

## Incentives

The word 'Khaana' in Urdu means 'to eat', and is one of the core guiding values that underpins how we think, and operate. This, in part, explains the derivation of the name Kana, and wholly explains one of our core beliefs that one should 'eat their own cooking'. This maxim gets to the heart of a crucial subject matter that permeates our lives in practically every capacity – incentives. After all, would you dine at a restaurant when the chef always ate elsewhere?

In *Poor Charlie's Almanack* by Peter D. Kauffman, Charlie Munger discusses the power of incentives in talk 11 titled 'The Psychology of Human Misjudgment'. He says:

*Perhaps the most important rule in management is to get the incentives right – Charlie Munger*

Munger goes on to illustrate the sheer power of incentives through examples from the world of business, namely Federal Express and Xerox.

*The integrity of the Federal Express system required that all packages be shifted rapidly among airplanes in one central airport each night. The system has no integrity for the customers if the night work shift can't accomplish its assignment fast. And Federal Express had one hell of a time getting the night shift to do the right thing. They tried moral suasion. They tried everything in the world without luck. And finally, somebody got the happy thought that it was foolish to pay the night shift by the hour when what the employer wanted was not maximized billable hours of employee service but fault-free, rapid performance of a particular task. Maybe this person thought, if they paid the employees per shift and let all night shift employees go home when all the planes were loaded, the system would work better. And, lo and behold, that solution worked.*

*Early in the history of Xerox, Joe Wilson, who was then in the government, had a similar experience. He had to go back to Xerox because he couldn't understand why its new machine was selling so poorly in relation to its older and inferior machine. When he got back to Xerox, he found out that the commission arrangement with the salesmen gave a large and perverse incentive to push the inferior machine on customers, who deserved a better result. - Charlie Munger*

These examples demonstrate how misaligned incentives can result in perverse outcomes, and outline a significant flaw in incentive design that is often overlooked, but explained by what is known as 'The Peltzman Effect'.

Named after economist Sam Peltzman, who proposed the idea in a 1975 study on car safety regulations. He observed that while seat belts and other safety features reduced the risk per accident, they may have encouraged riskier driving behavior, such as speeding or less cautious driving, because drivers felt more protected. The core idea is that when people feel safer, they may take more risks — reducing or even cancelling out the intended safety benefit. Clearly then, we must **consider the second and third order consequences** of any incentive system to avoid unintended or undesirable outcomes.

*If you want to persuade, appeal to interest not to reason – Benjamin Franklin*

A closely related concept is that of 'moral hazard' – when an individual or entity takes on more risk because they won't bear the full consequences. The GFC of 2007 is a textbook case of moral hazard playing out across multiple levels of the financial system:

1. **Banks took excessive risks** because they didn't expect to suffer the consequences, they earned fees up front from the sale of complex financial derivatives, and the risks were passed on to other investors.
2. **Rating agencies** had no skin in the game if their ratings proved to be disastrously wrong, their fees came from the banks that issued the securities – not from the buyers.

The GFC showed how moral hazard, when embedded into the incentives of key market players, can cause systemic failure. Everyone was chasing short-term profits without sufficient downside, and the broader public ended up footing the bill.

Such an asymmetry in the design of incentive structures is considerably common today, and not exclusive to seismic events like the GFC – from which you might think, we would have learned a tough but valuable lesson. The most common example is the grant of share based compensation amongst large organisations, where it is estimated around \$150-200 billion has been disbursed annually by companies within the S&P 500 in the decade following the GFC. The design of SBC, often by virtue of stock options creates a misalignment of incentives that deem them ineffective, and fail to align executive and employee behaviour with long term value creation.

1. **No downside risk** - options create asymmetric incentives; *heads, I win big. Tails, I lose nothing*. Like a call option, with an uncapped upside, and a negligible downside, one might be inclined to 'swing for the fences' and take careless risks.
2. **No cost of capital consideration** – Options can often reward price increases, not value creation relative to capital deployed. Without a tether between ROIC and the cost of capital – one cannot measure actual value creation. They can thus act like lottery tickets.

This raises the importance of another key feature that one must consider in incentive design – **symmetry**.

*A system is responsible in proportion to the degree that the people who make the decisions bear the consequences. – Charles Frankel*

Creating an incentive system which is therefore aligned both positively and negatively should take care of itself. Whilst incentives are designed to encourage positive behaviour, balancing them with disincentives to discourage bad behaviour should result in more optimal outcomes.

*An example of a really responsible system is the system the Romans used when they built an arch. The guy who created the arch stood under it as the scaffolding was removed. It's like packing your own parachute. - Charlie Munger*

The final component of appropriate incentive system design is the presence of **anti-gaming features**.

It is said that 'what get's measured, get's managed'. Corporate CEO's who are then motivated to manage EPS (earnings per share) targets might find innovative ways to meet their stated goals to unlock lucrative compensation benefits. Massaging accounting, or aggressive re-investment without regard for capital efficiency can therefore lead to optical performance rather than real value creation. This short-term thinking should be eschewed in favour of sustainable long term outcomes.

Another classic example of incentive systems being gamed comes from colonial India — in what is known as the "Cobra Effect." It's a vivid illustration of how poorly designed incentives can backfire spectacularly. Under British rule, colonial authorities in Delhi were concerned about the number of deadly cobras in the city. The government offered a bounty for every dead cobra — simply bring in a severed cobra head, and you'd receive a cash reward. Enterprising locals began breeding cobras, killing them, and collecting the bounty. When the government discovered the scheme, it cancelled the program. The breeders, now stuck with worthless snakes, released them into the wild — making the problem worse than before. When incentives are designed without accounting for human behaviour, people will game the system in rational but destructive ways.

## Incentive System Design

Bridging the gap between regular incentives and those that are radically aligned requires adherence to the features that are often overlooked when incentive systems are designed.

An effective incentive system should therefore address three core features when being developed:

1. **Symmetry** – Incentives to encourage good behaviour & disincentives to discourage bad behaviour.
  - Align both upside and downside for decision makers.
  - Ensure risk takers are also risk bearers.

**Key Question:** Does this person benefit when the business thrives, but also suffer if the business suffers?

2. **Use Second Order Thinking** – For the avoidance of unintended consequences.
  - Consider what happens when the metric becomes the goal (the 'cobra effect').
  - Design for long-term sustainability, not just short-term results.

**Key Question:** What unintended behaviors could this incentive produce in 6, 12, or 36 months?

3. **Anti-Gaming Features** – Accounting for human behaviour.
  - Design incentives that can't easily be manipulated.
  - Use metrics that reflect real value, not just optics.

**Key Question:** How could a clever person game this – and how do we close that loophole?

## Lessons From The Public Markets

Perhaps the most compelling example in the public markets of radically aligned incentives are, unsurprisingly, those used by **Berkshire Hathaway**. They follow a rational approach that address many of the nuances we had discussed above. Senior executives responsible for capital allocation decisions are held to account, rewarded in equal measure for sound judgement, as they are penalized for poor. This illustrates a **symmetry** in which the risk takers are also the risk bearers, with their bonus tied to returns above a sufficiently high cost of capital hurdle, and whereby falling short of the hurdle rate bears equally punitive consequences to their bonus on the downside. The use of metrics such as incremental returns on capital also ensures managers focus on true value creation measures, and not just optics like revenue growth or EPS.

This highly aligned approach has not been lost on others. **Constellation Software** (CSU) utilises an equally potent structure. As a serial acquirer of VMS (Vertical Market Software) businesses, CSU operate with a highly de-centralised structure, with a great degree of autonomy given to each business unit they purchase. Operators of these business units are given capital and told to generate returns above a specific internal hurdle rate. If they can't hit the hurdle rate, they are expected to return the capital to HQ. This enforces capital discipline and prevents the "empire-building" syndrome where managers spend for the sake of growth. Bonus' are similarly tied to metrics which measure actual economic performance (free cash flow return on invested capital), often formulaic for ease of calculation; the key principle here is that capital is a scarce internal resource, and only those who can deploy it rationally get to keep it. Poor allocators meanwhile may lose access to capital from HQ, and see reduced autonomy, status and influence within the organization – a subtle yet powerful cultural penalty as so many of the CSI managers are ex-entrepreneurs who value independence and control. Losing such control is a meaningful deterrent. CSI stock has compounded at a rate of 36.1% since its IPO in 2006, a total shareholder return of 367x between 2006 – 2025.

## Lessons From The Private Markets

A wonderful example of radical alignment from the private markets comes from **Orbis Investment Management** – one of the most philosophically rigorous investment firms when it comes to alignment with clients. As a global equity manager of over \$30bn in client funds, Orbis' flagship funds use a high water market performance fee, with a twist that is *extremely* rare. They use a **reversible performance fee** structure which means they return performance fees to their clients if performance drops below the high water mark. This radical alignment means their experience mirrors that of their clients, with true skin in the game.

1. If Orbis underperforms after earning a fee, they don't just stop earning new fees – they refund the old ones.
2. If the client gives up gains, so does the manager.
3. Orbis is incentivized to think multi-year, not quarter to quarter.
4. It avoids the 'harvest now' mindset common in 2/20 hedge fund models.
5. Investors know the firm is only compensated when it delivers sustainable performance – not via luck or temporary volatility.

This structure is complex to administer, and requires balance sheet resilience via a reserve fund able to absorb uncertainty during periods of underperformance, and when operating income visibility is highly unknown. This is particularly true for Orbis who follow a contrarian approach to public investing. However, given Orbis' private held and owner led culture, they have made it work for them and reaped the rewards, and trust of their clients as a consequence. For example, they faced less than 10% of net redemptions during the GFC despite a 35% drawdown in global indices – demonstrating far stickier capital base relative to their peers.

## Closing Thoughts

Incentives, when appropriately designed & set, can yield extremely powerful outcomes in business and in life. Using them alongside other equally powerful goal oriented strategies like OKR's (Objectives and Key Results) [developed by Andy Grove] can help transform outcomes for their participants, and help foster characteristics that are desirable in business, chiefly, long term value creation, and win-win dynamics brought about through an alignment of economic interests amongst the stakeholders for whom the incentives have been designed.

Our view is that the best incentives solve for symmetry, second order thinking, and anti-gaming features. Doing so can help align operators with the long term orientation that founder-led businesses inherently have, and to ensure decisions are made that will enable them to thrive for years to come.

*At Berkshire, we want managers who treat the business as if it were the only asset they and their families will own for the next 100 years – Warren Buffett*