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When Did Long-term Incentives Become So Short-term?

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Many leaders in the business, academic, and investment communities have been lamenting corporations' increasingly short-term focus. Many factors are cited as causes of this short-termism: the market's obsession with quarterly earnings; activists pushing companies to return cash to investors through share buybacks and dividend increases at the expense of long-term investment; and management's fear of investments that may not pay back, or pay back quickly enough, especially in an uncertain, slow-growth economic environment.

However, we see another driver. Business heads, daunted by the prospect of setting long-term goals, have largely acquiesced to a surprising notion: when it comes to their pay, long-term is defined as no more than three years. That notion has come about since the Dodd-Frank reforms and Say on Pay voting, which prompted most compensation committees to use three-year goals in their long-term plans. But three years—that's simply not long term.

The origin of this counterintuitive development is easy to explain. Three forces combined to move Compensation Committees in this direction. One is the standard three-year planning window used by most companies. It makes sense to match pay to the planning horizon. A second is that proxy advisors and most institutional investors have affirmed the standard, establishing 1- and 3-year time horizons as the pay-for-performance benchmark. A third is that Compensation Committees have just adopted prevailing practice, regardless of their businesses' circumstances or business cycles.

Business leaders cannot be faulted. With the world changing so rapidly, setting goals for incentive plans beyond one year is difficult; beyond two years, possible; and beyond three years, a real stretch. Given the average 4.9-year tenure of Fortune 500 CEOs as of 2014, three years can also seem surprisingly long term. Meanwhile, with hedge funds and activist investors nipping at their heels for near-term returns, who can resist blessing the three-year performance window?

But there's an inconsistency here: all of this occurs despite the fact that most fundamental change efforts extend well beyond three years—and the large institutional investors that manage pension and other long-term money clearly see the negative implications of the three-year performance horizon for their investments.

To be sure, management teams need to execute strategy and perform well even at one- and three-year intervals. These shorter time frames are critical building blocks for longer-term change. But to stay relevant and avoid obsolescence, companies need to be thinking beyond. Look at GE's ambition to become an advanced analytics and data sciences company; Ford's ambition to become a mobility company; or Amazon's continuing re-invention as a global marketplace. None of these companies could have achieved transformations in three years.

That's why many long-term investors, BlackRock CEO Larry Fink among them, challenge the increasingly short-term focus of many CEOs. Fink wrote in his 2016 governance letter to CEOs: "We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation."

Many of today's widely accepted compensation "best practices," although noble in purpose, have unintentionally contributed to short-termism. Most are byproducts of reforms instituted in response to events during the financial crisis. These reforms were intended to reduce risky decision-making, strengthen management accountability, link executive wealth to long-term stock performance, and increase pay transparency. But their impact has been to reduce the incentive power of compensation and create a myopic focus on shorter time periods. These well-intentioned reforms include:

The demise of stock options and the subsequent rise of performance plans. Stock options earned the affection of tech leaders and eventually Fortune 500 executives as instigators for innovation. At one point, options constituted approximately 75% of all long-term incentive opportunity.[1] However, options came under harsh criticism after the dot-com crash as drivers of excessive risk taking and undeserved windfall gains. In their stead, companies gave into shareholder advocacy pressure to adopt performance plans, 80% of which in the S&P 500 are based on three-year financial goals. Consequently, three years became the new "long-term"—almost no executive earns incentive compensation to manage profitably over longer time periods.

Annual grants of long-term incentives. As performance plans became more prevalent, so did annual grants of long-term incentives, with overlapping performance cycles. The rationale was akin to dollar cost averaging: if a cycle turned bad, participants always had a chance to reset the next year. Almost all companies make annual grants. At first glance, these annual awards seem innocuous—they keep total pay competitive, they promote ongoing retention, and they are in line with what everybody else is doing. However, with annual resets of goals or new strike prices for options, if plans or stock-price growth fall short of expectations, compensation committees are inclined to lower the performance bar to keep executives motivated. The result is essentially a series of annually set plans, and a loss of accountability for delivering superior long-term results.

A bias to formulaic awards tied largely to financial results, while eschewing other choices involving nonfinancial measures and/or discretion. As performance awards became more prominent, regulations such as 162(m) of the Internal Revenue Code and shareholder advocacy for transparency and accountability resulted in rigid formulas that could be easily verified. Discretion (other than negative discretion) became a dirty word, as shareholders became suspicious that discretion would only be used to absolve executives of responsibility for poor performance. Although

[1] Bachelder, Joseph. "What Has Happened to Stock Options?" *Harvard Law School Forum on Corporate Governance and Financial Regulation*. 2 October 2014.

measures addressing strategic accomplishments were allowed, in practice they were much less amenable to rigorous measurement. Among the Top 250 companies, only 14% of firms use nonfinancial measures compared to 54% for TSR, 51% for profit measures (e.g., EPS, EBITDA, operating profit), and 41% for capital efficiency measures (e.g., ROE, ROA, ROIC).[2] Working under plans designed in this way, management teams faced a dilemma–make low-risk bets with short payback periods or risk payouts on more ambitious investments whose returns might not arrive for five or more years. Not surprisingly most have opted for the more certain path.

Modest ownership requirements that were meant to increase "skin-in-the-game"—but in truth put only limited net worth at risk. About 25 years ago, boards began to view stockholding requirements as a solution to the problem of executives selling stock to bank big gains opportunistically—whenever a company's stock rose substantially, either because of broader bull markets or short-term run ups in the company's own stock price.[3] These practices were intended to create both stronger alignment between executives and shareholders and an incentive to grow company value over the longer-term. However, boards ran into dilemma. Executives naturally resisted requirements that prevented their ability to diversify personal wealth. Boards thus opted to put relatively modest ownership requirements in place, lest they put up a barrier to attracting and retaining the best and brightest. The norm for CEO ownership requirements became six times annual salary – two thirds of companies use multiples of six or less.[4] Given that salary on average represents less than 15% of annual total pay opportunity for S&P 500 CEOs, ownership requirements came to typically represent less than 150% of a single year's pay, and a relatively insignificant portion of many CEOs' total net worth. So an opportunity to use stock holding requirements to counterbalance short-termism has been sub-optimized.

So now we have this unfortunate situation. The more focus we have put on using pay as a motivator for long-term performance, the less we have to show for it. It's time for a reset—in thinking and pay design. As is often the case in executive pay design, if appropriate steps are not taken (e.g., adding lengthened performance periods to complement annual and three-year goals, greater use of strategic goals in long-term plans, and more robust stock holding requirements), the best of intentions will continue to go awry.

[2] "The 2015 Top 250 Report: Long-Term Incentive Grant Practices for Executives." *Frederic W. Cook & Co., Inc.* December 2015.

[3] "Stock Ownership Guidelines." *Frederic W. Cook & Co.,* Inc. 23 October 2009.

[4] "Executive Stock Ownership Guidelines." *Equilar.* 9 March 2016.

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