Outperform with Expectations-Based Management™

A State-of-the-Art Approach to Creating and Enhancing Shareholder Value

Tom Copeland
and
Aaron Dolgoff
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John Wiley & Sons, Inc.
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Why should you read this book? Because it will improve your company’s performance by focusing your management team on what counts, namely beating your (i.e., management’s) and the market’s (i.e., investors’) expectations. We show that the correlation between the return to shareholders and changes in expectations is about ten times stronger than it is with earnings, earnings growth, economic value added (EVA®), and the growth in EVA.¹ We show how Expectations-Based Management (EBM™) helps you to understand communications with potential investors, helps you to set internal performance standards, and how it can refocus your strategy.² We believe you will find EBM to be simple, direct, and common sense. You will wonder, as we have, why it has not been part of every manager’s toolkit for a long time. Indeed, many will recognize EBM principles and practices in their own current behavior—behavior that often seems at odds with existing systems but that managers instinctively know to be correct.

One day in the early 1980s an entrepreneur by the name of David Murdock, owner of Pacific Holding Corporation, was invited to speak to a corporate finance class at UCLA’s Graduate School of Management about why he had paid $200 million—a one hundred percent premium—to buy Cannon Mills and take it private. The marketplace thought it was worth only $100 million.

¹EVA is a registered trademark of Stern Stewart & Co.
²Expectations-Based Management (EBM) is a registered trademark of the Monitor Group.
Cannon Mills is a textile producer of high-quality white goods such as sheets and bath towels. Located in the town of Cannonapolis, North Carolina, it was closely held by various members of the Cannon family. Not long before, another tender offer for the company had been refused.

Listen to this story and identify the various expectations that led to the transaction and subsequent events. Certainly the market as a whole had expectations that caused it to value Cannon Mills at roughly $100 million. The members of the Cannon family had expectations that led them to turn down a substantially higher offer than the $100 million. And David Murdock had expectations that led him to believe the company was worth over $200 million.

What Murdock said in the classroom that day made the class realize that he understood very well that his own expectations had to be better founded in fact than those of the other parties. Simply put, Murdock had to have better judgment and better ideas.

He told the class that day that his first step was to buy more than five percent of the outstanding shares. According to the Williams Act this made him an insider and required him to announce the fact to the public. It also gave Murdock the right to visit the company and look over its records. After having done so, he quickly tendered for the remainder of the outstanding stock.

“How did I recover the $100 million premium?” he asked rhetorically. “Let’s review the facts. First, the company had a defined benefit pension plan that was overfunded by $80 million. Second, it had a $60 million LIFO inventory reserve. Third, it owned most of the housing in Cannonapolis, and carried it on the books at original purchase price. Finally, it owned 100,000 acres of prime timber land that was also undervalued on the books.” These numbers alone easily added up to more than the $100 million premium.

But then he said, “These facts are not why I bought the company. They were already publicly available information and were baked into the stock price.” The class could hardly believe what they were hearing. Murdock was right. Efficient markets do actually reflect relevant economic information in the stock price. It contains all public information about expectations of future performance—the so-called market expectations.

Murdock then continued, “Now let me tell you why I bought the company. First, I learned during my visit that the top 120 managers were all family relatives—brothers, sisters, aunts, uncles, cousins, nephews, nieces, and

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3A last-in-first-out (LIFO) inventory reserve refers to potentially higher profits that may result in the future if the company should accelerate sales and begin to expense older layers of inventory that are carried at lower cost.
the like. I replaced them all with 12 carefully selected managers. Second, the plant was operating during six day shifts per week. I cut prices, gained market share, and now operate 12 shifts per week.” It is not difficult to interpret what Murdock had said. His two ideas earned him over $100 million by cutting corporate overhead by 80 to 90 percent, and nearly doubling the return on invested capital (ROIC) by dramatically increasing the ratio of sales per dollar of capital employed. Neither the family owners nor the other takeover firm had similar expectations. David Murdock created value by understanding what information was already included in the stock price and not paying for it twice. He understood the market expectations. He also understood management expectations. There was a huge disconnect between his own expectations and those of management. Murdock arbitraged the difference.

**Expectations-Based Management**

Expectations-Based Management is about the link between performance standards, performance measurement, and the achievement of performance. It says that stock price goes up if performance exceeds the market’s expectations. David Murdock’s takeover of Cannon Mills dramatically changed its expected performance and he eventually sold the company for a sizeable gain. We will talk about how to set and revise expectations later in the book. For now let’s stick with the challenge of defining EBM.

When a CEO defines performance measurement right, then performance improvement follows. But what are the attributes of the “right” measure of performance? Which measure comes closest to being the “ideal,” and how do you use it to improve performance? These three themes are what this book is all about.

We want the measure of performance that has the strongest link to the creation of wealth for the owners of the company—its shareholders—whether they are private or public. Chapter 1 discusses the details, but the final word is that in order to create wealth for shareholders by raising the stock price, companies must exceed expectations both short-term and long-term, expectations of both income statement and balance sheet performance, and expectations about daily operating value drivers.

In 1890 Sir Alfred Marshall explained in *Principles of Economics* (Vol. 1, p. 142) a concept called economic profit. It is “What remains of his [the owner’s or manager’s] profits after deducting interest on his capital at the current rate…” Marshall’s economic profit is the accounting definition of profit minus a charge for the use of capital. It requires that the rate of return on capital invested be greater than the cost of capital. It extends the definition of profitability from sole focus on the income statement to also include the balance sheet. It predicts that if two companies have the same
profit, the one that uses less capital to generate said profit will have greater value for shareholders.

We agree that economic profit is an important and useful concept (especially for making capital investment decisions), but it falls short of the complete reality because it fails to include the rate of changing expectations as it affects the stock price. Consider two companies with the same economic profit. Suppose that they both earned 20 percent on $1,000 of invested capital, and that their cost of capital was 10 percent. They would both report economic profit of $(20\% - 10\%) \times 1,000 = 100$ to their boards of directors. Yet suppose the first company was expected to earn a 30 percent return on invested capital while the second was expected to earn 15 percent. The stock price of the first company will fall as the market revises its expectations downward, while the stock price of the second company will rise because it exceeded expectations. This example exposes the major shortcoming of economic profit—it does not compare actual with expected performance and is therefore decoupled from stock price movements.

Because EBM is based on changes in expectations of economic profit, it is more complete than other measures. Its correlation to (market-adjusted) total return to shareholders is an order of magnitude higher than traditional measures such as earnings per share and earnings growth (that do not include balance sheet information and ignore expectations), and economic profit and the growth in economic profit (that both ignore expectations.)

All measures of performance other than EBM fail to use expectations. As an example, take economic value added (EVA), which is defined as the amount of capital employed multiplied by the spread between the return on capital and its cost—the same definition as economic profit. Positive EVA results from good income statement and balance sheet management, and growth in EVA requires a multiperiod point of view. But EVA does not measure performance against expectations. It is positive when a business earns more than the cost of capital employed—an objective standard. For example, suppose your cost of capital is 10 percent and you earned 15 percent last year and 18 percent this year on $1 billion of capital employed (both years). Last year your EVA was $50 million and this year it is $80 million. Proponents of EVA argue that this performance surely implies that your stock price will increase. What if we told you that your owners expected you to earn a 20 percent return on invested capital both years and in the long run? If so, you would have failed to meet or exceed their expectations and when they revise those expectations downward, your stock price will fall.

Chapter 2 presents documentary evidence that compares earnings, earnings growth, EVA, and EVA growth to EBM in a horse race to see which of these performance measures actually provides the best link to the (market-adjusted) total return to shareholders. The results were refereed and published in *The Review of Accounting Studies*, a top academic journal, and
indicate that EBM is roughly 10 times better at explaining the total return to shareholders (TRS) than the other performance metrics with which it was compared.

Three other results emerge as well. First, the market reaction to changes in expectations of long-term earnings growth is eight to ten times larger than its reaction to changes in expectations about next year’s earnings. Second, changes in expectations this year about this year’s earnings are not significantly related to the return to shareholders in the presence of changes in expectations about next year’s earnings and in long-term earnings growth. Third, increases in noise are associated with lower return to shareholders.

How to Use EBM

Over our 25 years as consultants, we have spent hundreds of hours with CEOs ruminating over the topic of which measure of performance is best and how to use it to run a company. EBM is not a new fad. It is common sense. We define it as a system of three mutually consistent and linked ways of measuring and managing performance. We have proved that changes in expectations have a stronger logical and statistical link to the actual total returns to shareholders than any of the alternative measures.

A simple numerical example illustrates the fundamental difference between EBM and EVA when measuring business unit performance. Suppose that we are valuing a company with two business units, each with perpetual, level cash flows. The entity value is simply the expected cash flow divided by the cost of capital, assumed to be 10 percent per year. Data for the example is given in Table P.1. Relative to the cost of capital, both divisions did well, and so did the company.

But the value of the company is defined as its expected after-tax operating income divided by the cost of capital. Expectations at the beginning of the period are given in the “E_0(ROIC)” column (column 2) of Table P.1. Therefore, the beginning-of-period value of the company is 17.5 percent.

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>E_0(ROIC)</th>
<th>A_1(ROIC)</th>
<th>WACC</th>
<th>I_0</th>
<th>EVA</th>
<th>EBM</th>
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<tr>
<td>A</td>
<td>20%</td>
<td>15%</td>
<td>10%</td>
<td>$1,000</td>
<td>$50</td>
<td>$-50</td>
</tr>
<tr>
<td>B</td>
<td>15%</td>
<td>20%</td>
<td>10%</td>
<td>$1,000</td>
<td>$100</td>
<td>$50</td>
</tr>
<tr>
<td>Total</td>
<td>17.5%</td>
<td>17.5%</td>
<td>10%</td>
<td>$2,000</td>
<td>$150</td>
<td>0</td>
</tr>
</tbody>
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(the expected \( ROIC \)) times the \$2,000 of capital invested (i.e. \$350) divided by the cost of capital of 10 percent—resulting in a current entity value of \$3,500.

To determine the change in the value of the company from the beginning to the end of the time period, we need to know what the end-of-period expectations are. To keep the example simple, let’s assume that investors believe the actual period-one results, \( A_1(ROIC) \), will continue unchanged forever. For example, they revise their expectations for business unit A downward from 20 percent to 15 percent. Consequently, column 3, the actual period-one results, becomes the new forward-looking expectations, \( E_1(ROIC) \). The end-of-year value, based on the revised expectations, becomes 17.5 percent times \$2,000 of capital, divided by the unchanged 10 percent cost of capital. The beginning-of-period value is \$3,500 and so is the end-of-period value. There is no change in shareholders’ wealth.

If we compare EVA to EBM, we see that EBM for the company as a whole is \$0 and that this is consistent with the change in value that we just calculated. On the other hand, EVA is positive \$150, and presumably we should see an increase in value to accompany it. But we do not. Why? Because the market rewards management for performance that exceeds expectations and the company has failed to do so.

In review, both EVA and EBM include income and balance sheet information combined in the form of free cash flows. Both can be extended to a multiperiod context, but EVA does not include any information about the changes in expectations that drive stock prices. Therefore it is not surprising that EVA is not highly correlated with the (market-adjusted) total return to shares. EBM is highly correlated because it is based on changes in expectations.

## Change in Mindset

The tone and character of companies that measure their performance relative to expectations is very different than those that measure their performance vis-à-vis the cost of capital. When the management team realizes just how important expectations are, they try to become better informed in order to better establish internal expected performance standards. They also become more investor-oriented because they believe that successful performance means understanding and exceeding investor expectations rather than earning more than the cost of capital. If we were to characterize the difference in corporate personality between companies that use EBM and those that do not, we would say that EBM companies are more extroverted and communicate better. Their standards are set by what others think of them—and they know it.
What Will I Do Differently and How Will My Company Use EBM?

A chapter in a book called The Europeans, strangely enough, is dedicated to the idiosyncracies of the Americans. They are, the book claims, incredibly enamored with what is new. In fact, to be worthwhile at all, a fashion, an idea, or a strategy must be new and distinctive. This fetish is strange to Europeans, who live in a world where thousands of years of history lead one to believe that things may be better or worse, but are rarely new. Whether the reader judges what we have to say as new or better is a matter of opinion—but you will do things differently. You will:

Understand the cause-and-effect relationship between performance and your stock price. Business unit performance should not be measured relative to the cost of capital, but rather whether actual performance is better than expected. Your stock price is handicapped like a horse race. The investor who bets on your company makes good returns when your company beats the odds. A horse that is favored to win but finishes second doesn’t earn much, while a horse that was supposed only to show but ends up winning the race earns handsome returns.

Use two hurdle rates (if investment is to increase your stock price)—not one. The market has baked its expectations for the return on existing invested capital into your share price. Maintenance investments are made to keep this existing capital performing at expected levels and therefore must earn the expected return on invested capital in order to lift your share price—at successful companies, this is usually a percentage that is greater than the cost of capital. Maintenance investments that earn less than expected but more than the cost of capital are better than no investments at all, but your stock price will not grow enough to return the cost of equity.

New investments, such as acquisitions, are unexpected and, if they are competitive, will create value as long as they earn more than the cost of capital.

Thus, to increase your stock price it is necessary to earn an ROIC greater than what the market expects on maintenance investment—one hurdle rate. And for new (unexpected) investments it is necessary to earn more than the cost of capital—a second hurdle rate.

Communicate better with potential investors. Management sets expectations, if it chooses to do so, because it is better informed about the destiny of the company. EBM provides strong empirical evidence that information about the long-run growth of the firm is much more important than infor-
mation about this quarter’s earnings, and that more noise in communica-

tion with the market is associated with lower share prices.

*Have stronger budgeting and planning.* The budgeting process has been
described as being as painful as a root canal, and less useful. EBM, how-
ever, requires that you beat expectations when you want to manage busi-
ness unit performance, and they are established via the budgeting and
planning process. It is a subjective process to be sure, and therefore
requires active and knowledgable participation of all levels of management.

*Have incentives better aligned with performance.* We recast compensation.
Instead of thinking about salary and bonus, we parse total compensaton
into expected and unexpected components—and then define the unex-
pected component as pay at risk. It turns out that the median amount of
pay at risk for the CEO of a U.S.–based firm is only 17 percent of total com-
pensation. We also suggest that the pay-for-performance relationship be
made more linear with skin in the game.

*Be able to reverse engineer your stock price to understand what the market
expects.* There is a lot of information in your stock price. By reverse engi-
neering it and working back to the set of market expectations about rev-
enue growth, operating profit, the return on invested capital, capital
turnover, and financial leverage, you will build insight about differences
between what the market expects and what you can deliver.

**The Three Parts of EBM**

Figure P.1 shows EBM as a three-part system, but all three are tied together
logically so that they form an integrated managerial perspective. There is a
“golden thread” that extends from daily performance on operating value
drivers to annual performance as measured by EBM, to the value of the
firm that is driven by the changes in expectations over the indefinite future.
An improvement in performance on a value driver, such as the number
of sales calls per sales person, can, in principle, be traced through to its
effect on EBM for the relevant business unit, and to the value of the firm
as a whole.

What is different is that performance must exceed expectations to cre-
ate shareholder value. This is a subjective criterion and to get it right you
will have to put more time into getting your planning and budgeting
process retuned, changing your firm’s incentive system, listening to what
the market is telling you about its expectations for your company, and
stressing value creation as the search for ways to exceed expectations.
Figure P.1 Tripartite EBM system.
Guidelines for Reading this Book

“The devil is in the details,” as they say. But the details can be thorny and tedious. If you want the top line, read Chapter 1—it compares various measures of performance and discusses their shortcomings. Your current performance standard is undoubtedly there. Read only the first four parts of Chapter 2. They summarize the rest of it. Skip to Chapters 3, 4, and 6, which discuss how to make capital expenditures wisely, then to Chapter 8 (external communications) and Chapter 9 (incentive design).

If your philosophy is “In for a pound, in for a ton,” then the whole book is a good read. Chapter 2 presents irrefutable empirical evidence that confirms the strong link between EBM and the return to shareholders. Chapter 5 discusses the weighted average cost of capital. Chapter 10 discusses training and implementation. Chapter 11 takes the investor’s perspective. Chapter 12 compares competing value-based management systems. Chapter 13 discusses public policy implications.
Dedication and
Acknowledgments*

The intellectual foundations of our work go back centuries but emerged in modern times with the valuation work of Miller and Modigliani [1962], Malkiel [1963], and Gordon [1959]. These were all formula-based mathematical models, and have since been replaced by spreadsheet modeling—an approach pioneered by Al Rappaport and his partner Carl Nobel, and refined by others including Bennett Stewart and Joel Stern. The idea that expectations are important we trace back to John Maynard Keynes [1936] and Paul Samuelson [1965] and Robert Lucas [1975] in economic theory and to Al Rappaport [1986, 2001], more recently for good advice to investors. The theme of managing for value has also been around a long time and is traceable all the way back to Alfred Marshall [1890] and his notion of economic profit. In modern times Al Rappaport (ALCAR), Joel Stern (Stern Stewart), Jim McTaggert (Marakon) Bart McFadden (HOLT and BCG), and Tom Copeland, Tim Koller, and Jack Murrin (McKinsey and Monitor) are among the larger list of advocates.

We wish to thank the many people who helped make this book possible. First, our loved ones who supported us throughout—Maggie, Timothy, and Michael Copeland; and Jennifer and Maya Dolgoff. Then our colleagues: J. Fred Weston, Al Rappaport, Rob McLean, Hardy Tey, Alberto Moel, Alan Kantrow, Betsy Seybolt.

And finally the hard-working people at John Wiley & Sons: Bill Falloon, Todd Tedesco, and Jennifer MacDonald.

*See the back of the book for details of bibliographic citations.
Measuring Performance

Chapter 1—The Right Objective, Strategy, and Metric
Chapter 2—Expectations Count: The Evidence

This section sets the stage. Chapter 1 discusses the major flaws in traditional measures of performance and points out the salient fact that they are not correlated with the total return to shareholders (TRS) because they have no information about expected outcomes. Expectations-Based Management™ (EBM™) does have high correlation with TRS because it looks at performance relative to expectations. Chapter 2 provides irrefutable empirical evidence that EBM is highly correlated with market-adjusted total return to shareholders while other measures are not.
We are writing about one of the most important CEO top-of-mind issues—performance measurement. The way people behave in the workplace and the value that they create depends on it. The challenge is to align performance measurement and the resulting behavior with shareholder wealth creation. There are many gurus who claim to have found the secret link, but they all fail to account for the effect of changes in expectations. Consequently, none of their own measures of performance is highly correlated with the total return to shareholders (TRS). This book introduces, for the first time, an Expectations-Based Management (EBM) system, which measures performance in a way that is highly correlated with TRS.

But this book is not just for management, although they play a fundamental role in setting expectations. It is also written for investors who believe in using fundamental information to set their expectations of company performance, and analysts who forecast financial results and make investment recommendations. It is also, incidentally, for legislators who regulate the rules that determine the cost and flow of information that affect all securities prices.

To create a TRS higher than the normal return, a company has to exceed expectations. Why? Because expectations are already baked into its stock price. In October of 1998, Intel, a company that was regularly earning a return on invested capital 30 to 40 percent more than its cost of capital, announced that its earnings were up 19 percent over the year before. Immediately thereafter, its stock price fell six percent—because analysts had been expecting a 24 percent earnings increase. Intel's price corrected downward because it failed to meet expectations. Expectations count!

Any human endeavor involving teamwork requires three things: a common objective, a way of measuring progress toward that objective, and
methods for achieving the desired performance. Figure 1.1 illustrates these three interrelated issues.

We often take them for granted. But if any of the three is wrong, the team is likely to fail. Even agreement about what the objective should be is sometimes hard to achieve—some would say impossible. This book is about management’s choice of an objective—maximization of owners’ wealth, the choice of a measure of performance that is aligned with it, and the management implementation method that best achieves the desired performance.

For the objective function, or goal, of a company we use the expression “owners’ wealth” as a synonym for TRS to call attention to the fact that this objective applies equally well to privately as to publicly owned firms. When a company has publicly traded stock, the objective by corporate charter is to maximize the total return to shareholders.

Sometimes a team chooses the wrong objective. For example, we knew of a college soccer team where the coach stressed defense, and rewarded the team because it led the league for having the lowest average number of goals scored against them. No one can deny that the goal of having a good defense is laudable. But what if we tell you that the team won only 2 of 14 games that season and finished dead last? It lost many games 1 to 0 or 2 to 1. Good defense is fine, but not as good as scoring more goals than your opponent before the last whistle sounds. The team was pulling together and working hard—achieving an “A” for effort—but it had the wrong objective.

Sometimes an organization has the right objective. However, mistakes about the appropriate measure of performance have resulted in classic failures—the stuff that Barbara Tuchman wrote about in *The March of Folly*. For example, she writes of Britain’s loss of America (1763–1765):
Britain’s self-interest as regards her empire on the American continent in the 18th century was clearly to maintain her sovereignty, and for every reason of trade, peace, and profit, to maintain it with goodwill and by the voluntary desire of the colonies.¹

Britain’s goal was clear, yet her ministries repeatedly took measures that injured the relationship, and in the end she made rebels where there had been none. Tuchman goes on to analyze the folly: “…while the colonies were considered of vital importance to the prosperity and world status of Britain, very little thought or attention was paid to them.”² This myopic behavior was caused by failure to give proper weight to the value (in investment terms, the net present value) of the colonies to England. Instead, Britain placed greater weight on immediate concerns, such as raising taxes to provide reimbursement for the standing army in the Americas to defend against Native Americans and resurgence of the French. This short-term behavior caused England to lose sight of the larger goal of keeping the Americas. As we shall see, the analogy extends to companies and their managements—namely, the misapplication of myopic performance measures, such as maximizing short-term earnings at the expense of long-term earnings growth.

If the team’s objective is appropriate, and if it chooses measures of performance that are appropriately aligned with the objective, there is still the problem of implementation. This third part of the management system is at the grass roots of everyday management and is discussed later in the book as training, identification of value drivers, and incentive design.

This book is about a management system that we call Expectations-Based Management. It accepts the maximization of owners’ wealth as the objective of companies, shows that performance measurement must be based on changes in expectations in order to link the performance measurement to the stated objective, and then discusses implementation. All three parts of an EBM system should work together to achieve the best possible performance toward achievement of the goal.

Why Is Performance Measurement Top-of-Mind?

The team that has the right goal and the right resources usually wins—regardless of the competitive activity. In the United States at the beginning of the third millennium, one can confidently argue that the economic, legal, and socially desirable objective of corporations is to maximize owners’ wealth. Yet this tautology is discussed endlessly, because management does

²Ibid., p. 129.
not have direct control over a firm’s stock price. Rather, management influences the share price by achieving and communicating past, present, and future performance. The trick is to find a strong link between the measure of performance and actually winning in the stock market, thereby creating wealth. It may surprise you to learn that Economic Value Added (EVA®) (also called economic profit) and commonly used performance measures, such as earnings per share and the growth in earnings per share, are definitely not related to the total return to shareholders. (See Chapter 2, which reviews the preponderance of empirical evidence that confirms this fact.)

Like a team of horses, a high-performance management team has to pull together to win in competition, but it also must steer in the right direction. That is why performance measurement is always a top-of-mind topic for CEOs. This book not only suggests a common-sense performance measure; it also provides concrete evidence (taken from real market data) that this measure is closely linked to your firm’s stock price.

Commonly Used Performance Measures and Their Shortcomings

Every top manager becomes a believer in a causal linkage between the company’s performance objectives and its stock price. The only problem is that there are a lot of choices. A partial (but not exhaustive) list, based on our experience, is broken down here. Every performance measure has its problems.

Top-Line Growth

Top-line growth is simply the growth in sales revenues (or sales turnover). Its link to shareholder returns is weak at best, for several reasons. First, sales growth is a double-edged sword when it comes to value creation. It increases value when sales are profitable, but destroys value when each unit sold is unprofitable. Table 1.1 shows what we mean. On one axis is the five-year average sales growth rate for companies, broken down into five categories ranging from very high sales growth rates (greater than 12 percent per year) to very low or negative growth rates. Along the other axis is the spread between the company’s return on invested capital and its cost of capital (a decent measure of economic profitability). Within each of the 30 cells is the ratio of the market price per share divided by the book value per share—its market-to-book ratio. Higher market-to-book ratios are representative of strong economic growth. The table clearly indicates that revenue growth is related to higher stock prices only if it is profitable growth.

For example, if the company’s return on invested capital is less than the cost of capital, the market-to-book ratio stays flat or goes down (except in a few cells). If you look at the last column, however, where companies earned more than four percent above their cost of capital, the market-to-