How To Boost Pay For Performance

By Stephen F. O'Byrne

Companies could build better incentives in their executive compensation plans by adopting pay policies that tie compensation opportunity to performance, a consultant argues.

To understand executive incentives and executive pay, it is vital to: 1) look at wealth, not just annual pay; 2) measure the value of stock and options to executives who are largely undiversified; and 3) measure the sensitivity of executive wealth to controllable changes in shareholder wealth, such as shareholder return net of market and industry factors.

When we do all these things, we find that there is a lot more pay for performance than conventional analysis suggests. However, most companies could provide significantly stronger incentives by adopting pay policies that tie compensation opportunity to performance. A "fixed share" stock grant policy — such as one providing an annual grant of a fixed number of shares — provides a higher grant value when the stock price increases and a lower grant value when the stock price declines and hence, ties compensation opportunity to stock price performance. A stronger incentive increases compensation risk and will be good for shareholders only if it is cost-efficient.

Employing a wealth leverage measure quantifies the strength of the incentive and provides the basis for determining the impact of stronger incentives on firm performance and assessing whether the increase in shareholder wealth from the stronger incentive is sufficient to offset the cost of the compensation premium needed to control retention risk.

Measuring Pay

The most common criticism of executive compensation is that there is a low correlation between the percentage change in top management com-

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Objective	Definition	Measure
Strong wealth leverage	Offering managers sufficient incentive compensation to motivate them to work long hours, take risks and make unpleasant decisions to maximize shareholder value	Ratio of percentage change in executive wealth to percentage change in excess shareholder wealth
Limited retention risk	Offering good managers sufficient total compensation to retain them, particularly during periods of poor performance due to market and industry factors	Lowest total compensation percentage from market during periods of superior relative performance
Shareholder cost efficiency	Limiting the cost of management compensation to levels that will maximize the wealth of existing shareholders	Estimated incentive effect of above-market compensation minus the dollar cost of above-market compensation

pensation and the percentage change in the shareholders' wealth. The typical correlation analysis does not provide a meaningful picture of pay for performance because the pay measure used ignores the current year changes in the value of this year's stock and option grants, the value of prior years' stock and option grants and the present value of expected future compensation including future salary, bonus and stock adoption grants.

Using a pay measure ("realized pay") that includes the change in the value of all stock and option holdings and express realized pay as a percentage of the value of stock and option holdings at the beginning of the year, we find that 2002 shareholder return explains 62 percent of the variation in CFO pay vs. 3 percent for a conventional measure of current year grant date pay ("expected pay"). The sample used comprised 344 CFOs in the S&P Execucomp database.

To get a complete picture of pay and performance, we need to look at executive wealth return using a wealth measure that includes the present value of expected future compensation (such as future salary, bonus, long-term cash, other/other annual compensation and stock and option grant value). If a company offsets a decline in stock and option value by increasing base salary, the benefit to the executive far exceeds the current year salary payment.

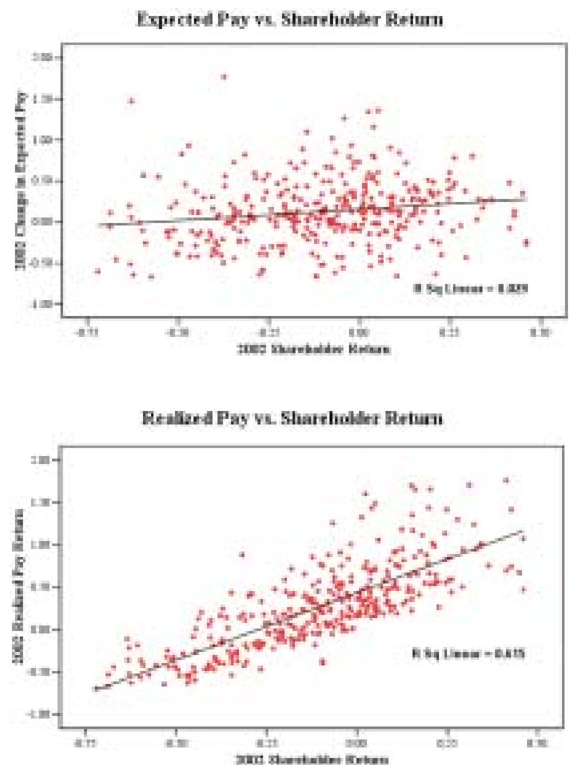
The present value of future compensation will be sensitive to current shareholder return if stock and option grant guidelines provide for a fixed number of shares or the bonus plan gives managers a fixed percentage interest in economic profit or economic profit improvement.

There are two ways the executive wealth return differs from the executive income return: the wealth gain or loss includes the change in the present value of future compensation and beginning wealth includes the present value of future compensation. Shareholder return explains 38 percent of the variation in 2002 CFO executive wealth return.

Measuring Incentives

High correlation tells us that executive and shareholder wealth move together, but it does not tell us the strength of the incentive — how much executive wealth changes in response to changes in shareholder wealth. A meaningful measure of incentive strength must reflect the sensitivity of executive wealth to changes in excess shareholder wealth, because the market and industry components of the return can't provide any incentive to managers, since managers have no control over market and industry factors. The measure of wealth leverage is the ratio of the percentage change in executive wealth to the percentage change in excess shareholder wealth.

The median wealth leverage of top management in a recent Shareholder Value Advisors study of 556 companies was 0.47. (For illustration, the wealth leverage of a "pure" entrepreneur, whose entire wealth is held in



company stock, is 1.0, since any change in excess shareholder wealth results in an equal percentage change in the entrepreneur's wealth.)

Designing Incentives

There are many ways to increase wealth leverage: front-load stock and option grants, adopt fixed-share stock and option grant guidelines, adopt fixed-share grant guidelines with larg-

er grants, tie expected bonus levels to cumulative performance by, for example, making the bonus a fixed percentage of economic profit and using a bonus bank to offset positive and negative years. The great challenge is to achieve increases in wealth leverage that maintain target (or better) levels of retention risk and are shareholder cost-efficient. The three critical objectives are illustrated (see chart, page 48).

Designing increases in wealth leverage that are cost-efficient and maintain target (or better) levels of retention risk requires a three-step process: 1) changing grant guidelines or plan design to increase wealth leverage; 2) offsetting the resulting increases in retention risk by increasing total compensation opportunities and/or changing plan design to reduce retention risk for superior relative performance; and 3) comparing the expected shareholder wealth gain from the additional leverage with the cost of the additional compensation needed to limit retention risk to ensure that the increase in leverage increases shareholder wealth.

Research on 1994-2002 wealth leverage and firm performance shows that a difference in wealth leverage of 0.5 is associated with a difference of 1.5 percentage points in annualized excess return. The three-step process shows that two grant policies provide, for the average company, increases in wealth leverage that remain cost-efficient when grant levels are raised to maintain target (or better) retention risk.

One of the grant policies is fixed-share option grants. The other grant policy, which is significantly more efficient than simple fixed-share grants, is "excess return fixed-share" option grants. In this grant policy, option grant shares are adjusted to offset changes in the stock price attributable to market and industry price changes, but are not adjusted to offset changes in the stock price attributable to the company's excess return.

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