What Investors Should Learn From the NFL

Roger Martin
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Too many executives are willing to sacrifice the future for the present. Roger Martin on why it's the whole game that matters—not just the the earnings score at the end of the quarters.

In the world of business, our time horizon is ever-shrinking. Once upon a time, in the era of the family-owned firm, John D. Rockefeller, Andrew Carnegie, and their peers set out to build companies that would last forever, securing bright futures for their families through steady growth. Then, as we shifted to professional managers in the 1940s and '50s, with leaders like GM's Alfred Sloan, the horizon grew smaller—decades, perhaps, rather than generations. But by the end of the 20th century, the typical CEO's attention was focused on a ludicrously short time frame—this year, or more likely, this quarter.

With the dawn of the cult of shareholder value maximization in the 1970s and 1980s, CEOs turned their attention away from the business of developing products, serving customers, and turning real profits to managing the expectation of the capital markets. Through the expansion of earnings guidance practices, analyst calls, and media scrutiny, CEOs have come to define their job to be meeting the numbers—that is, living up to the consensus analyst earning expectations, quarter by quarter.

This seems, at first blush, to be a good thing. We want our executives to be focused on increasing earnings over time—and a focus on the capital markets should encourage that. But not if the time horizon used is too short. As investors, we should want companies to build for the long haul, not just the next few weeks. And it has become all too clear that executives are willing to sacrifice the future for the present. In a 2005 study, John Graham, Campbell Harvey, and Shiva Rajgopal found that "the majority of managers would avoid initiating a positive NPV [net present value] project if it meant falling short of the current quarter's consensus earnings. Similarly, more than three-fourths of the surveyed executives would give up economic value in exchange for smooth earnings."

Why the focus on short-term quarterly results? Because our CEOs are rewarded on that basis, through the use of stock-based incentive compensation, which now represents a huge proportion of the CEO's overall pay package. As expectations about the company rise, the stock price goes up and the CEO gets ever wealthier. There is then huge incentive to keep the capital markets bullish on your stock, and the capital markets care very much about short-term results. Exceed the quarterly expectations and your stock goes up. Fail to do so, as Google did recently, and your stock will take a hit—even if real earnings look very good indeed.

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Think back to the 2010 Super Bowl between the Indianapolis Colts and the New Orleans Saints. The Indianapolis Colts were heavily favored to win the game. The point spread (which is the moral equivalent of the stock price in business, in that it captures the general expectations of all bettors/investors about what will happen in the future), was set at seven points in favor of the Colts. That meant that, in general, there was an expectation that the Colts would win by seven points. Anyone betting for the Colts would only win money if the Colts actually outperformed that expectation, beating the Saints by more than that point spread.

Things started out well for the Colts. By the end of the first quarter, they were up 10-0, in control of the game and outpacing the expectations of the bettors. If QB Peyton Manning and his coach Jim Caldwell were being rewarded based on short-term performance in the expectations market, they would have made out like bandits. They could have cashed in options, earned bonuses and called it a day. For Saints QB and his coach Sean Payton, well, things weren't looking so good. If they were CEO and chairman, underperforming for the quarter might well have led to unemployment. They certainly would have been called on the carpet by analysts and media pundits. But things don't work that way in football. It isn't the quarter that matters—it's the whole game. And at the end of that game, the Saints came out on top 31-17, thanks to brilliant coaching and play in the second half of the game.

In business, we have forgotten that it is the whole game that matters—real performance, over a very long time period, not short-term performance relative to expectations. As long as we embrace the short-term mindset, we will face increasing volatility in the capital markets and shorter CEO tenure. We would do better to follow the example of NFL football, which forbids its players and coaches from even thinking about the expectations bound up in the point spread. In business, we force our CEOs to think of almost nothing else. It's a game that needs fixing.

Roger Martin is author of Fixing the Game: Bubbles, Crashes and What Capitalism can Learn *from the NFL, which was published May 3 by Harvard Business Review Press.*

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