PAY FOR PERFORMANCE

Help for a Broken System

"While 'broken' may seem overly harsh, we should at least acknowledge that executive pay often falls far short of its objective in rewarding executives for long-term value creation."

Somewhere along the way, executive compensation veered off the road. It became too complex, isolated from true performance and downside risk, and in many cases, too high. The original idea of executive compensation was to pay an adequate and fair wage and good benefits. Any additional pay was intended to place executives in the same position as owners. However, with high base salaries, equally powerful short-term incentives, long-term incentives that are treated as income rather than investment and often protect against downside risk, and the potential for golden parachute payments that reward executives when they fail, something went wrong. The good news is that it can be fixed. The bad news is that it will require some bold new thinking on the part of boards and management.

Performance. Before discussing pay, let's examine performance.

- More often than not we reward CEOs for luck and good timing rather than for leadership, stewardship, and good strategy. Research has shown that as much as 80% of total return may be based on macroeconomic factors and industry trends unrelated to company behavior.
- Performance against internally developed goals is important, but may be unrelated to actions that build long-term value for investors. If a CEO is truly operating at a strategic level, the real impact of that leadership may not be evident for five to 10 years, and in some industries with long development or capital cycles, perhaps 15 years. Yet for the most part, we define CEO performance in terms of annual financial results rather than on more broad indicators of long-term value creation.
- Current year plan-based targets, ROIC, and share price are all great dashboard measures indicating directional progress, but these measures should not be confused with the actual success of a strategy or long-term value creation within an organization. Boards need to think long *and* broad when it comes to assessing performance.

If we are to improve the pay model, we must first be willing to commit to a longer-term view of performance and articulate exactly what success looks like.

Pay. Much of the current executive compensation thinking is a product of the 1980s and 1990s. Many of today's practices are influenced by the SEC's efforts to standardize disclosure, bringing more transparency and comparability to executive pay. Unfortunately, as with many things, there were unintended consequences.

- We think about and communicate pay in annual terms rather than in long-term outcomes. If in doubt, read the "compensation philosophy" section of the typical CD&A.
- We emphasize annual bonuses that pit CEOs' self-interest against investors when negotiating performance targets.
- We claim that equity is an incentive to create alignment and balance risk, but we allocate it on the basis of "competitive pay" like cash; we too rarely acknowledge an intended career allocation or a targeted ownership objective.
- We rationalize equity programs as putting executives in the same position as owners, but in our experience, executives rarely lose money. Annual equity awards are typically based on dollar-denominated "target values," protecting executives from stock price changes, and executive stock holdings are often sold once they exceed minimal ownership requirements.
- We use "competitive practice" as a synonym for minimum requirement, whether dealing with salary and incentives, terms of employment, or severance. Boards seldom exercise leadership in crafting employment arrangements directly supportive of the company's mission.

To say that executive pay is "broken" may seem overly harsh, but we should at least acknowledge that executive pay often falls far short of delivering on its objective of rewarding executives for long-term value creation. The first step in the cure is admitting you have a problem.

In out next article, we will examine several solutions to these problems.


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