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# New Behaviour for Superior Performance

The Sixth AQ Research Conference

London, 24 June 2009

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## Slide 1 – Introduction

A June 2009 *Keep Britain Working* Campaign survey shows that since the onset of the recession 56% of financial services managers have done less to motivate employees.

In this presentation, delivered at the Sixth AQ Research Conference in London on 24 June 2009, I call upon managers to take seriously the need to define, assess and reward individual and team performance.

Extel 2009 showed that in the EU analyst numbers have fallen by 20%, yet stock coverage remains comparable with 2008: effectiveness is more important than ever. So, in answer to the question “*How can a senior manager encourage individuals to achieve superior performance by adopting new behaviours?*” I examine best practice for the annual performance management process.

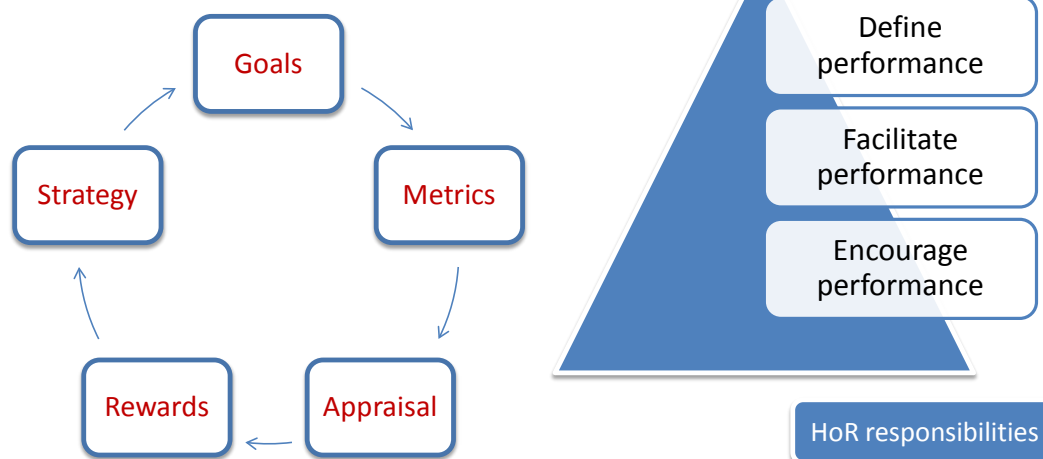
The challenge, of course, is that managers are distracted by the need to keep the lights on and put out fires. This problem may be overcome only through the deliberate cultivation of a performance-oriented leadership culture, which takes time and effort.

Illustrations in the presentation are taken from the world of investment research. However, the overarching principles are applicable to all industries where high-performing human capital is crucial to business success.

With six content slides the presentation is mercifully brief; notes are conversational and non-technical. If you have any questions, please contact me by e-mail or on +44 7944 444000.

# Performance Management

Adapted from Mabey et al., 1998



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## Slide 2 - Performance Management

Bull or bear market, the research franchise depends upon analyst quality and leadership strength. Sales, Trading, technology and brand all impact apparent performance in the same way as marketing, distribution, servicing and image influence buyers of motor-cars. Ultimately, however, the cornerstone of the franchise is the analyst, just as success for BMW lies in its vehicles.

The only sure-fire way of improving the research business, then, is to change the behaviour of analysts: Action X generally results in Outcome A and Performance 1; only when analysts adopt Action Y can they reliably achieve Outcome B and thereby Performance 2.

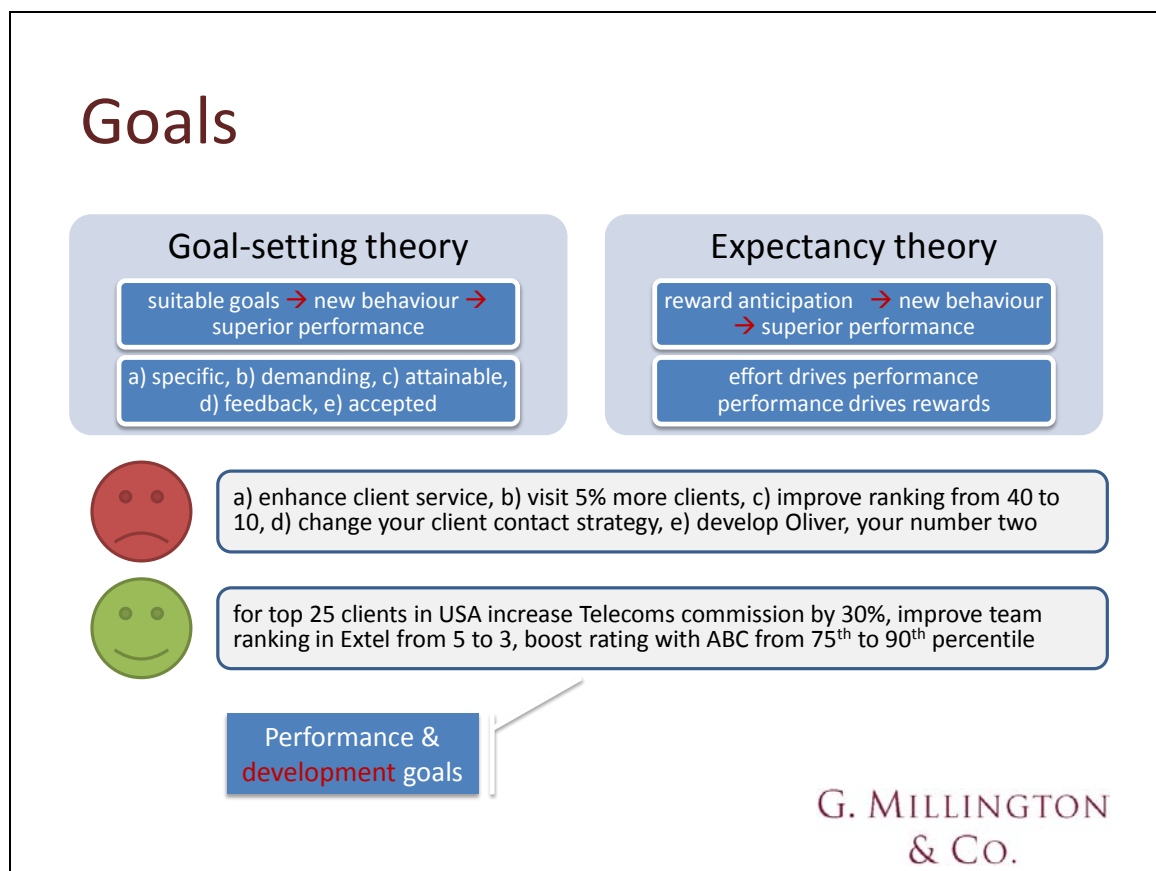
Performance Management (“PM”) is the process by which a firm encourages *modified behaviour* by setting goals for performance; agreeing metrics for assessment; conducting appraisals of success and failure; and allocating rewards – all within an agreed strategy.

PM leads to business success. A study of 278 organizations shows that firms with effective PM outperform competitors by 51% on financial measures; and by 41% on measures such as employee retention and client satisfaction (Bernthal, Rogers and Smith, 2003).

However, PM is dogged by common problems, including inconsistent goals and ratings; compensation, promotion and dismissal not linked to appraisal; and the perception of PM as “just another case of HR red-tape”.

Bernthal et al. conclude that fewer than 40% of organizations hold managers accountable for acting upon the findings of the PM process. If performance is to be managed effectively the Head of Research (“HoR”) and other managers must:

1. *Define performance*: set goals for performance; establish measures for how analyst contribution is to be assessed; conduct meaningful and regular appraisals.
2. *Facilitate performance*: eliminate road-blocks, ensure that necessary resources are available; select the best managers and employees; remove poor performers.
3. *Encourage performance*: offer sufficient, timely and fair incentives.



**Slide 3 - Goals**

Setting appropriate goals is the first step in encouraging new behaviours that lead to superior performance. Two generally accepted theories predict how goals may result in new behaviours: *goal-setting theory* and *expectancy theory*.

*Goal-setting* improves performance first by directing the analyst’s attention to specific needs of the organisation; second, it mobilises effort to accomplish required performance standards; third, it fosters persistence in pursuing success. Studies show that effective goal-setting results in at least 10% performance improvement.

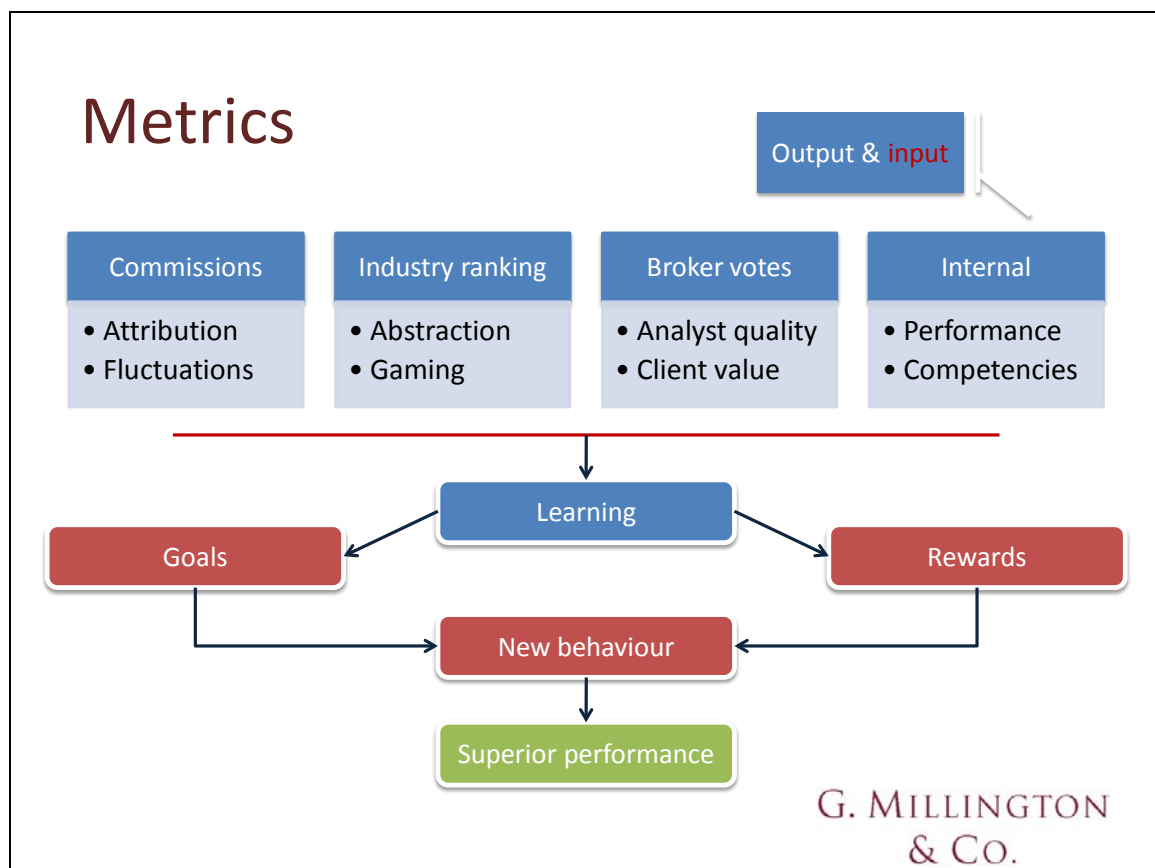
Exhortation to “do your best” is insufficient: to encourage new behaviour goals must be SMART (specific, measurable, achievable, realistic and timed). Similarly, they must be

owned by the analyst, viz. he must be both empowered *and* accountable. Goals must be accepted by individuals responsible for achieving them.

Goals must also be demanding: easy goals result in boredom, demotivation and lacklustre performance. Weak goals prompt questions: “What do you mean by ‘change’?” “What happens to me when we promote Oliver?” If questions are unanswered, behaviour does not change. Goals must cover both *performance* and *development*: firms operating in a complex market must examine what competencies and skills are required for long-term success.

*Expectancy theory* suggests that when an individual anticipates a reward upon achieving a goal he will adopt behaviour consistent with maximising his chances of attaining the reward.

The reward must be valued, i.e., what the analyst wants. Similarly, there must be strong correlation between the effort an analyst invests and the performance outcome; and between the outcome and the reward itself. Without these connections new behaviours may not result.



**Slide 4 - Metrics**

Within investment research there are four standards for measuring analyst performance: (1) commissions; (2) industry rankings; (3) broker votes; and (4) internal assessments. While these sources of intelligence are well understood within the industry community, from the standpoint of encouraging new behaviours several challenges are noteworthy.

It is difficult to attribute rises and falls in *commissions* solely to the analyst: research performance improvements may, for example, be offset by deterioration in the sales force contribution. Hence the connection between effort and outcome (implied by expectancy theory) may be weak. Similarly, market fluctuations may mean that research performance shortfalls are masked by an upswing in trading volumes.

*Industry rankings* such as Extel, Institutional Investor, Starmine, AQ and Trade Ideas offer quantitative and qualitative assessments of analyst performance. For qualitative assessments, multiple data-points and diverse sources mandate a high level of abstraction, and so industry rankings may not directly reflect performance. Similarly, quantitative metrics largely fail to embrace the importance of the analyst-client relationship, a key determinant of research success. Finally, industry rankings may be ‘gamed’ by organizations that have the resources to woo clients during voting season. Over-reliance on industry rankings is a mistake.

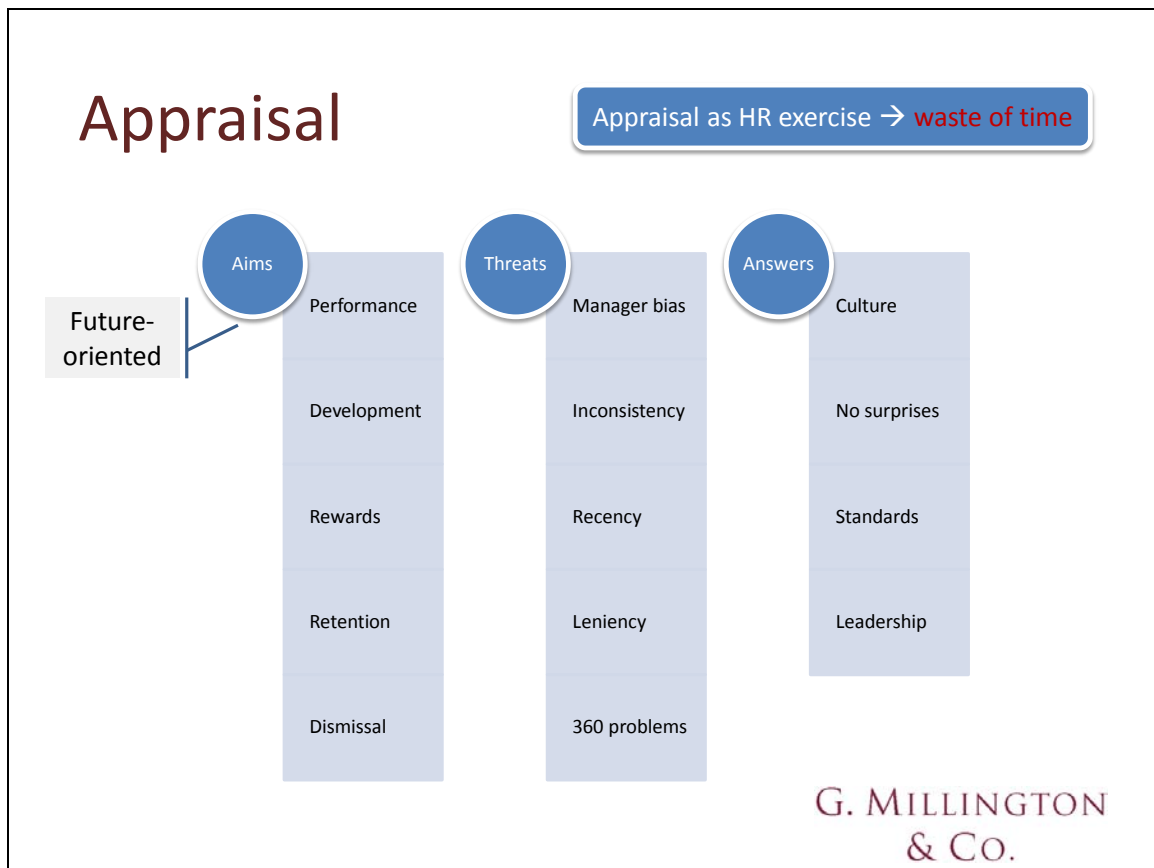
*Broker votes* have become increasingly daring in recent years: clients have no qualms about blowing the whistle on first-tier firms that send over second-rate analysts (data are available on systems such as Starmine). As clients now rate the value of meetings and eschew maintenance research, performance metrics must emphasise the *quality* of analyst contact and research ideas. Conversely, analyst performance must be measured against votes from *profitable* clients: it is a waste of resources to give (sic) research ideas and time to clients that do not pay. The days of servicing the “tail” for potential marketing value are over.

By *internal assessments* analysts are appraised by salesmen, traders, managers, peers and subordinates. These reviews, often in the shape of “the annual 360”, allow firms to measure not just actual results, but also the development of core competencies that drive ongoing performance.

None of the four metric types is perfect and a balance must be struck that reflects the strategy of the research business. There is no best practice and within a single organization measurement differences between, say, sectors and markets, may be justifiable. The important point is that data gleaned from measurements re successes, failures, strengths and weaknesses be fed into the appraisal process. This in turn drives the setting of goals and the allocation of rewards; resulting in modified behaviour and superior performance.

Without feedback, there is no learning: consider the child who burns himself on a hot oven door. The aim of appraisal is first to learn; and then, to ensure that the firm has capable people working towards strategic goals (*Slide 5 - Appraisal*).

To encourage new behaviour the appraisal process must be *future-oriented* rather than purely retrospective: examine the past, then set guidelines for future performance and ongoing development. Rewards are allocated for past contributions and offered as incentives for future accomplishments. The appraisal process shapes retention and dismissal strategies: up to a year of stock coverage may be lost when a good analyst resigns; and why demoralise an entire team by paying individuals who do not perform?



## Slide 5 - Appraisal

Still, performance appraisal is easily compromised, and 60% of firms report poor usage, ineffective monitoring and low accountability on the part of managers (Berntal et al., 2003).

Managers may use appraisal to serve their own ends by rating poorly subordinates by whom they feel threatened. Inconsistencies abound: my rating of “excellent” may equate to your “good”. Appraisers are often lenient and rate the most recent performance only.

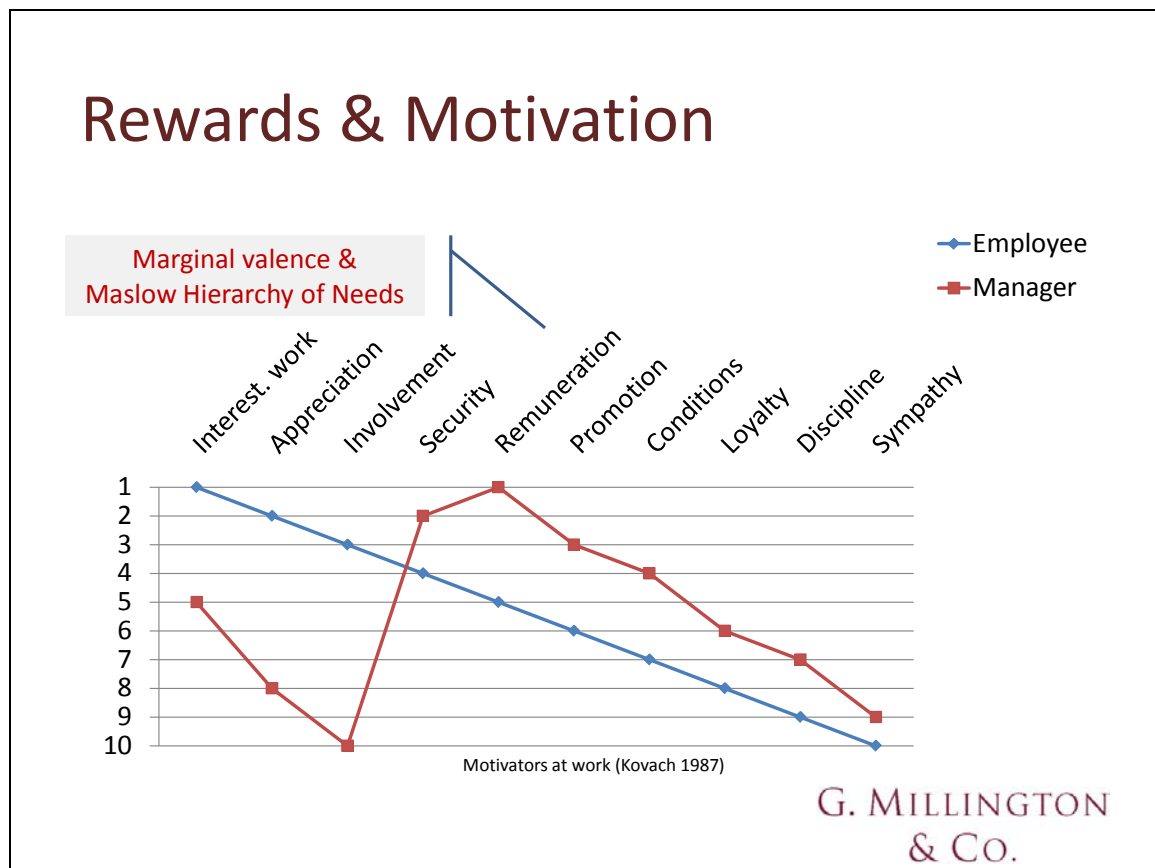
One may often guess who wrote feedback in a 360 review. However, as comments officially are anonymous there is no recourse to question the rater, and this may lead to latent conflict and ill-feeling. Finally, 360 ratings suffer from the “horns and halo” effect – if one instance of behaviour is perceived highly, this has a buoyant effect upon other ratings, regardless of merit; the opposite is similarly true.

How can a HoR guard against these threats? The first step is to build a culture of performance, where transparency is valued and constructive, objective feedback is welcomed. Second, ensure that there are no surprises: even when the formal appraisal process is annual, regular feedback may be communicated through the ongoing HoR-analyst relationship. Of the surveyed firms 41% had formal processes on a more-than-annual basis: good practice.

Training is important: not how to fill in forms, but how to generate and deliver constructive, meaningful feedback that may be used to generate new behaviours. So-called “frame of reference” training – where a group (a) discusses behaviours and suitable ratings; (b) watches

video of a manager in action; (c) rates the manager and writes scores on a blackboard; (d) receives feedback regarding ratings – is shown *by far* to be the most effective form of training.

Most important, if performance appraisal is to be more than a red-tape exercise, is unequivocal leadership. This means having the credibility to set goals for senior analysts; the courage to stand by controversial remuneration and dismissal decisions; and the authority to fight for the research franchise within the larger organization (especially true after the secular decline of research that attended the Spitzer debacle).



### Slide 6 - Rewards & Motivation

The chart above shows (blue line) how US employees in an iconic 1980s study rated motivators at work. Surprisingly, remuneration is placed fifth out of ten. Interesting work, being appreciated by one's manager and being involved occupy the top three slots. The red line shows what managers believe motivates their subordinates – the contrast is glaring.

If rewards are to act as motivators for new behaviour they must be:

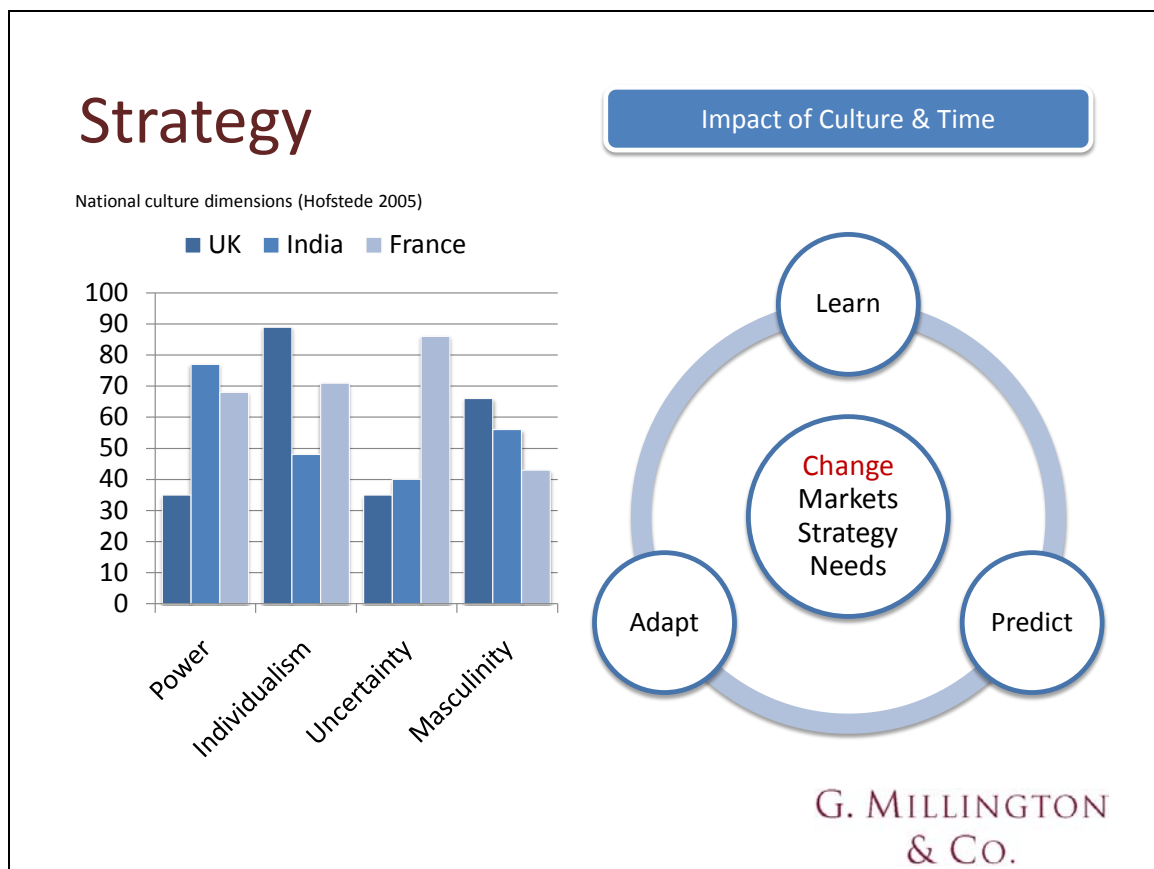
1. *Sufficient*: valued by the individual analyst and aligned with his needs.
2. *Fair*: analysts must have a voice in reward strategy; allocations must be consistent and the logic behind awards must be communicated across the department.
3. *Timely*: offered soon after performance; "late" rewards may make analysts happy, but they do not necessarily lead to new behaviours (as predicted by *reinforcement theory*).

Creativity is welcome: in the 1970s Weyerhaeuser dramatically increased productivity and eliminated petty grievances on the part of its mountain-beaver trappers by switching incentives from \$1/rodent to \$4/rodent *if* they correctly guessed the colour of a marble picked from a bag (1/4 probability). Dead rodents effectively became poker-chips!

In driving new behaviour, the problem of *marginal valence* and the diminishing value of incremental adjustments (so the second million dollars has less impact than the first) may be considered. Maslow's *Hierarchy of Needs* also comes into play – when an analyst has paid off the mortgage and set up a trust fund for his children's education he is likely to look beyond monetary rewards to opportunities for personal development and self-actualisation.

That said, money has a symbolic significance in terms of, for example, self-esteem. A package of a million pounds appears to say much more about how a firm values an employee than one of £900,000. And, of course, money can always be converted into rewards that offer the analyst chances to fulfil other, “higher-order” needs.

Bad rewards result in performance degradation. An analyst paid £300,000 who believes his contribution is worth £750,000 may resolve his inner conflict by reducing his contribution (thereby alleviating “cognitive dissonance” and the attendant sense of aggrievement).



As for performance management strategy, *national culture* has a bearing upon goals, metrics and incentives. Cultural differences are expected when westerners are dealing with far-flung countries such as India. However, in a European organization managers may also encounter differences in behavioural norms between, say, the UK and France. Hofstede's landmark study of employees in 53 IBM locations shows that France evinces a wider *power distance* and has higher *needs to avoid uncertainty* than the UK. To illustrate, this means that French managers may be more autocratic in setting metrics; and analysts more resistant to open-ended goals. Deferred compensation may have less of a motivating effect than in the UK. Thoughtful communication is the key to understanding and resolving cultural differences.

Finally, it is no revelation that we live in a time of *change*: financial markets evolve, company strategy responds and analyst needs develop. To be effective, managers must learn about the impact of such shifts, predict future trends and adapt the framework of goals, metrics and incentives accordingly.

In conclusion, performance management can generate new behaviours that deliver superior investment research performance. Success is determined ultimately by the strength of leadership within the organization, and its commitment to setting clear goals, establishing relevant metrics, conducting candid appraisals and allocating fair rewards.

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