

FORETHOUGHT COMPENSATION

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## Why Executive Pay Is Failing

by Stephen F. O'Byrne and S. David Young

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Most compensation packages do a poor job of linking pay to performance. Our research of pay packages at 702 publicly traded U.S. companies between 1995 and 2004 reveals that on average a 1% increase in company value generated a 0.43% increase in the estimated wealth of senior executives. That might not seem unreasonable, but there were huge variations across the sample, with executive wealth at some firms being highly sensitive to company value, while at others there was no sensitivity at all. More significant, nearly all of the incentives came from current stock and option holdings. (See the chart "Sensitivity of Executive Wealth.") The present value of future compensation, which constitutes 75% of executive wealth, shows very little sensitivity to company value.

So what did the incentive programs at these companies reward? We found that in nearly two-fifths of our sample firms, incentives for sales growth exceeded those for shareholder wealth, resulting in the obvious risk that managers at those companies pursued growth to the detriment of shareholder value.

Most of the blame for this sorry state of affairs, we believe, rests with the companies' reliance on competitive pay policies. When the primary focus of compensation is to ensure that managers are paid more or less in line with their peers at other companies, then pay

becomes decoupled from performance. If the share price drops, the number of option grant shares issued will be increased to ensure expected pay is maintained at competitive levels. Similarly, if the share price increases, fewer shares will be granted. In effect, the number of shares awarded (and potentially other elements of incentive pay) rises or falls inversely with the company's share price. The strong sales growth incentive arises because pay levels are closely tied to company size—the larger the company's revenues, the larger the average pay package.

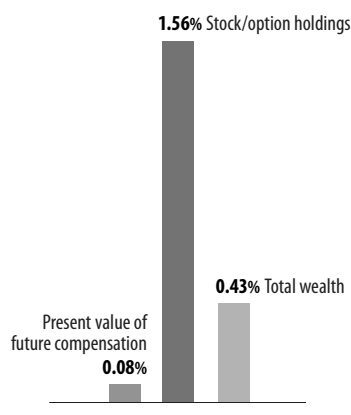
The justification for maintaining pay competitiveness is that it reduces the risk of losing good managers, who could be costly to replace. Corporate boards could also argue that it minimizes the risk of seriously overpaying managers as a consequence of large, windfall gains from surging share prices. In short, the claim is that competitive pay policies not only help lower retention risk but also impose limits on shareholder cost. This is false logic. By causing companies to overpay underperforming managers and underpay star performers, a competitive pay policy will actually increase retention risk. The poor performers stay on and the good ones go. What's more, it ignores the potential wealth-creating effects of strong financial incentives.

Despite their commitment to competitive pay policies, compensation committees sometimes do act to strengthen incentives by increasing option grant shares after a year of strong stock-price performance or decreasing them after a bad year. On the surface, this appears to be good news. But such moves have little overall impact because directors tend to reverse their actions in the following year. In other words, an option grant that rewards good performance or penalizes poor performance is followed, almost half the time, by a grant that penalizes good performance or rewards poor performance. On balance, therefore, ad hoc adjustments by boards contribute almost nothing to wealth leverage.

If companies are serious about rewarding performance and retaining star performers,

## Sensitivity of Executive Wealth

This chart shows the percent increase in the value of executive wealth in response to a 1% increase in company value.<sup>1</sup> While only 25% of executive wealth is in the form of stock and option holdings, holdings are far more sensitive to changes in company value than other components of executive wealth.



1. Median values for 702 publicly traded U.S. companies (1995–2004)

they will first have to wean themselves off competitive pay. They should give managers fixed-share interests in stock appreciation and economic profit improvement, thereby increasing the impact of future pay on executive wealth. Perhaps most important, they need to review vesting and holding requirements to prevent managers from unilaterally cashing out share-based pay, which also reduces the sensitivity of their wealth to company value.

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