CHAPTER 1

To the CEO

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Management incentive plans cost a ton of money and often do not work very well. At most medium to large companies, a group of executives numbering from a few dozen to a few hundred make most of the big-ticket decisions on the part of shareholders. Yet, for many, the linkage from performance to payout is too muted and inert to be called an *incentive*. Instead, most of the money in variable rewards is delivered as a kind of vague results-sharing arrangement, one administered distantly and after the fact.

There's also just a lot of wasted money. Executives often discount their incentive opportunities. To them, an incentive plan with a likely cost of a dollar might seem like it is worth only a quarter or two. The rest is an avoidable waste of corporate assets, one sometimes called an *agency cost*.

Incentives are supposed to link senior management's interests and shareholder interests very closely. Often, they do not. In many important ways, they can leave open the possibility of paying people to make poor business decisions. Poorly designed incentives may do the following:

- Consistently favor short-term results over the long-term ones that weigh much more heavily in value creation.
- Encourage executives to manage expectations for their performance more than to deliver the best possible results.
- Contribute to common failures in mergers and acquisitions and other pivotal investing activities by biasing the selection and evaluation processes and systemically weakening accountabilities.
- Drive excessive risk-taking or risk aversion.
- Encourage talented people to do whatever is involved in moving up the career ladder—not always the same thing as making their best contributions in roles they fill along the way.

These shortcomings persist despite a significant restructuring of senior management incentives that has occurred in the marketplace in recent years in

response to pressing concerns such as option expensing and shareholder activism. Here's a current snapshot:

- The biggest part of executive incentives is in stock-denominated long-term incentive grants. Purely stock-based incentives—stock options, restricted stock—do not come with instructions on how to create value. It's a stretch to expect executives in a stock-heavy incentive structure to readily understand how to optimize the share price. Valuation is complex, and stock prices can bewilder investors. Tellingly, executives themselves do not demonstrate a consistent edge in their timing of option exercises and share purchases and sales. Corporate experience with acquisitions does not testify to valuation expertise, either.
- Annual incentive and performance-based long-term incentive (LTI) plans often are not much help, either. They often feature payout schedules that permit a range of imprudent actions to be rewarded. Metrics are drawn from a short list of the usual suspects. Goals flow from a difficult targeting process that begs mediocre outcomes. A common result is an overwhelmingly short-term focus.

The big management incentives are not in formal incentive plans, anyway. Stock and cash incentive gains can move up and down a lot, but most of senior management cannot affect most of that. The payouts that one *can* control have to do with advancing up the organizational ladder. Pay rises hugely when people get bigger and bigger jobs. Division chief executive officer (CEO) pay is twice that of the division's head of manufacturing. The corporate CEO earns many times what the division CEO does. What the executive rewards system says to most of its participants is just to do whatever is involved in moving up. When you come down to it, the efficacy of performance-based pay relies extremely heavily on the company's ability to judge the merit and contributions of individual executives and to match them with promotions and higher pay.

But individual merit and contribution can be hard things to judge. And a group of people with high individual performance ratings may not generate high levels of business results. The system would work better if it specifically encouraged these powerful individuals and teams to take those actions most productive to value creation—irrespective of whether they count toward individual performance, bring individual accolades, or secure the next job or the current one. Performance is not something to be hoped for, as some byproduct of a tournament for individual promotions. It should be encouraged and paid for directly. For that to happen, incentive gains must move up or down based on outcomes that people feel they influence. That is a path toward better business decisions, results, and value.

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After all, you and your senior management team are in the *decision* business. You commit investor resources to business activities and see them through to success or failure, often over a period of many years.[1] Like any company, if you somehow could have avoided some past mistakes and made more successful decisions, your business performance would have been better. The future will be no different in this regard. Value creation in your business—and the role of your senior management group—is very much about choosing. It is about coming up with a range of real choices, accentuating the positive ones and eliminating the negative. If you could improve business decision making in a broad and systemic way, you could get a materially better yield from the opportunities surrounding your businesses.

Performance outcomes are a bit like the kids' game "Chutes and Ladders." Most of the time, you are moving along a few squares at a time toward your goal. But, once in awhile, you have a big opportunity. You can move far ahead with one good move by landing on one of the ladders and advancing a bunch of squares at once. Or you can hit a chute and fall far back. You may think this setback can be "made up" on later turns. But odds-makers would disagree, noting that falling down the chute actually is a permanent setback, since it does not improve your chances on future turns.

Business is not purely a game of chance, though—instead, you get to chose. If you make better decisions, you can avoid the chutes and land on more of the ladders. Incentives can help by standing vigil at every at the time of every decision—whether the stakes are high or low. Using better incentives, you can improve the quality of many business decisions made at your company and their results for shareholders. You can encourage your senior management team to take better account of first-line value drivers—how their decisions use investor resources, balance risks, and trade off short-term income effects against the more important long-term ones. By using incentive policy more actively in business governance, you can get a better yield for your shareholders from the collection of business traits and market opportunities that underlies the value of your enterprise. Your incentive structure can be a proactive instrument of governance.

Well-Designed Incentives Are Governance Defined

For years, companies have been responding to a wide range of heightened governance concerns. Board deliberations about pay are influenced by regulatory matters including Sarbanes-Oxley, listing requirements, option expensing, 8K reporting, vote disclosure, and new proxy rules. Shareholder activism and corporate guidance is promulgated by a wide range of outside parties, including The Council of Institutional Investors, the Business Roundtable,

governance scorekeepers, pension funds, unions, rating agencies, and individual shareholders.

Companies are responding directly to these influences in a range of ways. They also continue to pursue good practice in the administration of pay and performance through the following:

- Competitive benchmarking, to avoid paying more than necessary
- Evaluating incentive practices in the market and pursuing good-quality choices
- Complying with relevant regulations (e.g., accounting, legal)
- Focusing on high-quality implementation of programs

Among these matters, incentive design is especially pertinent to governance subject matter. Well-designed plans can be proactive governance tools. Instead, incentives often are costly arrangements that are of little help to governance.

Consider the arrangements in place among the main figures in the governance tableau shown in Exhibit 1.1. Corporations separate power between shareholders and hired managers. Boards have fiduciary duties to shareholders, overseeing management on their behalf. Managers are meant to act in the best interests of shareholders—as their "agents."

The Corporate Library defines governance as:

> The relationship between the shareholders, directors, and management of a company, as defined by the corporate charter, bylaws, formal policy, and rule of law.[2]

Senior management's incentive programs define the relationship between management and shareholders expressly in money terms. These programs number among the company's formal policies, and arguably constitute one of the higher-impact ones. Implications are set out further in Monks & Minow, *Corporate Governance*.

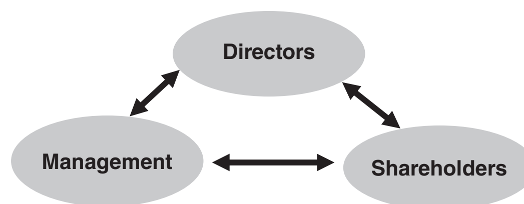

EXHIBIT 1.1 Corporate Governance Actors

> . . . the structure that is intended to make sure that the right questions get asked and that the *checks and balances* are in place to make sure that the answers reflect what is best for the *creation of long-term, sustainable value* [emphasis added].[3]

Well-designed incentive opportunities—issued in prudent amounts—constitute one set of thorough and formal checks and balances on management decision making. They can be used to create explicit balance among the main drivers of value, consistently favoring long-term, sustainable value creation. Effects on decisions and performance can go far beyond the CEO and a few top officers. They can extend to a much larger group of material decision makers at the corporate and business-unit levels. When well designed, incentives can define the connections between business decisions, value creation for owners, and executive rewards. Incentives are governance, defined.

Management, inescapably, has wide latitude and control. Boards do not run operations, judge prospects expertly, or initiate business decisions. In this setting, proactive agency arrangements are very important. Unfortunately, however, many traditional governance responses are reactive, taking effect too late—after the company and its shareholders have borne performance losses from poor decisions.

Current mechanisms of governance for executive pay itself are limited and reactive. Responses often are test- or checklist-centered. Activists and regulators often express mixed and underdeveloped ideas about what constitutes effective incentive design on the ground—it takes some work to identify their common, actionable themes. Also, current pay governance processes are focused mainly on cost rather than performance. Performance metrics are not evaluated for use in encouraging good performance prospectively. Instead, they are used merely as a scale to evaluate pay costs after the fact.

Sound incentives, by contrast, can take on a proactive role in business governance generally. They can do the following:

- Encourage value-creating decisions in clear and direct terms.
- Do so prospectively, for every year of the near-, medium-, and long-term.
- Put real "skin in the game" by creating clear stakes and accountabilities.

Incentives do not meet on a quarterly basis. They are on the job all the time, pressing for shareholders when the big business decisions are being made. Shareholders normally pay a lot for this sort of protection. Governance and agency costs are high. Outlays add up for things like boards, advisors, stock administration and staff, and executive effort on these time-consuming matters. There are agency costs, too, like the gap between what incentive grants are worth and what participants think they are worth. And there are potentially costly risks from ineffective agency arrangements—the moral hazards of flawed incentive design.

What shareholders are hoping to buy with these costs is prudence and efficacy in the handling of their capital. One might borrow the song title *Dear Prudence*, since prudence in these matters seems to come at a dear price. Well-designed incentives, by contrast, do not require companies to pay dearly. They do not cost any more than typical incentive pay. They take the range of payouts promised now, for the most part, and line them up much more closely with high-quality business results.

Companies can take the lead in addressing the governance concerns pressing on executive pay. They can move the discussion well beyond a compliance activity. Incentive design can be made into a strategically pivotal process, one driving real results.

Old School

Monetary arrangements between investors and hired managers—between principals and agents—have been around for a while. Here is one clause recorded on the Stele of Hammurabi—a monument dating to the reign of King Hammurabi of Babylon. He took the throne in 1792 B.C.:

> If a merchant should give silver to a trading agent for an investment and he incurs a loss on his journeys, he shall return silver to the merchant in the amount of the capital sum.[4]

That quote is nearly 4,000 years old but it sets out some principles that are quite applicable today. It is, in fact, a good idea to take account of capital usage when determining the procedures for distributing rewards between principal and agent. The idea of capital recourse is no less familiar to modern merchant bankers than to Hammurabi's merchant. Some principles are worth carving in stone. Principal-agent arrangements apparently were in Hammurabi's era and, today, they still are.

Incentives lie at the heart of the business, connecting senior management's actions with rewards. Like Adam Smith's *invisible hand*, your system of executive rewards affects many important actions by people throughout your company. Incentive plans may imbue a wide range of senior management decision making with bias, and bias is the boll weevil of value creation.

If you have biased decision-making processes at the senior management level, your company is a mistake-making machine. Consider the biggest mistakes your business has made over the years. Or, if you prefer, consider the biggest ones made by other companies around town. When companies recount such errors, they do not always describe good business decisions that simply did not work out. Rather, they often point out standing problems with decision making—

things like short-term bias, organizational inertia, indifference, either insensitivity to risk or disproportionate fear of it, or an unconditional growth mandate driving everything the company does. They often describe problems that contributed to their business mistakes in the past and that might well create more of them in the future. Consider whether it would have been helpful to have incentives that do the following:

- Directly encourage every person in senior management to take a long view.
- Create a predictable and direct stake for them in the results of their business decisions.
- Establish reasonable accountabilities when management uses new investor capital, and fair credit when it gets sent back to investors.
- Balance business prospects and risks as an investor would.
- Attach first-dollar financial stake and unbroken accountability to the money the company budgets, spends, and earns each year.
- Put the bulk of incentive pay, rather than some fraction of it, directly within executives' line of sight.
- Rebalance the system to favor business performance decisively over narrower individual interests.
- Make clear that performance gains always are worth pursuing, even if things are going much better or worse than planned.
- Create peer pressure, overcome bureaucratic inertia, and start up a real contest for performance.

How do your incentive policies stack up against these criteria? Would all of the mistakes you envisioned have been made, under these circumstances? And would your business success stories have been impeded by such a system?

Act Now

Most companies simply have not yet looked deeply enough at their incentive policies or considered the full range of available solutions. The situation is changing, however. The proverbial *burning platform* is by now fully ablaze. Option expensing, now in place for a few years, has spurred companies to reverse their heavy reliance on stock options and to consider other alternatives. In the past, zero-expense treatment lead to near-100 percent market reliance on stock options with little serious thought to alternatives. There was a kind of moratorium on thinking, where the bulk of public company incentive policy was concerned.

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Now, everything is on the table. Option expensing has brought far heavier use of other kinds of long-term incentive pay, denominated in cash or shares and often based on attainment of preset performance goals. Long-term incentive design now is much more complex, with far higher stakes placed on matters like metrics, targets, ranges, and leverage. And, for most companies, there is no going back. Companies know they can get better retention, efficacy, and "line of sight" if they improve their mix of long-term incentives as well as the details of delivery. But they continue to face challenges and to make ongoing changes in their efforts to get it right.

Annual incentives have always been a big, big deal at most companies. Dollars promised in these plans tend to be watched very closely. They can drive management decision making very strongly in both positive and negative ways. Decision makers normally understand pretty well what they can do to affect bonus payouts, and payouts occur within a few months. Long-term incentive gains, in contrast, used to hinge on the distant and deferred matter of exercise-date stock prices. That apparently did not redirect executive thinking to the long-term in every case. For example, 78 percent of more than 400 executives interviewed said they had smoothed earnings *at the expense of value creation*.[5] This testifies to the pressures often concentrated on short-term performance.

Annual incentive pay targets climbed rapidly in recent years. The rise is due in part to demands of I.R.C. section 162(m) for explicitly performance-based pay. The higher size of awards—coupled with the new tax-compliance concerns about the goals themselves—has placed increased stakes on how performance targets are specified. And again, not just bonuses move around based on preset goals, but much of LTI pay as well.

Risk concerns are part of the new situation as well. In an earlier book, I predicted that "Risk is the next big thing."[6] That is out of date. Risk is the big thing *now*, when talking about incentives and decision making. Governance experts are weighing in much more heavily on how problems with risk and incentive pay might subvert the interests of shareholders. Government, too, has weighed in, in part with risk-related proxy disclosure rules from the SEC.

The executive pay commentariat is focused on much more than risk, of course. Later, we will review what the governance voices have to say about incentives at the top. We will find that most hold activist views on executive incentive policy. They differ in their details, certainly, and also in terms of how much meat they put on the bone. But, at a high level, many of them are setting out similar general preferences for incentive architecture. Some of their more unanimous preferences overlap with the key themes of this book—not to overrely on exclusively stock-based LTI pay, to emphasize business goals heavily, and to focus on both the financial quantity and quality of business performance. This

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last item includes being sure that performance parameters are set properly, focused on the long-term, cognizant of risk effects, and pledged by senior executives with an ongoing commitment to stock ownership.

Overall, companies are operating in an era of new standards. The old ways will not do, but there are not any magic bullets. There are performance gains to be had through improving the efficacy of incentive pay. Companies have been in hot pursuit for years, particularly since the onset of option expensing. You should expect your competitors to pursue those advantages and to use them against you, not only in labor markets but in markets for commerce and capital.

Standards continue to ratchet up in a macro sense, as well. In highly competitive global markets, human capital is decisive, since it is one of the few remaining sources of competitive edge. To an increasing extent, it is the whole game. More and more companies are saying things like, "Our assets walk out the door at the end of the day." This once was a human resource platitude. It is now a genuine business reality just about everywhere. And it is never truer than at the senior management level, where very disproportionate decision-making power resides. Companies should be using the explicit terms of incentives at top levels of the organization to encourage high performance.

You Do Not Run Your Company

The people in your senior management team make the bulk of business decisions on the part of shareholders. Together they hold much more information than you about the truest, best sources of business advantage and gain within your company. They are in a position to decide which ideas get advanced to you and which do not. Their scope of authority means they take many actions without needing to consult you at all. In many other matters, you properly defer to them based on their expertise. They decide which business initiatives are executed faithfully and which are not.

You do not always know what they are thinking. They do not always do what you say. *Liar's Poker* author Michael Lewis provided a lively example after his 2008 conversation with John Gutfreund, former CEO of Solomon Brothers:

> We agreed that the Wall Street CEO had no real ability to keep track of the frantic innovation occurring inside his firm. ("I didn't understand all the product lines, and they don't either," he said.) We agreed, further, that the chief of the Wall Street investment bank had little control over his subordinates. ("They're buttering you up and then doing whatever the f---they want to do.")[7]

Things are not this extreme in your business, no doubt, but your senior managers as a group may well have greater effective decision rights than you. And

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your position vis-à-vis them is replicated in their own ties to successive tiers of subordinates, in a process cascading throughout the enterprise.

Incentives are present at every level in that cascading process. To an extent that may or may not surprise you, your company is run by its system of incentives. An example, albeit again extreme, involves the CEO of AIG, Robert Benmosche, and the treasury's "pay czar," Kenneth Feinberg. It shows in unusually frank terms that setting pay for one's subordinates is one of the more important powers of the CEO:

> "Benmosche understood that he had lost control. 'It's Feinberg's company. That's what he learned,' one director in the board meeting later told me. 'We all thought there was an ability to run this company. We were wrong.' "[8]

In this example, losing control over executive pay was seen as losing the ability to run the company. Your company may not be at all like AIG, but executive pay no doubt has important effects on who gets into your senior management team, how long they stay, and what they do while they are there. Incentive pay is the centerpiece of your system of executive rewards.

Incentives, of course, are not the only driver of management performance at companies. There are many. Here is a big one—figuring out how to find, develop, and hang onto the best people. To do this, the simple *amount* of incentive pay offered can be more important than the particulars of its design. Nonetheless, problems with the structure of incentives and its effects on decision making are ones that arise frequently, have significant effects, and merit our attention.

The New Standards

I am not quite as old as Hammurabi, but I can recall a quaint era when the term *unprincipled* was an insult. A problem with executive pay is that it often appears unprincipled. Incentive policy at companies often does not follow a consistent, coherent philosophy. We strive to help remedy that problem in this book. In the early part, we examine a range of perspectives that can inform incentive policy:

- Basic principles of finance and valuation—the links from decisions to business results to value creation
- Evident aspects of how decision rights are held in the organization and how financial incentives can affect motivation and decision making
- Fundamental guidance offered by standard setters in the marketplace (e.g., the National Association of Corporate Directors [NACD], shareholder activists)

We then compile them into a set of principles and methods that can be used to set incentive policy for senior management and to design incentive plans. These are basic facts of business governance, performance measurement, and valuation that should shape incentive pay at the senior management level. They are derived and set out in the next three chapters. Here are some of the most salient points:

- Management's job is to run the enterprise in such a way as to maximize the wealth of shareholders.[9] Incentive plans must support this goal by creating a high degree of line of sight from actions to results to rewards. The stakes are high in terms of cost and business impact. They demand that incentives be specific and proactive, encouraging business decisions that create value and discouraging those that do not. Vague and distant incentives waste shareholder money.
- The structure of incentives, like the structure of investor interests, should be unlimited, long-term, concrete, and continuous. It should take account of the capital market criteria and performance expectations that determine the valuation of a business initiative and its results.
- Three basic financial variables describe the value of a business enterprise: long-run operating income, capital usage, and the risk-adjusted cost of capital. For a current or prospective business event to have an impact on the stock price, it must pass through one or more of these doors. These drivers must be represented in proper proportion in incentive pay.
- Pay outcomes should reflect sustained financial results and how those results drive value creation. Executives should have significant, persistent exposure to company performance and share price across a wide range of outcomes.
- Companies must make sure executives, whether found at the corporate level or in business units, have a decisive stake in the business activities they lead. Achieving this kind of "line of sight" includes focusing more on results of operations and less on nonoperational matters like capital structure and share repurchases.
- Incentive plans should be kept clear and simple, creating a direct, enduring stake in value creation that needs limited adjustment or revision over time.
- Executive incentive policy should be deployed as an active instrument of business governance.

These principles are straightforward and obvious. They jump out rather quickly when you link incentive policy with performance and valuation. At the same time, they demand big changes to correct problems with the incentive structures used in the marketplace now:

- Bonus plans whose targets are based on annual, one-off episodes of internally focused study and negotiation, with accountability for pivotal decisions written in disappearing ink
- Payout schedules that enable value destruction, are skewed by financing decisions, and reflect inadequate forethought about how to deal with events like acquisitions, one-time gains, or big variances from target
- Long-term incentives that create low levels of line of sight, engagement, and efficacy along with high levels of economic cost
- An overall structure based almost entirely on corporate-level performance, oriented heavily toward the short term, and constantly being renegotiated, adjusted, or redesigned

Incentives aren't stage props meant for a run of a few months. They shouldn't need constant rework. They should anticipate a range of pressures and events rather than constantly reacting to them.

And incentive principles do not have to be turned upside down in response to the shrillest of critics. Companies should not get rid of annual bonus plans nor make people wait for years to get payouts. Having a long-term pay structure does not mean glacial rates of vesting. Commitment does not require jitter-inducing stock-sale restrictions. Applying proper performance standards does not mean disqualifying most contenders. And lasting accountability does not require a standing threat of capricious pauperization.

Companies can take the overall incentive structure and orient it toward longer-term performance using any of a range of reasonable tools and tactics. Incentives should reflect the enduring connections between business decisions, results, and value. Those rules are never repealed. And incentives work better when the ground rules are stable and well understood. This book will set out a range of specific actions and techniques that many companies ought to pursue. Here is an overview of some of the key recommendations:

- *Feature goal-based pay more heavily in the long-term incentive structure.* Goal-based long-term incentives—with proper standards and metrics—can concentrate payouts on actions that create real long-run value from operations. Stock performance drives most of long-term incentive pay today, via gains from stock options and other stock-denominated grants. However, stock-based incentives create a very weak agency structure for most decision makers in the company. Only the CEO and a short list of others at the very top have a strong impact on the stock price. Stock and option grants create very limited line of sight for almost all who receive them. And options gains occur mainly after the four- or five-year mark—well beyond their freshness date.

Although it is appropriate for the broader senior management group to have a significant portion of their long-term incentives tied to the performance of company stock, basing some of everyone's pay on proper goals is also important. *Stock and option grants do not come with instructions* on how to create value. Properly specified goals, in contrast, can act as instructions on which decisions create value over time and which do not. An apparatus of long-term goals, tied over time to cash, shares, or both, is one of the best opportunities a company has to address some pivotal matters in incentive efficacy—line of sight, targeting, accountability, and controls on decision bias and risk.

- *Pushing long-term financial stakes to the business-unit level, where appropriate.* Basing long-term incentive pay on unit results, with payouts in cash or corporate shares, can increase line of sight enormously for executives below the top tier. Bonuses are the only aspect of pay that creates much line of sight for many executives, since few people can affect the stock price and, thus, influence their LTI gains under stock-based programs. This is particularly true at the business-unit level, where large parts of the company's value, executive workforce, and consequential decision making are found. And, at this level, corporate-level control and knowledge are most distant and diffuse, so the stakes placed on governance and agency arrangements arguably are highest.
- *Upgrading bonus plan design.* Bonus plans are often flawed as agency arrangements. Metrics and award schedules often permit bad decisions to be rewarded. Budget-based targets encourage decision makers to manage goals and results into a modest, narrow range. A very short-term orientation can discourage many of the longer-focused decisions that weigh heavily in value creation. Bonus plans can use metrics and payout schedules that better align with economic success, ensuring that pay is awarded for real performance and that pay costs are not incurred for failure. And they can do this without resorting to unfamiliar metrics or strange incentive plan formats.
- *Escaping the budget trap.* Common approaches to incentive target-setting can bias and thwart the intended effects of key governance processes—budgeting, planning, acquisition review, and capital budgeting. To address this pitfall, companies should make better use of external standards. They can consult peer and analyst data, shareholder expectations, and value-based frameworks to calibrate goals and payouts. These approaches to target-setting can supplement or replace existing methods, improving agency effects in both annual- and long-term incentive plans at the corporate and business unit levels. Companies do not have to rely entirely on

centralized governance and control. Incentives can be quite helpful by encouraging more effective, truer planning and enhanced long-run results.

- *Better bang for the buck*. Incentive plan participants often see their stock-based incentives and much of their bonus as matters over which they have little influence. This risks heavy discounting of incentive opportunity. The solution is to re-center pay on compelling and achievable goals and pay them out in cash and whole shares. This can help convert what is often a costly results-sharing apparatus into a proactive governance tool.
- *Keeping costs in line with competitive norms and proper standards*. Executive incentives represent a large cost for many companies. Proper benchmarking of pay—and proper standard-setting—can help ensure that the money is earned and funded in economic terms. Plan calibration and scenario testing can help ensure that this is the case, not just at the targeted award level but in the many other scenarios that may emerge over time.

Although the movement for improved corporate governance continues to gain ground rapidly, let us not forget what really governs much of business decision making much of the time, in many parts of the business—management incentive plans. These agency arrangements can have a very strong impact on business success.

It Is Not about You

When turning incentives into proactive governance tools, the changes to incentive structure for the CEO may be the least consequential ones. In the pay package for the top few corporate officers:

- The long-term incentive component is very large within the pay mix and will remain that way.
- Stock-based pay in one form or another will continue to make up the bulk of top officer long-term incentive granting in public companies.
- Trailing, unvested grants of options and stock, coupled with mandated stock holdings, will continue to give top officers a very high level of exposure to the stock price.

The very top officers *can* affect the stock price over time, and they have huge equity stakes. This means they have a huge stake in high-quality financial results, so their incentives will work in a directionally correct way over time. What the incentive structure says to them, basically, is to do everything they can to maximize value and returns over a sustained period of time. The stock price isn't persistently wrong, after all, as an arbiter of a company's results and outlook. It is hard to read and hard for most people to affect, and sometimes it makes you wait

until your performance story is proven. But top officers can affect it more than other executives can. And they can be asked to wait for gains to pile up.

The stock price game can be a tough one, to be sure. A company may offer really superb products and services, sell them at good prices and margins, and beat tough rivals for market share. They may run the most efficient operations in their industries or grow to be the dominant player in each of them. They may beat all their peers in the race for earnings growth. None of these things assures high stock market performance. Why? These business scenarios may not create value for shareholders. The longer-term income outlook, capital requirements, or risks of any of these scenarios may be unprofitable in an economic sense. Also, shareholders may have expected more. The price of their stock is based on the hopes investors hold about future performance. To them, current disappointments may portend bad news that plays out over the longer term.

You may already be a winner. Your company may have won this game every year for years, reaching the top deciles of stock performance rankings. Unfortunately, future stock performance is subject to the same caveat as an investment manager's—past returns are not a guarantee of future results. If a company has had outsized expansion in its stock price, it surely implies outsized expectations for future business results. You have to beat those to regain the pole position.

The stock market ratchets up performance expectations a bit like a golf handicap, but it adjusts more quickly and cannot be fudged for long. Overall, stock markets are efficient, updating expectations and prices so thoroughly that the pattern of future stock price movements is predicted best as a statistical *random walk* rather than any function of past business results.[10] The constant demand of such markets is not merely "what have you done for me lately" but "what will you do for me next?" At the same time, it is quite possible to generate above-market returns with little or no growth in enterprise size or income, depending on the shape of investor expectations and the charges they assess for the risks and capital involved.

One thing is certain, though. All of the strategies, prospects, and results of the business will be distilled by the cruel, reductive math of business valuation into the stock price. And that determines how you get paid. You get paid mainly with stock-denominated grants, and then you are asked to hold large blocks of those shares indefinitely.

So, for those at the top of the pyramid, share price movement has dominant incentive effects. It may not be comfortable to sit atop a pyramid, but the view up there does make certain matters clear enough. The performance standards could be made clearer, though. The view of how to achieve high shareholder returns is often a bit cloudy. And the need for clarity becomes even more compelling as you move farther and farther down the pyramid.

You should not see the system of senior management rewards as the system that pays you. The stock market, for the most part, makes the big decisions about your pay. You should see rewards policy as a business governance tool that you possess. Working with your board, you can use rewards policy to drive better performance and increase the stock price. You should be focusing on the decision rights and performance rewards of the broader senior management group—those dozens or hundreds of top managers who are out making consequential decisions all the time. You can use incentive policy to encourage the best decision making throughout management and at the many places and times where shareholder wealth is at stake.

Incentive effects for the balance of senior management are not like yours. Theirs may or may not align with shareholders. Sure, their equity stakes might encourage them to take decisions that might bring about a little share price bump at some point, if they believe in that sort of thing. However, the message they may be hearing is that they are better off avoiding risk and managing their expectations and results. That, after all, may be how they keep their high-paying jobs and keep themselves in the hunt for bigger ones.

Last Things First

So, how do you get started on solutions? The best incentive design process for top officers is to ignore their incentives during the bulk of the design process. Instead, I recommend focusing on the balance of senior management. Companies should design the system of incentives up to the much higher standards of efficacy and line of sight needed to work well across the broader, more dispersed senior management group.

Along the way, they will have done most of the design work needed for top officers. Once you reach this point, you will probably decide that the top few officers should be paid using the same general set of instruments and premises that applies in the broader senior management group. You may do this for reasons of alignment, but you may also find by then that you have the right system for your company and that it obviously should apply at the very top. At that point, top officer pay is a matter that can be extrapolated up a step or two from the balance of senior management. It might be distinguished by a higher exposure to stock performance and complete focus on corporate results rather than those of business units.

This approach is backward, in relation to the usual process. The usual process focuses far too much on the top few officers and particularly upon the CEO. One of the reasons we have such a heavily stock-centered system now is because it *is* sensible to use stock as the core of the pay structure for the very top officers. Extending that prescription much deeper into the ranks is a mistake, but it is one

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easily made if you're only paying close attention to the top of the house. Making the system work for the broader senior management group—a group that is, again, pivotally important, yet subject to a highly ineffective incentive system—is the much bigger deal.

Proper incentives broaden and energize the stakeholder group for any materially sized business initiative. This may affect how the whole business is run and change how you approach your job as CEO. You'll be using incentives to ask your key decision makers to put their money where their mouth is. You'll be using incentives—and their effects on the many aspects of the decision-making process that you cannot read or direct—as a supplement to your own business judgment, persuasive powers, and authority.

And let us remember that the big business decisions all bear your *imprimatur*. If you put in place an incentive system meant to engage the senior management workforce more strongly, that means the matters they will be minding more actively are, to a certain extent, yours. You will be inviting a broad group of senior managers to get involved in some productive way and to express what they know when the big decisions are being made, rather than waiting to second-guess the results in private.

These policy changes do not change your decision rights or anyone else's. They do recognize the decision rights already in place at the company and the asymmetric information flows that surround them. Better incentives may change your dialogue with the senior management group. You will be dealing with co-investors rather than functionaries. This will encourage good information to come to the forefront as big choices are being made by the company, potentially improving the process of business decision making and many of its outcomes. And, once a decision is made, these changes encourage everyone to get on board and get it executed.

Bottom Lines

Money helps all this to happen, and this is the way to use it. Companies should use senior management incentives purposefully; to help them prosper. Instead, this tool often is left in the shed. This book is about how to employ the company's structure of incentives in an active way to get better business decisions and better results from senior management. This is the best way to use incentives—to encourage high business performance proactively rather than acknowledging it in a distanced and vague manner after the fact.

It is not easy to get better performance out of a business. The virtue of this performance initiative is that it does not involve turning the whole business upside down. Rather, it concerns a limited group of people over whom you hold much sway. It does not depend on actions of your competitors or on

market conditions you cannot affect. Rather, it is about getting better economic yield from business opportunities under all market conditions. It is comparatively easy. Getting it done is completely within your control. And it cannot really happen without you.

Incentive policy is important to business success. It also is important in a broader sense. Actions of those at the top of enterprise affect resource allocation in the economy. Ultimately, the material wealth of a nation relies on a few intangibles. These are things like the industriousness of its people, the degree of freedom individuals have in commerce, and the general trust and confidence they hold in markets and laws. Among these key intangibles is a properly functioning system of rewards for top management. The system should use the self-interest of executives as a way to get the best performance for owners. A proper system of management rewards is one of the drivers of the wealth of nations.

NOTES

1. Consulting firm Strategic Decisions Group coined the saying, "Management is in the decision business."
2. thecorporatelibrary.com
3. Robert A.G. Monks and Neil Minow, *Corporate Governance*, 3rd ed. (Hoboken, NJ: John Wiley & Sons, 2002).
4. Text cited from exhibit placard, "Beyond Babylon: Art, Trade and Diplomacy: the Second Millenium B.C." Metropolitan Museum of Art, New York, November 18, 2008—March 15, 2009.
5. David Bogoslaw, "Shareholder Value: Time for a Longer View?" *BusinessWeek,* (March 17, 2009).
6. Richard N. Ericson, *Pay to Prosper* (Scottsdale, AZ: World at Work, 2004).
7. Michael Lewis, "The End," Portfolio.com, November 11, 2008.
8. Gabriel Sherman, "An Inside Look at the Tug-of-War Over Pay at AIG," *New York Magazine,* November 2009.
9. This is a general tenet of the area of economics called *agency theory*.
10. For descriptions of the statistical behavior of equity prices, see Nobel Prize winner Eugene Fama's book, *Foundations of Finance* (New York: Basic Books, 1976), as well as Burton G. Malkiel's *A Random Walk Down Wall Street* (New York: W. W. Norton & Company, 1981).