



"Unequaled Personalized Service"

March 2009

Research Perspective – Compensation Frustration

Introduction

Executive compensation is a popular topic in government, in the media, and among clients. This is primarily because many executives have continued to receive huge salaries and bonuses even though their firms have generated massive losses and are eliminating jobs. As a result, the U.S. government is stepping in to curb executive compensation at firms receiving taxpayers' dollars.

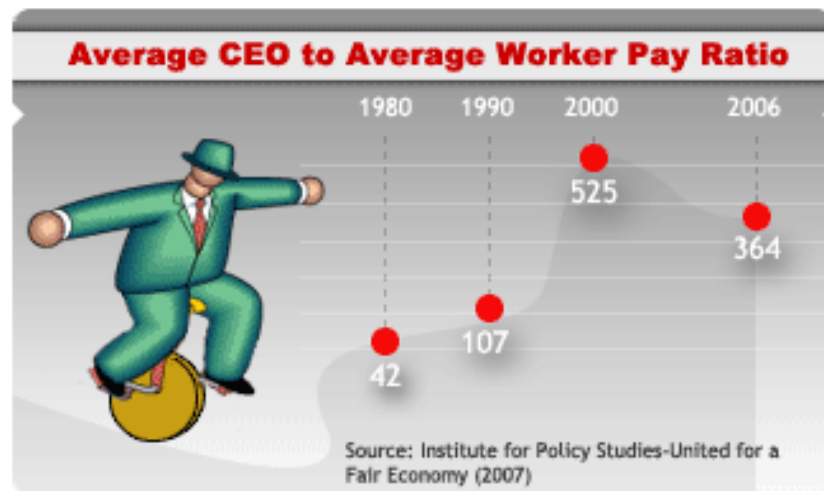
This research perspective will provide a brief history of how executive compensation has evolved and then describe key guidelines that we believe firms' boards of directors should follow to improve the way executives are compensated. A summary is below:

Summary

- Since 1980, executive compensation has increased dramatically.
- The U.S. government has tried to limit excessive compensation to executives for decades, without success. In fact these efforts seem to have had the opposite impact, enabling the law of unintended consequences. Executives have become adept at bypassing government legislation and finding new ways to enrich themselves.
- The recently passed stimulus bill, the American Recovery and Reinvestment Act of 2009, limits compensation for executives of firms receiving taxpayer funds through the Troubled Asset Relief Program (TARP). Like past efforts, this latest government attempt to reign in compensation is likely to result in unintended consequences that might not be in the best interests of rank-and-file employees, shareholders, or U.S. taxpayers.
- Rather than rely on government intervention, company boards of directors should follow several key guidelines to create an environment that more appropriately rewards executives for creating significant shareholder value over time. The key guidelines are as follows:
 - ✓ Pay executives to create shareholder value based on measures of profitability such as return-on-assets and return-on-equity
 - ✓ Pay should be tied to long-term results and subject to "clawback" provisions
 - ✓ Pay for what executives accomplish, not in advance for what they *might* accomplish
 - ✓ Pay compensation in stock and cash, but not stock options
 - ✓ Avoid rewarding or penalizing executive pay based on actions outside of management control
 - ✓ Executives should be required to retain substantial stock holdings after retirement
 - ✓ Hire capable board members that are likely to challenge executives and look out for shareholders' best interests
 - ✓ Boards of directors and shareholders should avoid hiring executive compensation consultants

A Brief History of Executive Compensation

A recent study found that CEO pay increased approximately 600% from 1980 to 2003. Since 2003, executive compensation has continued to grow. These are dramatic increases, considering that rank-and-file employees' salaries have not gone up nearly as fast. As a result, the average CEO's annual compensation package is hundreds of times more than the pay of the average worker (see picture below).



Excessive compensation has always been under scrutiny, more so during times of distress.

In 1984, Congress tried to limit excessive compensation by imposing an additional tax on severance pay greater than three times an executive's annual pay. At the time, many companies provided severance of approximately one year of pay. Companies interpreted the new rule to mean that anything up to three times an executive's pay was permissible, so severance packages began rising. Additionally, many companies that exceeded the specified severance level began providing the executive with a "gross up", which is a bonus payment to cover the additional taxes. As a result, regulation intended to *limit* severance pay actually *increased* it.

Similarly, in 1993 the government tried to limit companies' tax deductibility of salaries greater than one million dollars in the hopes of reducing executive pay. This had the intended benefit of limiting executive salaries, but executives started receiving larger amounts of stock options that provided tax benefits for the firms that doled them out. This unintended consequence resulted in even bigger gains for executives, especially in the bull market of the 1990's.

Earlier this decade, many people hoped corporate embarrassments at companies such as Enron and WorldCom generated enough public disgust that improved management behavior and pay would result. The U.S. government introduced the Sarbanes-Oxley Act of 2002 to encourage more proper management actions and pay. The outcome is increased oversight of companies by corporate boards of directors, but excessive executive pay clearly still exists.

The government has tried to limit excessive compensation in the past by speaking out against excessive pay and imposing regulations, but it has been unsuccessful. When new rules are put in place, executives find ways around them to get paid more. Partially as a result of government actions, executive compensation has morphed from simple, cash-based plans into complex packages that can include stock options, deferred compensation, restricted stock, stock appreciation rights, and pre-negotiated severance plans (aka “Golden Parachutes”). Now it is difficult for anybody to tell how much an executive is paid and what an executive is paid to do.

The latest round of government intervention could cause its fair share of unintended consequences as well. A few we see are:

- Companies that did not receive TARP funds could poach talented executives from firms that did receive taxpayer money with the allure of higher pay, thus hurting the taxpayer-backed firms’ prospects.
- The new regulations may also incentivize some banks to return the taxpayers’ money early instead of using the funds to improve credit conditions by lending more.

It is a sad state of affairs when the government needs to step in and regulate executive compensation. The good news is that with executive compensation in the spotlight, all firms have a wonderful opportunity to improve their executive compensation structures for the benefit of shareholders. Below are guidelines that we believe boards of directors should follow to establish appropriate compensation structures that can eliminate most of the problems we see in executive compensation today.

Key Guidelines for Improving Executive Compensation

✓ ***Pay executives to create shareholder value based on measures of profitability such as return-on-assets and return-on-equity***

Executive pay should be tied to financial measures that reflect the creation of value for a company’s shareholders. The best way to increase shareholder value is to increase a firm’s profits over time. Financial measures that most adequately capture profitability are *return-on-asset* (ROA) and *return-on-equity* (ROE). If you are not familiar with these terms, please do not let them intimidate you. They are simply ways of measuring what profit can be made relative to the money and resources invested in a business... so the higher the ROA and ROE for a business, the more profit is generated from money and resources invested in a business.

While paying based on measures of profitability sounds logical and straightforward, you might be surprised how many companies compensate executives for other reasons (i.e. job title, years of service, sales, market share, firm size, etc). Many companies that claim to pay executives based on profitability are doing so inappropriately (i.e. firms might be using metrics that ignore certain costs and can be easily manipulated).

✓ ***Pay should be tied to long-term results and subject to “clawback” provisions***

Too many executives and Wall Street employees have reaped the benefits of generating large profits in a year or less. When many of those same employees generate huge losses for their companies, they do not lose any of the compensation that was previously given to them. That type of compensation system encourages significant risk-taking in pursuit of short-term personal gains. That system can be detrimental to companies and their long-term shareholders. In attempting to align executives' interests with a company's long-term viability, *we would prefer these employees receive compensation based on their contributions over multiple years, at a minimum.*

Under this model an executive could have a great year and receive a large bonus, but the bonus would not be paid out immediately. Instead, the bonus is set aside at the firm and paid out to the executive over the course of several years. If the executive continues to do well in future years, more bonuses will result and get paid out over time. If the executive has some bad years, the prior bonuses will be *reduced* (the process of reclaiming prior income is also known as a “clawback”). By rewarding an executive for good years and penalizing him/her during bad years, a company sets up a system that decreases risk-taking for short-term personal gains, and reduces the likelihood of short-sighted decisions. This model helps align executives' actions with the interests of long-term shareholders.

✓ ***Pay for what executives accomplish, not in advance for what they might accomplish***

Executives are often lavished with generous compensation packages before they even start their new job. As mentioned earlier, compensation packages typically include not only sizeable cash salaries and bonuses, but also a host of other items upfront: stock options, restricted stock, other stock-related forms of compensation, deferred compensation packages, and pre-negotiated severance packages. Before an executive has to lift a finger at the new job, he/she already has received a very large pay day.

Many board members say they need to offer these lucrative packages upfront for fear of losing executives to other firms that will compensate handsomely. These compensation packages achieve the result of *hiring* and *retaining* an executive, but they reward an executive for just showing up. This is inappropriate because it reduces the executive's incentive to earn the compensation and does not align his/her interests with shareholders.

For example, if a CEO gets fired for doing a miserable job, shareholders probably suffered as a result of the CEO's efforts (or lack thereof). However, that CEO will typically benefit from getting dismissed via receiving a multimillion dollar severance package agreed upon before he/she was hired. Additionally, the CEO typically is granted the ability to exercise all of his/her stock options regardless of whether the options were previously exercisable. Obviously, this is not an appropriate structure to align interests of executives and long-term shareholders.

If your potential executive hire really is that concerned about receiving these types of compensation packages, he/she is probably not the right fit for long-term shareholders anyway. We prefer executives that are honest, capable, and value the well-being of the firm rather than hired mercenaries that bounce from firm to firm based on who the highest bidders are for their talents.

That being said, we want to make it clear that we actually like seeing executives get paid very well, but only *after* they achieve or exceed their goals.

✓ ***Pay compensation in stock and cash, not stock options***

As an executive produces results, compensation should be calculated and paid in the form of cash and stock. We believe stock should be the primary means of payment until the executive has a substantial amount of wealth in the stock, further aligning an executive's interests with those of shareholders.

Note that we prefer minimizing the use of stock options in compensation plans. Stock options are difficult to value, are similar in many ways to lottery tickets, and can encourage risky behavior on the part of executives.

✓ ***Avoid rewarding or penalizing executive pay based on actions outside of management control***

We also recommend avoiding structures where executives derive significant value from something they do not control. For example, an upfront grant of a block of stock options at the time of hire could transfer substantial value to the executive if interest rates fall, which drives up stock prices. This has nothing to do with the executive's performance. Additionally, management underperformance could actually make the company vulnerable to a takeover that would enrich management because of the stock option package.

✓ ***Executives should be required to retain substantial stock holdings after retirement***

We recommend requiring executives to retain a substantial amount of their stock investment that had been accumulated for a significant number of years after retiring (typically three to five years). This aspect of the plan creates an enormous incentive for the executive to take the necessary steps to groom a replacement and leave the company well prepared and in good hands. This also eliminates any desires to cut corners, inflate earnings in the short-term, and pump up the stock price to retire and cash out. As a result, this increases the odds that good profitable results will be sustained over time for the benefit of the firm and its long-term shareholders.

✓ ***Hire capable board members that are likely to challenge executives and look out for shareholders' best interests***

Board members have a fiduciary obligation to monitor senior executives of a firm on behalf of shareholders. However, potential board members are oftentimes selected by the CEOs they are supposed to oversee. These board member candidates are then easily elected to boards by shareholders via voting contests where no opponents run against them. Many times, candidates are the CEO's friends. As a result, it is not hard to see why board members are beholden to CEOs and compensate them handsomely.

The solution is for shareholders to elect board members that are honest, capable, have a genuine interest in the company, and are likely to challenge the CEO and other board members. If shareholders have difficulty electing the correct board members, electing a new Chairman to run the board of directors might be warranted.

✓ ***Boards of directors and shareholders should avoid hiring executive compensation consultants***

Executive compensation consultants are supposed to be experts in their field, and so it might sound logical to have them help construct better compensation plans for executives and board members. However, compensation consultants are expected to evaluate the same executives and directors who hire them. Additionally, these consultants many times provide other services like benefits administration to the same firm, thus creating a potential conflict of interest and increasing the incentive for consultants to pay executives and directors more.

Research supports our view. Recent studies reveal that companies using compensation consultants tend to pay CEOs and directors more than companies that do not hire compensation consultants. Studies also conclude that larger firms hire compensation consultants more often than smaller firms, and that these larger firms pay their CEOs more than smaller firms, regardless of performance.

After reading the guidelines above, it may become apparent that we like investing in companies with executives that have large ownership stakes and are founders or parts of long-standing management teams (think decades). Several studies show that historically, these types of companies, often labeled "family-owned companies," generated higher returns-on-assets and returns-on-equity than their peers, and were less likely than other firms to overpay for acquisitions. We believe the outperformance occurs because large direct ownership makes management view *corporate* dollars and resources as *their* dollars and resources (as opposed to some other shareholders' dollars). Therefore, they spend and invest corporate dollars more consciously and carefully than others. As a result of the time and effort devoted toward creating and sustaining businesses over time, these executives may also care for their organizations in ways hired hands do not.

Conclusion

We appreciate the intent of the government's recent legislation to reduce executive compensation, which has gone up significantly over the past several decades. However, we feel the spirit of this new regulation may be trumped by the unplanned consequences that could occur. If the past is any indicator, the government efforts might come up short in benefitting shareholders, employees, and U.S. taxpayers.

Rather than having the government impose itself on companies, we believe companies have a great opportunity to reform their compensation policies from within. We are not so naïve as to believe that there is a perfect one-size-fits-all compensation plan that will eliminate excessive pay and poor management behavior. If management is dishonest and up to no good for his/her own self-interest, a company and its shareholders are likely to suffer regardless of the compensation plan in place. In our view, adopting the guidelines above would go a long way toward eliminating the majority of the flaws and abuses that exist today.

If interested in reading more about executive compensation, we suggest the following material.

Recommended Reading

1. EBS Asset Management. *White Paper: Improving Compensation Structures*. 2003 and 2006.
2. Warren E. Buffett. *The Essays of Warren Buffett: Lessons for Corporate America, selected, arranged, and introduced by Lawrence A. Cunningham*. The Cunningham Group, 2001.
3. G. Bennett Stewart III. "How to Structure Incentive Plans that Work." *EVALuation* April 2002.
4. Anderson, Ronald C. and David M. Reeb. "Founding-Family Ownership and Firm Performance: Evidence from the S&P 500." *Journal of Finance* 58 (2003): 1301-1329.
5. The Conference Board. *Commission on Public Trust and Private Enterprise Findings and Recommendations*. 2003.
6. Fortune's Issue on Executive Compensation. April 14, 2003.
7. Journal of Applied Corporate Finance's Issue on Corporate Governance. Spring 2003.

Disclosure: The information provided by third parties has been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed.