The Challenges of Target Setting

By Janice Koch, Editor

In our May–June 2006 issue, Robert Kaplan examined some fundamental issues in target setting, focusing on how to design stretch targets that sufficiently motivate people to strive to outperform targets without encouraging overly risky behavior—or raising the cost of the incentive so that it outweighs the financial gain. In this first of an occasional series on the challenges of target setting, we’ll look at specific challenges two organizations faced in establishing stretch targets—and the solutions they devised.

Stretch Targets and Variable Compensation at Endesa

Madrid-based Endesa is Spain’s largest electric utility, the number-one private utility in Latin America, and a major operator in Mediterranean Europe. Due in part to its stellar performance and growth, the utility has become the object of a protracted and complicated takeover battle. In 2000, two years after it was fully privatized, the company adopted the BSC to facilitate its strategic transformation—a transformation so impressive that it won Endesa a place in the BSC Hall of Fame in 2005.

To set effective targets, particularly stretch targets, managers must strike a balance: between setting the bar high enough to encourage greater performance without prompting excessively risky behavior; and differentiating between “good” and “great” performance—without leaving loopholes that allow people to game the system. Juan Andalaft, until recently Director of Corporate Budgeting and Controlling at Endesa and the driving force behind the company’s BSC program, used the SMART formula for designing Key Performance Indicators (KPIs): simple (easy to understand for those responsible for its performance), measurable (has a precise calculation methodology), attainable, representative (must relate to the main function of the person being evaluated), and time-relevant (captures an adequate time period based on the nature of the KPI). Of attainable, he notes “the goals have to be perceived as being challenging and motivating, but attainable with a reasonable amount of effort. Where possible, they must be negotiated with the team responsible to obtain greater commitment.”

As part of the company’s BSC-based strategic transformation (and transition from public entity to private enterprise), corporate HR implemented a new performance-based variable compensation system for management—an uncommon practice among utilities, and one that upset what in effect had been a system of near-guaranteed bonuses. Not surprisingly, it triggered resistance. Andalaft knew that the new system would require great rigor and fairness to win managers over—and do its job. “When you’re playing with the money of people with variable bonuses, it’s crucial for the methodology to be precise, repeatable, and objective,” he points out.

Endesa’s budgeting and controlling unit did macroeconomic analysis, economic and financial planning, and annual budgeting at the corporate level. They also set all the metrics for the business, including those in the operational excellence and learning and growth areas. Annual targets were derived from the company’s budget, which was tightly aligned with strategy.

Initially, Endesa used three ranges for targets: 0 to 75% of target (“red” or poor), 75% to 100% (“yellow” or below target), and over 100% (“green” or over target). But when general directors received a report filled with yellows and reds, it wasn’t very motivating, says Andalaft. He and his team realized a broader scale was necessary to distinguish between the good, the bad, the mediocre, and the extraordinary. Endesa added a fourth target range, as follows:

- 0% to 50% of target = red (minimum target, i.e., required by industry regulation)
- 50% to 87.5% = yellow (insufficient)
- 87.5% to 99.9% = light green (close to or at target)
- above 100% = dark green (exceeding target)

By making 100% the budgeted full-target amount, Endesa now had a way to establish a true stretch target. But there still wasn’t enough of a range separating target and above-target performance. So corporate HR adjusted the scale from a 0%-to-100% range to a 0%-to-120% spread, in which stretch performance extended 20% beyond scale. This enabled them to achieve the needed differentiation. Says Andalaft, “We sold the idea by saying the company was willing to reward even more the best performers by putting more money on them.”

The total money the company allocated to bonuses remained the same. “To put 1/3 of the people above 100%, we needed to have 1/3 below 90%, by adjusting our ranges we were improving the standard deviation,” Andalaft explains.
Setting Stretch Targets at TD Ameritrade

Omaha, Nebraska–based TD Ameritrade is a leading online brokerage that in 2007 was ranked number one by Barron’s and named to Forbes magazine’s Best Big Companies List.

As a brokerage, TD Ameritrade understands that volatility is an everyday business reality. However, the company, which serves retail traders and investors and also offers services to registered investment advisers, recognizes that while short-term results are strongly influenced by external market conditions, that is not the case over the longer term. According to John Langwith, managing director of analysis, planning, and reporting, “Over the long term, those ups and downs average each other out; in three years, the market is usually up more than it is down, and the U.S. economy grows more quarters than it doesn’t.” On that basis, the company is comfortable setting growth targets.

The real challenge for TD Ameritrade is not how to interpret performance in the context of volatility, but rather how to define, motivate, and reward exceptional performance—and how to do it fairly, in a way that acknowledges the degree of difficulty in achieving company-wide objectives from unit to unit.

Performance metrics are very serious business at TD Ameritrade. Stretch targets are set by the Senior Operating Committee—CEO Joseph Moglia, along with the heads of TD Ameritrade’s major operating divisions—all of whom set company strategy and who develop targets in conjunction with finance and business development. Langwith’s team meets monthly with a team of metrics experts representing each area of the business; they regularly vet new measures and work to align existing measures. Division heads have some latitude in adding or eliminating measures, though there is a negotiation process they go through with the analysis, planning, and reporting group to maintain a disciplined metrics and measurement process. Each unit leader chooses a key measure—the most relevant, most representative target—that supports each enterprise-wide objective.

TD Ameritrade’s rationale goes like this: if you want people to reach 200, set the target at 300, not 205. Sound extreme? Not really, when one considers the expertise behind the target-setting (many of the company’s executives are former consultants, professionals with significant experience in performance measurement and the complexities of statistical analysis that go with the investment business) and the company culture—the high-pressure, highly competitive brokerage world. Furthermore, says Langwith, “If you create a difficult target, you force people to think outside the box—to make them think hard about their business model. Setting stretch targets makes you continually challenge the way your base model is set.”

Consider one of TD Ameritrade’s key company goals: increasing trading volume (number of transactions) per day. Stretch targets are, of course, designed to push performance to that goal. Transaction levels, Langwith points out, are driven by the company’s tools, speed of execution, and the quality of the client experience. Those who manage the transaction part of the business must determine what, if anything, needs to be changed to drive that growth. If targeted growth is greater than what the market can provide, the company must assess how it will seize that market share—through new products, quality, tools, and so forth.

TD Ameritrade sets three levels of target: external (what it reveals to Wall Street), internal (actual desired targets, less conservative than those it reveals publicly), and stretch. For example, an external target of 200 would have an internal amount of 225 and a stretch amount of 300. Like Endesa, the company uses four performance indicators: red (below minimum threshold), yellow (between threshold and target), green (between target and outstanding), and blue (outstanding). These ranges enable the company to show what it considers to be everything from “the least we expect” to “truly outstanding performance.”

The next step is range setting. Each metric has its normal (historical) variability. A measure driven by external factors, Langwith notes, will have much wider variability. Asymmetry is important in designing stretch targets, since outstanding and mere threshold performance are not equidistant from the target. That 200 target would have a threshold of 195, which means only five points are needed to trigger a red flag, while it takes 25 to trigger outstanding performance. Why is this important? As Langwith explains, “Overall range is determined by variability—and establishes the minimum below and above. How close to that minimum you set the threshold or outstanding mark is based on the degree of difficulty the target represents, as well as the severity of a miss—and the importance of overachieving.” If missing a target has serious ramifications, the company will set a narrow range beneath the target. Take, for example, the goal of achieving a certain level of growth in a particular market. If the company has made a substantial investment in that market, the range between target and threshold will be set tight.

Says Langwith, “We pay incentives

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in many cases off these ranges, so a tight range means underperformance will kill your incentive very quickly. A large range on the upside means people have a way to go to achieve the full payout; conversely, with a tight range on top, overachievement could quickly get you to a much larger payout.”

Keeping Targets and Ranges Aligned with the Zigzag Chart

To get the best performance out of its people, TD Ameritrade strives to achieve what it calls “aligned commitment”: ensuring that the degree of difficulty in reaching each new target range is as equal as possible across lines of business. In other words, it wants goals for the same category of measure to be equally attainable across units. To keep targets and ranges aligned in this way, the company recently instituted a tool it refers to as the “zigzag chart.” With it, the company plots the key metric identified by each unit leader as representative of performance against a given enterprise-wide objective. (Performance is tracked monthly; targets are set each quarter.) Performance in a given metric is plotted on a chart that shows the full range of target levels, from 0% to 150%, with each unit’s performance stacked on top of the others’. In Figure 1, for example, for the strategic theme “Grow Accounts,” we can see the range of performance across all units. Overachievement in one area of the company should be related to overachievement in another. If a range is out of sync, this chart will indicate that. If four of the measures are highly positive but one is negative, it could mean either a very successful period for those four units—or some kind of anomaly or unfair target for the fifth one. An anomaly in one month would typically trigger some kind of remedial action.

After one year of use, the response to the zigzag chart has been “very positive,” says Langwith. “Sometimes product heads and branch sales heads have different ideas about what their targets should be. This helps generate a collaborative approach across the groups.”

1. From a presentation given to the SFO Workshop for RAO-UES in Moscow, June 26, 2006.