The Incentives Paradox

Toggling between long-term strategy and short-term earnings pressure

Anybody can manage short, and anybody can manage long. Balancing those two things is what management is

--Jack Welch, former Chairman and CEO, GE

What is short-termism?

- “ The excessive focus of decision-makers on short-term goals at the expense of longer term objectives” *Ernst & Young Poland Report*
- What suffers?
  – Strategy
  – Fundamentals (ROA, ROIC)
  – Human capital

What drives it?

- Every pundit has a view
- And every pundit cites different research, most of which is contradictory
- BUT some common drivers are…
  - Incentive plans of asset managers <u>and</u> executives
  - Decreasing CEO tenure
  - Frequency and nature of CEO communication
  - “Transient” investors

- Plus:
  - new technologies
  - globalization of financial markets
  - reduced trading times and transaction costs
  - market volatility
  - omnipresent media
  - increasing role of institutional investors
  - shareholder activism

Emerging regulation/standards don't help

- Relentless focus on relative TSR (see proposed SEC regs on disclosure) – "every dog has his day"
- Negative proxy advisor view of CEO contracts potentially influencing reduction in tenure
- Fixation on performance-based pay: emerging research suggest no meaningful correlation with results

Is this problem solvable?

- NO
  - “It’s unrealistic to expect most CEOs of publicly listed companies to ignore short-term pressure from the financial markets...The only way to foster meaningful change is to enlist pension funds, mutual funds, and other large investors in the cause. ” Dominic Barton, Mckinsey and Co, with Mark Wiseman, head of Canada Pension Plan Investment Board

NO…

- “Too many investment managers…focus excessively on quarterly performance relative to their benchmark and competing funds…People do what they are rewarded for doing…” Alfred Rappaport, Saving Capitalism from Short-Termism
- “The world would be a better place if businesses stopped thinking so much about short-term results and focused more on the long term…Yet it has proved nearly impossible to shift their behavior…” Adi Ignatius, Harvard Business Review

…Or maybe

- Lengthen CEO tenure and focus on long-term investment *EY Poland Report*
- Abandon the notion of growing shareholder value – a money-maker for the C-suite – and focus instead on investing in the future and in talent *Roger Martin, Fixing the Game*
- Lengthen time horizons of comp packages for executives and asset managers, stop projecting quarterly earnings and limit empty voting by transient investors *Robert Pozen, Curbing Short-Termis in Corporate America: Focus on Executive Compensation*

How can compensation tools help?

- Lengthen time horizon of performance plans
- Stick with consistent performance measures – companies with consistent measures 5+ years outperformed peers
- Choose the right measures

IF YOU CAN FIGURE OUT WHICH ONES THEY ARE!

TSR?

- Dodd Frank proposed pay vs performance disclosure. 5-year table showing actual pay for CEO/NEOs compared to SCT data and cumulative TSR of company/peer group.
- Critical ISS measure
- BUT – abundant research suggests limited value in motivating executives, rewards volatility rather then performance, low correlation with strong returns

EPS?

- Research suggest EPS more strongly related to strong TSR and relative TSR or capital efficiency measures
- BUT – EPS can be distorted by accounting changes, mergers and acquisitions; disregards debt and leverage; and has been shown to be relatively vulnerable to management manipulation

What's left?
A combination of measures

- Growth plus capital efficiency (e.g., ROIC) – *Greg Arnold & Barry Sullivan, Semler Brossy*
- Capital efficiency plus EPS –*James Reda & David Schmidt, FEI Daily*

PLUS

- Longer time horizons on incentive plans, more deferred cash

Board Role

- Set metrics, measures and duration of incentive plans that support longer term behavior
- Support management to develop sound long-term strategy that drives value
- Challenge management to articulate powerfully the strategic rationale and communicate regularly with key shareholders
- Avoid constant focus on the share price and help CEO balance short term pressures against investment in the longer term

Beyond compensation…

- Growing coalition of leaders is calling for a more holistic approach
- Aspen Institute Business & Society Program has called for:
  - Market incentives that encourage patient capital
  - Aligning interests of financial intermediaries and investors
  - Strengthening investor disclosures

- Redefining corporate purpose – support policies that move away from purely shareholder-centric primacy
  - Gear comp to longer term
  - Measure and monetize abstract matters to balance share price
  - Simplify tax code
  - Focus on clear mission and alignment with strategy
  - Foster transparency and shift tone of communications
  - Increase employees' role in decision-making
  - Make leadership attraction and training a priority
  - Make reputation a higher priority, measure and track it
  - Explore new ways of forming corporations
  - Attach different rights to long vs short-term shareholders

Useful references

- Dorf, Michael, Indispensable and Other Myths, University of California Press 2014
- Short-termism in business: causes,, EY Poland Report 2014
- Pozen, Robert, Curbing Short-termism in Corporate America, Governance Studies at Brookings 2014
- “Why Can’t We End Short-Termism?”, Forbes 7/22/2014
- “TSR Can Be a Flawed Incentive Measure”, Semler Brossy Insights, 5/27/2015
- “The Holy Grail: What LTI Measures Drive Corporate Performance?” FEI Daily 6/4/2015
- “Unpacking Corporate Purpose: A Report on the Beliefs of Executives, Investors and Scholars”, Keller Fay Group prepared for the Aspen Institute Business & Society Program, May 2014