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Rethinking executive compensation

By Marcel Côté

For the past 30 years, to foster a better alignment of the interests of senior management with those of shareholders, a large portion of their variable compensation has been share-based, generally through stock-option plans. Roger Martin, dean of the University of Toronto's Rotman School of Management, is now challenging this principle. According to Martin, shares and options are not good incentives because they encourage executives to rely on short-term strategies and to take excessive risks. Performance-based compensation should be tied solely to a company's actual results, i.e., profit or earnings before interest, taxes, depreciation and amortization (EBITDA), and not to what's happening in the stock market.

Martin's proposal, introduced in his new book, The Design of Business: Why Design Thinking is the Next Competitive Advantage, is worthy of serious debate. He uses a football analogy to illustrate his point. What would happen if a quarterback's pay depended on the number of times the team beat bookmakers' expectations — the spread they offer the betting public — and not on the number of games won? If a quarterback beats the spread systematically, bookmakers would increase it, anticipating actual results and levelling the odds for bettors. In the long run, beating the spread wouldn't work as a compensation system, and quarterbacks would fail as often as they won, although it would encourage them to take more chances.

Executives whose variable compensation is stock-based are in a similar situation. Stock prices reflect investors' expectations. Management can surprise the market, but not consistently. So unless the game is fixed, stock options are an unreliable way to reward executive performance.

Stock options are issued at market prices. To benefit from them, the stock price has to increase, which implies that senior managers have to increase investor expectations. Since there is no reason why investors would systematically underestimate the value of a stock, how can management win at this game?

For a while, management can invent a rosy story, wait for share prices to go up and cash out on their options before investors realize they are being fooled. But that would be illegal. Another way is for management to be lucky and benefit from a general rise in stock market value, as experienced from 2002 to 2008. A booming stock market allows executives to pocket huge, often undeserved, profits. That's just luck, but it does work in bearish markets.

Another way to beat investors' expectations is for management to surprise the market by taking on more risks, which often involves betting the farm.

Stock-option plans can also demotivate management when options go under, either because of stock market crashes, as in 2002 and 2008, or when a company reaches maturity and its stock peaks. Holders of stock options are then penalized regardless of their actual performance. Managers at companies such as Microsoft and General Electric, whose stock has peaked as investors readjust-ed their expectations, lost on their options even if earnings kept increasing. When maturity reduces investor expectations about future growth, executive options lose their value, no matter what the executives' input.

Variable compensation plans for senior executives should be tied to the company's actual performance, not its share price, which mainly reflects investor expectations. What should count is the company's actual performance while the executive is in the C-suite. In addition to salary and a short-term bonus based on annual results, a well-defined compensation plan should include a long-term bonus based on the average financial results of the last three to five years. This would help focus management's attention on improving actual performance and steer it from trying to influence stock market speculation.

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