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Unintended Consequences

The term "cobra effect" is often used to describe a situation where a solution to a problem makes the problem even worse. The term originated back in Colonial India, during a time when the British government was concerned about the growing number of venomous cobras in Delhi. In an attempt to rid the city of this problem, the government offered a bounty in exchange for each cobra skin. At first, the incentive seemed like a sensible solution and appeared to be working. But some individuals discovered a loophole and began to breed cobras for the income. Eventually the government found out and rescinded the bounty. The breeders then set the snakes free, making the initial problem even worse. This anecdote provides an excellent example of how a well-intended incentive can sometimes produce the opposite of the expected outcome.

Sionna believes in the power of incentives. But what about unintended consequences like the cobra effect? By their very nature these situations are difficult to avoid since the outcomes are never intentional. Let's explore a few examples.

In 2016, Wells Fargo, a highly regarded financial institution in the United States, faced a whirlwind of issues stemming from problems with its incentive scheme. The company had long been known for its strong retail footprint, low-cost deposit base and high customer satisfaction. Investors praised the bank for having several touch points with its clients, and Wells Fargo's incentives were designed to deepen relationships through sales goals that promoted selling multiple products to customers. However, somewhere along the way, some employees who struggled to meet these targets cut corners by opening deposit and credit card accounts for customers without their knowledge. This resulted in the opening of approximately two million unauthorized accounts between 2011 and 2016. As a result, the company fired 5,300 employees, abandoned the sales targets and faced significant public scrutiny. The CEO was also forced to resign. Wells Fargo is a recent example of the cobra effect – management had logical incentives in place to promote increased customer satisfaction and profitability; however, the incentive structure produced an unintended consequence, which had quite the opposite effect.

Other examples of such debacles exist. Consider Home Capital Group's issues with fraud stemming from the mortgage broker network in 2014 and 2015. The broker network was incentivized by volume growth, which encouraged some less-ethical brokers to submit fraudulent documentation to increase mortgage volumes and ultimately their personal compensation. Contrary to the intent of this incentive structure, the scandal resulted in lower mortgage growth as the company was subsequently forced to deal with operational and regulatory challenges, not to mention a damaged reputation.

One of the most profound examples of incentives gone wrong was during the financial crisis of 2008/2009. A major factor that encouraged financial institutions to create and sell instruments that were not fully understood was the desire to keep pace with industry earnings expectations. There were also those individuals at these institutions whose personal incentives were aligned with promoting these products. While these choices may have benefited certain individuals in the short term, the financial institutions they worked for faced significant long-term implications, including financial and reputational consequences.

There are many more examples of companies who have faced challenges (or successes) because of incentives. Sionna believes that studying behavioural economics can help explain what drives individuals, management teams and even stock market participants. A central tenant of behavioural economics is that incentives drive human behaviour. While businesses often use this knowledge to influence the actions and direction of employees, the power of unintended consequences can get in the way at times. There will always be individuals manipulating the system to obtain a desired outcome in a faster or easier fashion.

With this in mind, how does Sionna analyze a company’s incentive structure in order to mitigate potential unintended consequences? There are a few critical features that we look for; including a simple incentive structure that is transparent, varied and easy for employees to understand. Using a simple structure also makes it easier for management to consider potential unintended consequences beforehand. Additionally, we look for incentives that are balanced on a number of measures and time horizons. We prefer companies who consider short-term along with long-term incentives, and balance both individual and company-wide goals. While each business is unique and requires a different set of objectives, in general we are advocates of companies who pay attention to return on capital and profitability on a per-share basis. Return on capital balances growth in profitability while considering the level of capital investment needed to achieve that growth. Focusing on increasing the per-share value of a business encourages management to strive for value enhancing growth, and think critically before issuing new equity. Further, a strong alignment of interests motivates management and employees to be thoughtful and proactive where necessary. Management who invests their own money alongside shareholders demonstrates their commitment to the business and not just their paycheque.

We recognize that even well-thought-out compensation plans are at risk of human abuse. Therefore, it is arguably even more important for companies to foster a culture of trust and integrity, and be willing to recognize blunders and fix them when necessary. Strong organizations typically instill the appropriate controls into their processes to catch unintended consequences early. But if something slithers through the cracks, a culture of candor and a lack of ego may help companies respond and move forward. Throughout our research process, we analyze the qualitative aspects of a business to better understand how an organization is wired. We try to get a feel for the culture through management meetings, facility tours and analysis of company communications. A company’s business decisions can also tell you a lot about their culture and predispositions. Ultimately, we are seeking businesses with strong, enduring cultures and management teams.

The analysis of incentive structures is an important aspect of our investment process because it allows us to see what objectives management and the organization are striving for and quantify how they measure success. Charlie Munger said it best, “Never, ever, think about something else when you should be thinking about the power of incentives.” Regardless, it is likely that the examples noted above will not be the end of incentives that have gone awry. Just like in Colonial India, unintended consequences will always be a risk in business and in life. Whether it’s related to compensation or otherwise, the laws of behavioural economics will prevail; we will continue to see individuals incentivized to meet innocent objectives, sometimes creating unintended consequences along the way.

Sionna Investment Managers 8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5
For further information, please email Kelly Battle at kelly.battle@sionna.ca or call (416) 203-2732