 88 percent of current leaders and 90 percent of future leaders agreed that "businesses should have social purpose." It would suggest that the notion of maximizing shareholder value may well be dead and buried in the future.

In conclusion, I suggest that the biggest challenge in bringing about change was highlighted by Michael Skapinker in the *Financial Times*: "Other managerial responsibilities — to employees, customers or the community — are numerically less precise."[19] But I do not think this is any excuse for not working out what the new metrics should be. Thankfully several initiatives are focused on this, but the right measures should also be a mix that is specific to each company's business model.

In *Beyond Performance* Scott Keller and Colin Price, both of McKinsey & Company, sum up the problem:

> When it comes to achieving and sustaining excellence in performance, what separates winners from losers is, paradoxically, the very focus on performance itself. Performance-focused leaders invest heavily in those things that enable targets to be met quarter by quarter, year by year. What they tend to neglect, however, are investments in company health — investments in the organization that need to be made today in order to survive and thrive tomorrow.[20]

Based on their large-scale and long-term research, Keller and Price have developed an evidence-based framework to help managers balance performance and health, but fixing the problem must necessarily involve boards and investors addressing the problem of perverse incentives that are corrupting the system. In his latest *Harvard Business Review* article, Martin suggested that change could be triggered by the top 50 pension and sovereign wealth funds as institutional investors with control over funds of $11.5 trillion. Amongst other things, he suggests that they must stop supplying large amounts of capital to hedge funds, and that they should stop supporting stock-based compensation.[21]

In the context of Martin's recommendations, the decision by California Public Employees' Retirement System (CalPERS), the largest U.S. public pension fund, to withdraw all its investments in hedge funds should be seen as a positive development. On the other hand, news from the U.K. that the growth in directors' total earnings was propelled by share awards rather than salaries is a real concern, although I understand that some are long-term incentive share awards.[22] ■

NOTES

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[9] *Op. cit.* note 6.

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[11] *Op. cit.* note 6.

[12] *Ibid.*

[13] *Op. cit.* note 6.

[14] Dichev, I.D., Graham, J.R., Harvey, C.R., and Rajgopal, S., The misrepresentation of earnings (Sept 12, 2014). Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2376408.

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[17] Stevenson, A., Warren Buffet: I made a mistake on Tesco, CNBC (Oct 3, 2014). Available at: http://www.cnbc.com/id/102054399#.

[18] *Op. cit.* note 2.

[19] *Op. cit.* note 5.

[20] Keller, S. and Price, C., *Beyond Performance*. (Hoboken, NJ: John Wiley & Sons, 2011).

[21] *Op. cit.* note 6.

[22] Strategic Management Forum Focus Groups (think tanks) will look at the issues raised in this article from a number of perspectives. The groups include: The Strategic Importance of Business Reporting, The Strategic Importance of Reputation, and The Future of Finance. For details visit: www.strategicmanagementforum.org.