Harvard Business Review

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The Goldman Bonuses: I'm Shocked, Shocked

10:17 AM Friday October 16, 2009
by Roger Martin | Comments (14)

In the debate surrounding the Goldman Sachs bonuses, it feels to me as though commentators are missing some fundamentals. They are looking at the size of the potential bonuses and, in the wake of the $10 billion of bailout money Goldman received in the darkest hours of the financial crisis, asking, "How could they?"

In my view, we should not be the least bit surprised. For the first 130 years of its 140-year existence, Goldman Sachs was a partnership; its sole purpose for that period was to use the partners' money to make as much more money for the partners as humanly possible.

In 1999, Goldman went public and its sole purpose changed: thereafter its purpose was to use the public shareholders' capital to make as much money for the partners as humanly possible. The story isn't much more complicated. So we should not be surprised that Goldman has chosen to use taxpayers' money to make as much money for the partners as humanly possible — after all, it's just another pool of capital to be used to achieve the end goal of enriching the Goldman partners.

I find that the capital markets are quite Pollyanna-ish about publicly traded professional service firms and have written about that in HBR previously ("Capital versus Talent: The Battle That's Reshaping Business"). The natural form of business organization for a professional service firm, such as an investment bank, law firm, consulting firm or ad agency, is a partnership rather than a public company.

The reason goes right back to a basic Michael Porter five-forces analysis. The key supplied input in a professional services firm is a group of talented professionals and their supplier power is immense. They have the power to extract a disproportionate amount of the profitability out of the enterprise by pushing up their own compensation.

How should the enterprise seek to ameliorate supplier power? Porter has the answer: backwards integrate. In the case of aluminum producers, that means buying your bauxite supplier. In the case of a law firm or investment bank, it means acquiring your supplier of talent by making the talent the owner. The way to do that is structure the enterprise as a partnership. The suppliers won't put a gun to their own heads and yell: "Give me more compensation or I will blow my own head off." That would be silly.

And so it was for investment banks for the longest time. They were money-making partnerships and the minute a talented associate got sufficiently powerful that he/she would be in a position to start extracting major remuneration from the partnership, the partnership counter-struck by making the associate a partner. The new partner would then have balanced incentives that would prevent him or her from overtaxing the firm to the point of its extinction.

But in due course, these partnerships recognized that if they could convince naïve external capital to give them more resources, they would have a brand new pool of capital from which to extract value. They could show what an impressive and profitable (before partner distributions) a business they were in order to entice external shareholders into the tent. And as soon as they had the external shareholders' capital, they would return to the sole purpose of making money for the partners-turned-senior executives.

Thanks to the external capital, they could engage in lots more sales and trading and principal investing activities. Eventually these would drive the major investment banks off the cliff in the fall of 2008. Even Goldman saw its share price fall to $52 in November 2008, in the middle of the Lehman Brothers/Bear Stearns crisis, a dollar less than its $53/share IPO price in May 1999. It wasn't much of a return for shareholders over ten years, though the Goldman bankers during that period earned wonderful compensation. But thankfully for those Goldman bankers, the taxpayers stepped in and stabilized the financial markets with a huge infusion of their current and future tax dollars and Goldman shares traded above $190/share within a year. Life is good again and it is time for the bonuses to flow, as they always have.

So this is not new at all. The order of priority is: Goldman bankers first, the external shareholders second, and everybody else last. This is not a secret and has never been. The Goldman bankers are not trying to be sneaky. In the current situation, if sounding sorrowful or giving a bit more money to charities helps preserve Goldman's primary imperative of maximizing banker earnings in the future, we will see a dollop of each. But there should be no confusion as to the purpose of any such gesture.

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