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How Incentives for Long-Term Management Backfire

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To hear long-term investors tell it, company executives have embraced short-term thinking like never before. Two obvious pieces of evidence: The use of earnings for share buybacks that cost more than they're worth, and dividend increases that divert cash from long-term investment. Four hundred seventy-one companies in the S&P 500 bought back stock last year, and 372 companies expanded their dividends — actions undertaken in spite of the need to invest heavily to keep up with global market changes.

Why would executives, charged with sustainable value creation, put so much focus on short-term maneuvers like distributing earnings instead of reinvesting them? Why isn't more of that cash going into developing businesses for long-term gains — the big, outsized gains that come from big bets on the future? Among many good explanations is one that deserves more airtime: compensation design changes stemming from recent reforms that, ironically, were meant to benefit long-term shareholders.

This is a classic story of unintended consequences — inadvertently short-circuiting long-term management — to the detriment of companies, investors, and the economy. The normal culprits for short-termism are short-term-minded hedge-fund managers and activist shareholders, as well as CEOs worried about big bet investments with uncertain paybacks. But one other big factor has been hiding in plain sight: The efforts of corporate-governance activists and proxy advisers, empowered by the "Say on Pay" votes mandated by Dodd-Frank reforms, to stress transparency and pay for performance.

In the five years since the advent of Dodd-Frank regulation, corporate governance groups, with their policies requiring at least half of long-term incentives to be "performance-based," have pushed companies to replace options with multi-year, performance plans. How could anyone object to such an effort? Hardly anyone, except here is the rub: Performance plans require performance targets, and in most companies, planning works in three-year cycles. The logical performance period for long-term incentives is one that matches those cycles. Three years has thus become the standard performance window for measuring achievement.

So a three-year horizon — not even a presidential term — has inexorably become the norm for investing hundreds of billions of dollars of money aimed at creating "long term" value. With the best of intentions, many proxy advisors and long-term investors have widely blessed three years as appropriate, adopting three-year pay for performance as their standard comparison. Today, four out of five S&P 500 companies use a three-year performance period in their long-term incentives.

But executives today, who are paid on this new "long term," typically with equity based partly on earnings-per-share performance, naturally think twice about retaining earnings for projects beyond three years. Their measurements conflict with their managerial inclinations, encouraging them to use earnings booked today to immediately return cash to shareholders.

The downside of this "shareholder friendly" approach is evident at many companies. For example, one large technology company embraced a strategy to win through new digital businesses. The board chose earnings per share (among other financial metrics) to measure and reward executives for long-term performance. As earnings goals became harder to hit with internal growth, the company used most of its money for share buybacks to achieve its three-year earnings-per-share goals. The diversion of cash from investment slowed long-term strategic success. Eventually, the company's share price nosedived.

Another company, in the agricultural technology sector, chose free cash flow as the primary long-term incentive measure. Facing headwinds to growth, executives delayed R&D and capital investments to hit three-year free-cash-flow goals. In effect, the pay plan rewarded them for sacrificing the long term.

Look no farther than GE to see how the hard wiring of the three-year time period has taken hold in even the most well-run companies. Jeff Immelt is transforming GE to make it a leader in the "Internet of Really Big Things" and to loft GE into the top echelon of software companies. This is a very long-term — decade-long — task. But, surprisingly, Immelt's pay plan largely focuses on one- and three-year increments. The plan does make Immelt and his team accountable for GE's intermediate goals: repositioning GE's portfolio of businesses, simplifying its structure, making GE Capital smaller and more focused, and emphasizing returns.

But what about incentive pay for motivating Immelt and his team to execute the company's "big bets" on digital transformation? Little financial incentive exists.

What do we suggest as pay-program essentials for GE and others going through massive change? Four things:

- First, continue the common practice of annual plans, generally paid in cash, based on annual financial goals and short-term strategic objectives.
- Second, continue three-year plans, generally paid in stock and based on financial goals.
- Third, add a new element: strategic milestones, mostly nonfinancial and ranging from three to seven years, whose achievement is required for executives to earn long-term payouts.
- Fourth, to strengthen the focus on the genuine long term, continue or add back stock options while also toughening stock-holding requirements so a meaningful portion of stock incentives must be held to retirement or beyond.

Strategic milestones, a key element, would be part of the new norm. They would be specific, objective strategic achievements, having zero room for interpretation and would provide a gauge of progress on the road to strategic success. These strategic goals could be tied to restricted stock or next-generation options that vest upon the attainment of key strategic milestones. The combination of these actions would directly encourage executives to extend their three-year gaze to as much as a ten-year horizon.

Here's a hypothetical example of how they might work at GE. One milestone might include completion of prototype-level next-generation digital products. A subsequent milestone might be delivering $10 billion in sales of the new product or service. A third might be retrofitting a specified share of veteran customers with the new product.

A handful of companies have already started to include strategic milestones in their three-year long-term incentive plans, a good first step. One technology company is focusing on consumer adoption of new platforms. One retailer is focusing on improvements in average dollars per transaction, the number of new and newly renovated stores, and percentage international sales growth.

We expect a lot of long-term investors to cheer as such change takes hold. Investors in this long-term class are those like Larry Fink, CEO of BlackRock. Fink wrote in his 2016 governance letter to CEOs: "We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation." In his letter, Fink added that he wanted to see company bosses "more focused…on demonstrating progress against their strategic plans than a one-penny deviation from their [quarterly] EPS targets or analyst consensus estimates."

With the changes we suggest, company outsiders would see even more clearly how executives are executing a plan, and getting properly paid, for winning over five and ten years. To be sure, we are addressing only one difficulty arising with executive pay, and the many unintended consequences from incentive pay have been widely debated and discussed. Still, we believe the right incentive structure, coupled with appropriate governance, market, and managerial reforms, can help motivate executives to take bold action for the future and reward outsized long-term success with outsized rewards.

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