Compensation

Too Much Short-Termism: Has Executive Pay Contributed to the Problem?

Re-evaluating pay practices can help boards protect long-term company interests.

By Blair Jones and Roger Brossy

If you take large-company executive pay packages at face value, they typically offer a strong incentive for superior, long-term performance. Incentive grants for the long term make up about 80 percent of CEO pay packages for the 250 largest companies in the S&P 500. That percentage dwarfs the 20 percent represented by salaries and annual bonuses. With so much long-term pay at stake, why do long-term institutional investors object that companies are too short-term–oriented? The Vanguard Group, BlackRock, and State Street, for example, have raised concerns over the lack of a long-term value creation mind-set. If we take a close look at executive pay practices, we can gain a greater understanding of the evolution of long-term incentives, how they might contribute to short-termism, and how they might better fuel long-term gains.

How Incentives Have Evolved

Since the start of the 1982 bull market, long-term incentive grants were substantially—if not wholly—awarded in stock options. Those options typically had 10-year terms and were struck at the share price at the time of grant. While options gradually lost favor as a component of executive pay packages, the advent of the Securities and Exchange Commission's say-on-pay rule in 2011 nearly put an end to them. Proxy advisors, flexing newfound muscle, took a dim view of stock options. The advisors objected—as did others—to gains on options by executives merely riding the bull-market wave, even while underperforming in relation to direct peers or the market. Options were branded "not performance-based" and thus went out the window. In their stead, proxy advisors advocated issuing incentives based on specific, preset performance goals or high performance relative to other companies.

In cases where options are still a component of compensation packages, they rarely exceed 25 percent of the value of long-term awards. Grants tied to absolute goals or relative performance measures now make up 90 percent of pay packages for executives of the 250 largest S&P 500 companies, and typically constitute at least half or three-quarters of the granted value. Restricted shares—which are tied to the executive staying with the company and are non-transferable—have also increased in use.

The Changing Time Horizon

Anyone who has served on a board knows that choosing measures that stand the test of time and then setting goals for those measures over multiyear time frames is tough, if not a fool's errand. The more you weight these incentives, the more their architects are inclined to "dumb them down" so that they don't become dysfunctional and destructive. This can result in easier-than-desired goals, shallower payout curves so over- or underperformance carries less consequence, or shorter time frames to make the setting of multiyear goals less quixotic.

And time frame is key. Today, the typical executive's goal-based incentive carries a three-year performance period, and restricted shares generally vest over that period as well. Without stock options to encourage a long-term focus, pay programs create a three-year myopia, shorter than many companies' investment and market cycles.

Proposing an Ownership Ethic

The point of most executive pay philosophies is to align executive and shareowner interests. Given that some of the biggest institutional shareholders are themselves long-term–oriented—their index strategies imply they will hold company stock indefinitely—what about encouraging or requiring executives to be long-term holders too? Would that extend the executive time horizon beyond the three years?

We looked at the stock holdings of long-tenured CEOs of S&P 500 companies who were not founders. (The founders of companies like Amazon, Google, and Facebook are outliers and we left them out of our analysis.) We selected CEOs who have been in their jobs for at least seven years and then ranked them from highest to lowest based on seven-year total shareholder return. Turns out the top half own shares worth 11 times their annual total compensation. By contrast, the figure for the bottom half is only an average of 5 times. In other words, ownership interest correlates with long-term performance.

A Few Modest Proposals

An ownership ethic is just that—an ethic. Boards cannot mandate it. Aside from asking an executive to voluntarily take a greater ownership interest, we believe boards can strengthen and align programs with an ownership mentality.

1. Revisit share ownership guidelines. Most large companies have adopted share ownership guidelines. In one study, Equilar found that 88 percent of companies disclosed their guidelines in 2014. But many of these companies achieve little more than a tick in the checkbox on the corporate governance score sheet. With unvested shares counted, many executives achieve their requirement without having much, if any, outright ownership. So that the board better communicates its expectations, directors should consider having guidelines requiring the accumulation of outright ownership over time.

One approach that helps executives build ownership over time while still allowing a reasonable opportunity to diversify risk is to adopt retention, instead of share ownership, guidelines. Executives would then have to keep a portion of the shares they acquire through long-term incentives for the duration of their tenure.

2. Keep a place for stock options. While we don't argue for a return of the options-only designs of the 1980s and 1990s, we do urge companies to use options in long-term incentive portfolios to lengthen and diversify the time frames covered. Options lead executives to think like owners, despite assertions to the contrary. Options are performance-based: the share price has to appreciate before anyone can make anything from them—exactly mirroring the experience of shareholders. As a tool to encourage and reward long-term share price appreciation, options have been highly effective. They encourage executives to look past ephemeral, exogenous knocks and rewards for investment that has a sustained, long-tail return.

3. Consider longer-term vested equity.

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A recent thought piece in *The Economist* argued for the award of stock without any contingent performance conditions but with restrictions on the executive's ability to sell. The argument is to tie managers' payouts to long-term performance without the incentive to game results or the stimulus to prompt dysfunctional outcomes during multiyear goal setting. In fact, some companies have used such an approach to stake executives in the business and build an ownership ethic over a career. Exxon has granted stock with 10-year vesting and no performance conditions for years. Apple has granted 10-year stock, too, without performance conditions.

But proxy advisors have criticized these practices. In the advisors' eyes, the long time frames during which the executive would have no access to the stock and would have a long exposure to the fates of shareholders did not offset the absence of specific (or steep enough) performance goals. As a sign of the times, Apple amended its grant to CEO Tim Cook to add performance conditions. Still, we think this school of thought has to evolve to recognize that you get better long-term thinking and stewardship with a different approach than three- or even four-year goals.

Executive pay isn't the sole culprit in short-termism, and it doesn't contain a silver bullet to fix the problem. But the shift to goal-based long-term incentives has brought the unintended shortening of performance time horizons—as much as 70 percent shorter than the historical 10-year long-term performance window. Making the three shifts in thinking and pay design we have outlined here can help boards to restore balance and address the concerns of true long-term investors.

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The authors' colleague Margaret Hylas also contributed to this article.