MAKING STRATEGY WORK

Are you paying for performance or paying for results?

While perfectly aligned with investors in the short term, TSR programs may diminish accountability for strategy by rewarding for events unrelated to changes in long-term franchise value"

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Pay-for-performance is assumed to be the objective of most pay plans, particularly long-term incentives. A quick read of most proxy statements will likely find the phrase prominently used; the Dodd-Frank act expressly requires the SEC to require companies to describe their pay-for-performance program. However, we find many of these programs simply pay for results.

Let me explain. Pay for performance infers that the reward is somehow linked to actual contribution, whether as individuals or as a team. It infers some level of cause and effect. In the context of a long-term incentive arrangement (LTI), this might be achieved by linking the number of shares vesting to management based on achievement of a key strategic objective, like successful diversification into an adjacent business, or introducing sufficient new products to sustain a higher gross margin.

Paying for results is simply managing incentive payments to an outcome, whether the result of performance or not. A company's stock may rise for many reasons, including factors well outside the impact of management. This approach is typical of many total shareholder return-based long-term incentive plans. The plans are defensible on the basis of alignment with shareholder returns or a comparable period of time. However, let's not lose the distinction here, that paying for results is not the same as paying for performance.

Investors support long-term incentives primarily because they believe the incentive will both reduce the performance risk inherent in strategy execution and decrease the eventual investor cost to realize the strategy. The LTI should reward successful strategy execution and serve to counter-balance the short-term nature of the annual cash incentive. It's about providing a financial incentive to create future value through execution of a strategy developed and approved by the board, which may require an extended period of time to achieve. For these reasons we argue that performance – causality to results – is critical to maximize the value of the incentive investment.

If you simply pay for share price appreciation or total return, either absolute or relative TSR, the LTI may serve more as a lottery ticket than an incentive. In short, exceptional rewards unrelated to management's contribution, or substantial punishment for strategic accomplishments temporarily overshadowed by events unrelated to company operations. Either hardly serves to motivate any change in behavior on the part of the executive or help guide the executive team in navigating tactics and priorities. In short, such programs are publicly defensible and in keeping with Wall Streets continued encroachment on setting compensation policy, but may in fact diminish or delay accountability for a poor strategy by rewarding (or punishing) for events reflected in stock price that are not related to changes in long-term franchise value.

The LTI should address two equally important objectives – deliver the strategy (pay for performance) and create value for investors (pay for results). The former is an often difficult, uncertain and time-consuming effort. Yet, achieved thoughtfully, it produces a resilient and successful organization. The latter is the result of both management's effort as well as market forces. Realizable pay (the actual mark-to-market value of compensation) lies at the intersection of performance and results. The SO-SO (same-old, same-old) strategy should not reward managers beyond the level of mere "caretaker." Likewise, and unfortunately, the exceptional strategy that does not produce returns for investors, yields diminished rewards for management. The exceptional strategy, duly rewarded over time by the market, should deliver exceptional rewards to the management team.

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As we saw in 2013, institutional investors are beginning to migrate from simple, but poorly conceived metrics conjured up the proxy advisors (e.g., ISS and Glass Lewis) to a more nuanced dialogue with managers and board members regarding say-on-pay. In this dialogue, it is critically important for mangers and boards to speak clearly to their share owners to justify CEO compensation in terms of business strategy. Simply ensuring an alignment of interests is insufficient; compensation committees need to continually revisit long-term incentives to ensure the design, as well as the internal and external communication, serve to relate executive wealth to performance.