The Fundamental Problem with STOCK–BASED COMPENSATION

*Stock-based compensation is widely accepted as a way to align the interests of managers with those of shareholders. While he once believed this, Dean **Roger Martin** argues here that in reality, this type of compensation actually pits managers against shareholders – leaving too many shareholders holding the bag.*

IT is never easy to face the reality that something you hold near and dear to your heart is just plain wrong. It happened to me with respect to stock-based compensation – whether stock options, restricted stock, shadow stock or any other form of incentive compensation based on the publicly-traded stock of the manager's firm.

The dominant proposition is that stock-based compensation of management creates a harmonious alignment of their interests with the interests of shareholders. The reigning orthodoxy in the business world – as well as the realms of business academia and compensation consulting, is that with stock-based compensation, managers will manage in a fashion that is most beneficial to shareholders generally. In short, 'The more stock-based the compensation of management, the better.'

I, too, once believed this – but no longer.

With ever-increasing application of the dominant orthodoxy, we have witnessed increasingly dreadful results. Enron, WorldCom, Global Crossing, Tyco International, Qwest Communications and a host of dot.bombs were all led by managers with powerful stock-based incentives. Yet their shareholders have been devastated – in some cases completely, in most cases substantially.

At the heart of the problem is a fundamental schism between the stock market and the corporate market.

How did this happen? Isn't management supposedly aligned with shareholders? No, and that's the problem. Enron, WorldCom, Global Crossing, Tyco and Qwest are indicative of the problem, not outliers.

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corporate market. The corporate market is characterized by transactions between buyers and sellers of products. Products and services are produced and sold, and in the case of successful corporations, profit margins are generated, producing real earnings. To get more *real* earnings, a corporation needs to make more *real* sales and generate more *real* margins.

In contrast, the stock market is ethereal. Its transactions and valuations are based on expectations of future real earnings. It is based on inherently speculative predictions about the goings-on in the real corporate market.

The scenario is not unlike the schism between the 'real market' of NFL football and the ethereal market of betting on NFL football. Every Sunday afternoon, from September through January, real teams put on uniforms and play real games with real outcomes. However, floating above this reality like a cloud is another game entirely – the game of betting on these games. This is inherently a speculative endeavor, because it involves making predictions about what will happen in the real games.

In the stock market, stock prices rise only if expectations as to future earnings rise: there is no other way. Stock prices don't necessarily rise when real earnings rise – they will rise only if real earnings rise to a higher level than previous expectations. Similarly, the betting line for a football game will change only if expectations about the outcome of the upcoming game change.

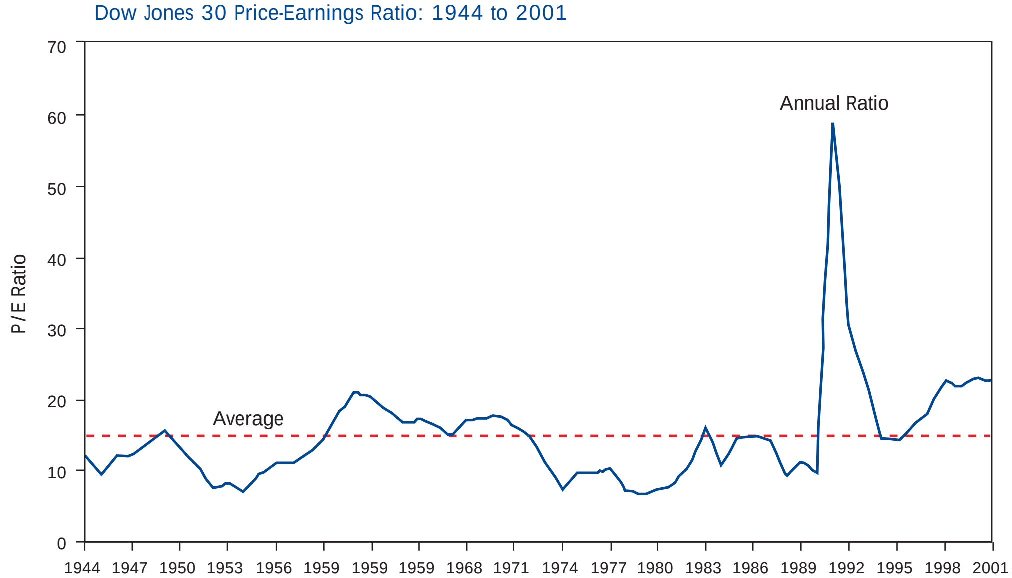
As a result, we can conclude that the biggest leverage in raising stock price is not in increasing real earnings, but rather in raising expectations about future earnings.

We all thought that giving managers – especially senior executives – stock-based compensation would generate, first and foremost, a strong incentive for these managers to increase real earnings. It has not. What it has done, first and foremost, is provide an incentive for them to raise expectations about future earnings.

The single toughest (and slowest) way to raise expectations is to increase real earnings. Fortunately for the stock-compensated manager, there are a number of easier ways. First, they can hype expectations for future earnings beyond anything that is actually achievable. Second, they can produce a simulated increase in real earnings by using 'aggressive accounting' to produce unreal earnings. Third, they can generate short-term real earnings that cannot be sustained, and thereby produce a short-term rise in expectations. These are much easier ways to raise expectations than working hard to increase real earnings.

The counter-argument might be that these tactics only raise expectations for the short term, and thus are not in the interests of managers with stock-based compensation. However, since the managers who follow these tactics have the ability to time their purchases and sales of stock, they can take

Dow Jones 30 Price-Earnings Ratio: 1944 to 2001



advantage of their knowledge about expectations versus real earnings and benefit tremendously. In fact, stock-based compensation creates the direct and clear incentive to raise expectations of future earnings and then sell the stock before expectations fall – and then do it all over again.

It should be no surprise that many executives involved in the recent spectacular corporate failures made tens and even hundreds of millions of dollars cashing out stock and stock options before the lofty expectations fell to more realistic levels. For example, a mere 13 insiders at Qwest sold $2 billion worth of stock in the period of time that Qwest dropped from a market capitalization of $85 billion to $4 billion. They simply followed the incentives placed before them by their Board of Directors – the representatives of the very shareholders these managers ended up devastating.

Rather than stock-based compensation aligning the interests of managers and shareholders, it actually pits them directly against each other. It provides an incentive for managers to create unrealistic expectations that drive up the stock price – even if the process of creating the unrealistic expectations irreparably harms the firm – and then sell their stock to outside shareholders before the expectations crater. All they need is a few unsuspecting outside shareholders to buy their inflated stocks for this tactic to work.

Of course, not all managers behave this way. What I am describing are simply incentives – not compulsions. Managers have a distinct choice to advance their personal net worth the slow, steady and honest way – by focusing on increasing long-term real earnings, stating their earnings honestly and eschewing hype – or the fast and dishonest way, through management of expectations and cleverly-timed stock sales. Fortunately for shareholders everywhere, many of the former exist. However, through the rise of stock-based compensation, these honest managers are increasingly encouraged to turn from focusing on increasing real earnings to focusing on raising expectations.

The solution is simple: don't use stock-based compensation. Compensate on the basis of real, long-term earnings growth – as if the firm in question were private, not publicly-traded. This is the best way to align the interests of management with the interests of shareholders. Interestingly, NFL football uses the analog of this approach: it strictly separates the real market of NFL games from the ethereal market of betting on games by strictly banning players from betting on games. Why does it do this? Because it doesn't want players manipulating the games in order to profit from betting. Arguably, the NFL's view of the potential problems with the schism between the real world and the ethereal world is more sophisticated than that of the entire business sector.

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If a firm insists on using stock-based compensation, despite its shortcomings, there are four ways to reduce its problematic outcomes:

1. Use long vesting periods to make it more difficult to sell efficiently on the basis of knowingly-excessive expectations;

2. Prohibit selling until the point of retirement or exit from the company for the same reason as the first tactic;

3. Use stock – not stock options – because ownership of stock options provides the strongest incentive to create excessive expectations, then sell-out, let the stock fall dramatically and start over again;

4. Force managers to publicly announce their intent to sell stock or exercise options one week before the actual transaction, to allow the market to adjust price on the basis of the forthcoming insider sale, rather than allowing the market to find out about insider sales only when it is too late.

These methods will only serve to decrease the schism in incentives between real earnings for shareholders and future expectations for managers with stock-based compensation. Instead, I firmly believe it is time to change the orthodoxy. Stock-based compensation sounded great, but real life has demonstrated that it disaligns, rather than aligns – and too many people have already paid the price.

An article on this topic by Dean Roger Martin appears in the January 2003 edition of Harvard Business Review. RM