CORPORATE GOVERNANCE

The Road Not Taken

"...Two roads diverged in a wood, and I— I took the one less traveled by, And that has made all the difference."

—Robert Frost

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The evolution of current executive pay practices may require more and more companies to take the "road less traveled by" in order to provide superior returns to shareholders. Pay practices continue to create heated debates among executives, boards, institutional investors, and their proxy advisories (e.g., ISS and Glass Lewis). Underlying the debate are two contrasting views about executive pay and the economy in general: zero-sum economics and expanding wealth.

Zero-sum economics simply holds that one person's gain is another person's loss. To wit, if the board pays their managers more, there is less for shareholders. The current metrics employed by ISS to assess pay for performance are really cost-control measures that seem to reflect ISS's view that executive pay is a zero-sum game. While zero sum may capture the economics of trading pork bellies or oil futures, it does not describe how an economy creates wealth and how managers should share in the wealth they create.

The view of expanding wealth is embodied in the likes of Steve Jobs, Meg Whitman, Jack Welch, and many others—business leaders who created substantial benefits for consumers and in the process created substantial wealth for themselves. In short, the pie got bigger and owners shared in the increasing size of the pie. It would be rare to find an investor who would begrudge the wealth these superstars have earned. Interestingly, among this illustrious group, some would likely fail today's proxy adviser screens.

Rewarding managers for wealth creation is a "value sharing" approach to executive pay. The model dates back to the industrial giants who emerged prior to WW II. GM, JCPenney, and others paid a share of the profits (after a fair return to investors) to the senior managers. After the war, public companies migrated to a "competitive pay" model that pays managers what other managers earn in the same sector, adjusted for size.

Unfortunately, with the exception of significant collapses in performance, competitive pay is often "memoryless"—regardless of performance, the CEO gets what the CEO's peers get. It should be noted that private equity has pretty much retained the "value sharing" approach to incentive pay, which is a potential source of competitive advantage in attracting talent.

While competitive pay addresses retention risk (if everyone's paid the same, no one will leave for more money), it may not address performance. Highly leveraged plans pay out more as performance increases, but could run into the immoveable code of the proxy advisers. While no board member wants to be voted off the island, boards may unknowingly be taking the road to mediocrity by delevering the compensation plan to assure favorable votes from investors.

Yet if ever there was a time to avoid mediocrity, this is it. Mediocrity is what puts a company on the short list of potential takeover targets. In a world where the economy creates new wealth, "value sharing" compensation programs do matter. They matter not only to attract and retain talent, but also to encourage managers to pursue all value-adding investment opportunities. The biggest impact on shareholder wealth from the competitive pay approach may well be the opportunities foregone.

It's time for boards to take a stand against mediocrity. Start with strategy—management must make a compelling case for its strategy and how it will create value for investors. The board must support the strategy (or change it). In supporting the strategy, the board must adopt a compensation program that is aligned with the strategy and allows managers to participate meaningfully in the value they create for shareholders. Finally, boards and managers will need to explain to institutional investors and their proxy advisers how they intend to create value (strategic intent) and how they will allow managers to "share" in the value created. In short, the road less traveled may not be an easy road—but then it may make all the difference.