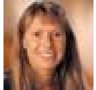

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The Uncommon Navigator

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BUSINESS

What Wall Street Should Learn from the NFL

At first pass (so to speak), the linebackers of the National Football League and the CEOs of corporate America might seem to have little in common, other than larger-than-average paychecks. But a recent article written by Roger Martin, Dean of the University of Toronto's Rotman School of Management, argues quite convincingly that they share more than most of us would think. And, more importantly, that the NFL has some very important lessons to teach American business leaders.

Personally, I'm impressed that a Canadian-born, Harvard-educated economist even *thought* to employ a football analogy to explain how flawed economic theories about compensation and investment contributed to the recent melt-down on Wall Street. More impressive still is that his basic argument, and the economics behind it, is so easy to follow, once you view it in football terms.

Martin's argument goes like this: both the NFL and publicly-traded companies operate in two different worlds. First, there is the real world. In football, that's where the players play real games, with real touchdowns, and games are won and lost. In business, that's where real products and services are developed, produced and sold. The second world is the world of expectations. In football, this is where bookies establish "point spreads" for each upcoming game, so people have to bet on not just whether or not a team will win or lose, but by how much. That way, a strong team isn't an easy-win bet. You have to bet whether or not the strong team will exceed expectations (the point spread) or not. In business, the

"expectations" world is called the stock market. Like point spreads, stock prices are based not on actual product sales or performance, but on *expectations* of a company's future performance.

The problem with expectations, and especially *rising* expectations, is that at some point, they become impossible to sustain. Martin gives the example of the New England Patriots, who in 2007 did not lose a single regular-season game. As a result, the point spread for their 14th game, against the New York Jets, was "a record high of 24.5." The Patriots won the game, but only by 10 points, thus winning the game in the real world, but failing to beat the spread in the expectations world.

Fortunately for the Patriots, the NFL compensates its players and managers based only on real-world results. Not only are they not *compensated* on beating the spread, they would be banned from football forever if they ever dared to bet money on whether or not their team would do so. Why? Because if they stood to gain from fluctuations in the expectations world, they might be tempted to throw or fudge the real game for their own financial remuneration. The integrity of the game would be compromised.

(You see where this is going, right? Like I said, it's really easy to follow, when you look at it in football terms.) In the business world, on the other hand, CEO pay has become more and more closely linked not to real-world results, but to the company's performance in the expectations (stock market) world. (Martin points to three flawed economic theories to explain how and why that evolution occurred, but the gist is that it was decided that CEOs needed to have their interests more aligned with the "principals" who invested in the company, and compensating executives with stock, or based on stock performance, was seen as a good way to make that alignment happen.)

But one of the problems with that approach is that expectations have an insatiable and ever-growing appetite (as the Patriots' rising point-spread demonstrates). A company might develop a very successful product, raising the stock value "x" amount. But once that product is launched, and the stock adjusts up accordingly, the success of that product, while perhaps profitable and stable over the long-term, isn't enough to drive the stock up further. So other strategies are needed to keep up the pace--and satisfy new stockholders, who bought at the higher price. As a result, executives are tempted (or pressured) to make decisions that aren't necessarily good for long-term stability or profitability, but which increase the next quarter's stock price.

And yet the expectations keep rising, and the math gets harder and harder to manage without big risks, or increasingly creative approaches to bookkeeping. And that's even without the concerted efforts of executives and hedge fund folks to drive prices up or down for their own profit.

In short, Martin suggests that the common sense that led the NFL (and most, if not all, professional sports) to prohibit players from betting on their own games should be adopted by the corporate boards of America, as well. Speculation is all fun and fine, as long as it's not linked to, or able to influence, the real game being played. Compensation to executives, Martin says, should be completely separate from stock

market performance, and compensation to investors should be in the form of "dividends plus appreciation of book value of equity in the long run."

"The true key to long-term sustainability," Martin argues, "is building customer and employee bases that enable long-term profitability. If we are to emerge from the current mess, executives must switch their focus entirely to the real market and completely ignore the expectations market. Management should not, and in fact cannot, protect the interests of those who buy shares on the open market at prices that are purely a function of expectations."

If that sounds radical or impossible, stop and imagine, for a moment, NFL owners arguing that part of the players' pay should be linked to how the bookies make out on each game, instead of just playing full-out to win the best game they know how to play. In the real world. And for keeps.

The best version of Martin's article is in the most recent Rotman Magazine, but unless you already subscribe, there's a fee to download it. (Raising another interesting question about how academic journals still routinely charge to view content, even as more "mainstream" media outlets have failed to make that model work.) But the *Financial Times* carried an abbreviated version of the article in a recent issue that can be viewed for free. Well worth reading the latter, if you can't justify, or get hold of, a copy of the former.