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# Should Options Reward Absolute or Relative Shareholder Returns?

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*Executive stock options are often poorly linked to shareholder value.*

*Here are some ways to fix the problem.*

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hen it comes to executive and management compensation, there are precious few “bedrock assumptions”—i.e., assumptions so solid that they can serve as a foundation for both compensation planning and company strategy. Take the simple assumption that executive compensation should be linked to the creation of shareholder value. The corollary should follow, then, that incentives such as stock options would have an unqualified positive impact on company share performance, producing appropriate rewards for those managers who increase shareholder returns.

However, stock options have become so widely accepted as a major component of executive compensation that we have not stopped to consider whether they actually accomplish the goals of motivating and rewarding superior performance. The recent, long-running bull market has brought this issue to the fore by creating a “lottery” in which mediocre-performing managers have been cashing in winning tickets. When we consider such developments, we begin to realize that stock options have not kept pace with changes in the business world over the past 50 years.

The purpose here is not to argue that the assumption is invalid. Quite the contrary:

Companies *should* link employees’ and executives’ compensation to shareholder value. Rather, the purpose is to point out that the houses we have built on this bedrock have structural and design weaknesses and need repairs.

Much is at stake. Stock options have become the primary long-term incentive device used in the United States and Western Europe, and their use continues to increase in other parts of the world. Clearly, the amount of compensation involved in these programs is immense, as is their impact on share dilution. We must ensure that we are delivering compensation efficiently and that we are using stock options in ways that motivate participants to achieve appropriate shareholder returns.

## **Absolute vs. Relative Stockholder Returns**

The fundamental issue concerning stock options and other long-term incentive devices is this: Should they be designed to motivate and reward *absolute* or *relative* shareholder returns? Simply put, are absolute stock price gains the best indicator of shareholder value creation, or is performance relative to the broad market or to industry peers a more meaningful indicator of success?

Remember that stock options as we know them today were conceived in the 1940s, following the Depression, and developed in the 1950s. This was a simpler time, when private individuals owned shares in blue chip industrial companies in order

to earn dividends that exceeded the return on long-term government bonds. Absolute returns—the only effective measure used at the time—were important. These developments predated the introduction of mutual funds, 401(k)s, IRAs, and diversified institutional ownership, all of which have shifted the emphasis to *relative* returns.

In today's investment environment, most investors focus primarily on relative returns when evaluating the success of an investment. Most hold an equity portfolio comprised of mutual funds and individual stocks diversified across both industries and countries. These investors are satisfied when a particular stock (or mutual fund) outperforms its benchmark, and they are unhappy when results trail the benchmark.

While in theory a management team whose company returns are poor could diversify the company out of a particular industry, in fact, the track record of large companies that have entered other businesses is poor. For most companies, the realistic alternatives for boosting returns are either to reinvest in the existing business or to return funds to shareholders through share repurchases, dividends, or a merger on favorable terms.

One practical test of how the marketplace views absolute vs. relative returns comes from the field of money management: *Almost all* retail and institutional portfolio managers are compensated on performance related to a specific market benchmark or to the results of other money managers. Only hedge funds and private equity investment partnerships base incentives on the achievement of absolute results. Furthermore, the Morningstar rating system for money managers and the models used by investment consultants to evaluate stock performance incorporate relative indicators of investment returns.

There are, however, exceptions to the general marketplace focus on relative investment returns:

➤ First, some public and (more often) private companies have a dominant shareholder, an individual who does not hold a reasonably diversified portfolio. For example, Bill Gates and other technology company founders fit this category; thus, these individuals focus on both absolute and relative performance.

➤ Second, current and former employees in many organizations may own company stock well above a nor-

mal amount for a diversified portfolio. While increasing the amounts of stock owned by executives and employees is one of the more positive compensation developments of the past decade, their holdings usually do not reflect the far more diversified ownership of major shareholders.

➤ Third, in private companies, it is quite common to find stockholders whose primary focus is on absolute returns, especially if there is heavy debt or continuing family ownership.

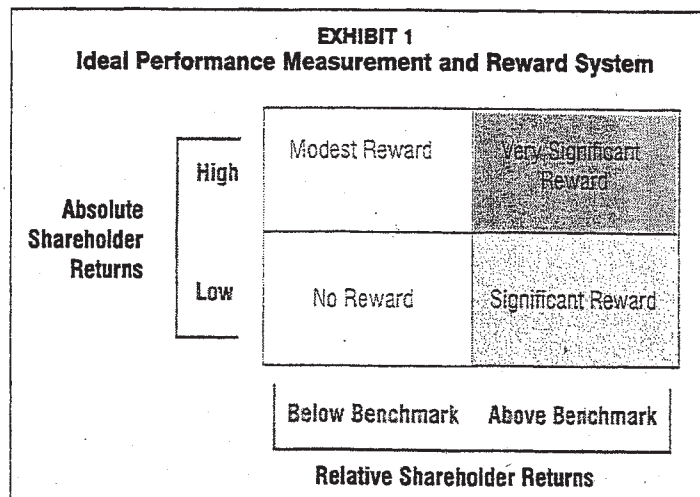
### Aligning Incentives with Relative Returns

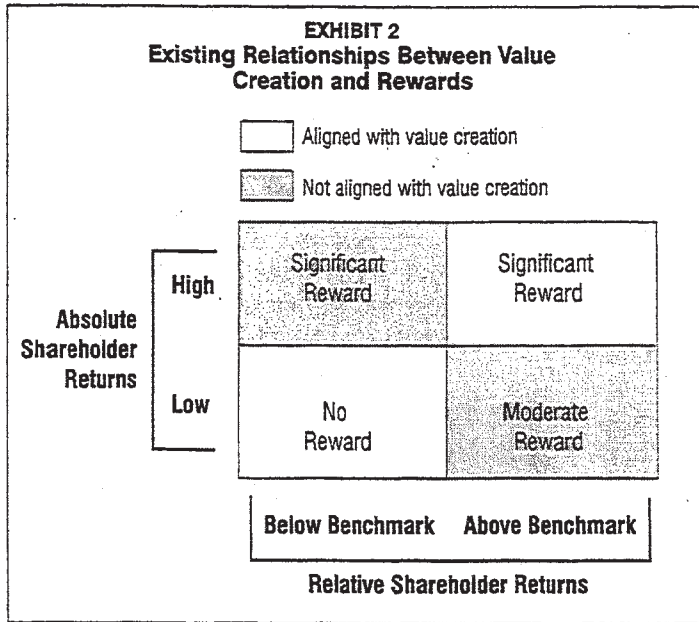
In most circumstances, however, companies should align management equity programs with the market primarily by emphasizing programs rewarding relative stockholder returns and reducing the link to absolute stock price increases to a much smaller component. Exhibit 1 provides a simple example of this emphasis as it should be present in today's management equity programs.

Unfortunately, this idealized picture of how rewards should work usually differs significantly from the reality of today's executive compensation programs. Conventional stock options reward only absolute increases in stock price and therefore are often a poor indicator of real value creation. This leads to significant misalignments between value creation and management equity payouts.

### Misalignments Between Performance and Pay

When equity markets or particular sectors are strong, many executives realize windfall gains from stock options that are out of line with the value created for shareholders. Moreover, executives who have produced both superior





relative returns *and* excellent absolute returns are likely to be undercompensated. Conversely, in poor equity markets, excellent performance has little opportunity to be rewarded. Meanwhile, mediocre management can be overrewarded in favorable markets and are at no particular disadvantage in unfavorable environments. Exhibit 2 shows the interrelationships between value creation and existing management equity incentives.

In the bull market of the past decade, many companies generously compensated management even when the companies underperformed the market. Significant unearned compensation not only wastes shareholders' money but also sends an inappropriate motivational message. It increases the skepticism of employees, customers, the press, and the public at large, giving the impression that compensation systems represent a kind of lottery rather than a serious way to reward performance. At the other extreme, a poor overall market or weakness in particular sectors provides few opportunities for companies to use conventional stock options to reward real performance.

### Resistance to Change

If standard stock options have such obvious shortcomings, why have companies been so resistant to changing them? The overwhelming reason is that, under current accounting rules, companies are not required to take a charge to earnings for gains from standard stock options. On the other hand, companies that use approaches based on relative performance must

take earnings charges in their financial statements. Both practical and academic studies have consistently concluded that these reported earnings are far less important to value creation than cash flow and other real measures. However, there continues to be a strong bias toward managing so-called "accounting earnings." Corporations and boards of directors continue their reliance on accounting earnings as the primary measure of success, which produces a bias towards "accounting-friendly" conventional stock options.

Moreover, neither companies nor boards feel pressure to change. Large institutional shareholders hold widely diversified portfolios and thus have little incentive to influence

change in a particular organization's compensation measures. In addition, an entire industry has developed devoted to advising institutional shareholders on how to vote on conventional share programs, and these advisors probably would be loath for corporate America to move to a more straightforward self-policing system.

### A Swing Back to Cash

Given the existing barriers to change, a surprising number of companies have installed programs with alternative option designs. Our prediction is that, over the next several years, companies will slowly begin to supplement many conventional option programs with cash-based plans focusing on direct business measures or stock options with a relative performance component. The move to cash-based plans will be a motivated, in part, by the feeling that the long-term incentive mix across industry has swung too far in favor of stock options and that a more balanced long-term incentive program may offer a better way to reward performance across business cycles.

### Growth in Relative Performance Options

We also predict that relative performance options will grow as companies recognize that modified conventional stock options (i.e., options vesting on relative performance, granting out-of-the-money options, or tying future awards to relative performance) are not fully effective under many scenarios, such as a volatile stock market. As mentioned, conventional stock options can only be truly effective as an incentive device with normal growth in the stock market.

**EXHIBIT 3**  
**Illustration of How to Reward Relative Performance**  
**(Measured and paid annually on 5-year rolling cycles)**

Company Return	S&P 500* Shareholder Return	Extra Shareholder Return	Beginning Market Capitalization	Management Share	Equity Pool
15%	- 12%	= 3%	x \$4 billion	x 20%	= \$24 million + \$15 million for matching market return = \$39 million
12%	- 12%	= 0%	x \$4 billion	x 20%	= \$0 million + \$15 million for matching market return = \$15 million
9%	- 12%	= (3%)	x \$4 billion	x 20%	= (\$24) million + \$15 million for matching market return = \$0 million

\*Could also be identified peer group or blend of peer group and broader index.

Exhibit 3 illustrates how companies could directly reward relative shareholder performance in a long-term incentive program while retaining a portion to be earned based on absolute results from conventional stock options. Importantly, the argument that "it's too complicated to reward relative performance" is not borne out by the facts: Literally hundreds of money managers are successfully rewarded on that basis, and an increasing number of industries have added a relative results element to their annual incentive and sales compensation programs.

### Stock Option Repricing and Additional Award Grants

The practice of repricing stock options whose value has dropped below the strike price is one of the most emotion-laden issues in all of executive and management compensation. Clearly, we cannot rationalize the repricing of options to ensure compensation for those managements that have consistently failed to deliver shareholder value. We can, however, call attention to situations in which a company's management can reasonably argue that a broad market or sector decline has resulted in a disconnect between the managers' potential option gains and the company's relative stock performance.

One can reasonably ask why a company would even consider such a politically incorrect action as repricing existing stock options. A simpler solution would be to grant more stock options at the new, lower strike price and let the existing

out-of-the-money awards run their course, with the potential for moderate future awards if the stock rebounds. However, many institutional shareholders and shareholder groups, in voting to approve new stock plans, use simple formulas that limit the percentage of shares that can be outstanding as stock options regardless of their economic impact (i.e., the overhang of potentially exercisable options as a percentage of outstanding stock.)

Perversely, under these simple option formulas, it is more advantageous for companies to have managers exercise awards early rather than to require longer vesting and other restrictions that produce a larger overhang but also offer better motivation and retention. Therefore, very good companies can be in a bind when they face a legitimate need to restore viability to option incentives when current options are out of the money. Option repricing becomes a necessary but unpalatable choice due to the share authorization restrictions present in the marketplace.

Consider a hypothetical example. A company has management stock options outstanding at \$60 per share and the industry sector and peers decline 50% as a result of unfavorable environmental and competitive reasons. If the company's stock declines less than 50%, management could argue that, given a competitive market for management talent, an option repricing—or the awarding of additional grants—would be in the best interest of shareholders from a motivational and retention perspective. In making these deci-

sions, directors' compensation committees often have not had clear guidance on how to adjust rewards to restore their incentive value.

Exhibit 4 shows one simple method compensation committees could use to reprice out-of-the-money stock options or to determine the size of any additional options awarded to replace the underwater options. The methodology incorporates both absolute and relative stock movements and shows how the company can make them work together in a program that is fair and explainable for both shareholders and stock option participants. An approach such as this allows companies to maintain the incentive impact of their awards in a volatile and unpredictable market environment.

### Stock Option Design Features

Most stock option programs follow a conventional pattern of annual grants at market prices with a 10-year maximum exercise period, pro-rata vesting, and exercisability that can begin over the first 3 to 4 years. In most cases, a company's stock ownership guidelines for executives are modest in relation to the size of stock option awards, so executives have little to restrain them from selling their shares shortly after exercise. Also, the commitment to stock ownership guidelines has not yet been tested across market cycles.

Companies typically grant awards annually in order to smooth out absolute stock prices as well as to recognize individual performance and contributions on a frequent basis. In a rapidly evolving environment, too much can change if grants are made every other year or on an every third-year cycle.

It is, however, more difficult to explain why companies routinely grant 10-year stock options but allow early exercisability and, thus, the opportunity for early potential gains. This clearly runs counter to the concept that stock options are primarily intended to recognize long-term performance and that management should not be unduly rewarded for short-term, often transitory gains in stock prices.

From a retention standpoint also, many of the vesting schedules in place today appear to be too short. While an individual company has to be competitive in the marketplace on the terms of its awards, our experience is that vesting can often be extended at least a year or "back-end" loaded with most of the vesting coming in later years rather than pro-rata. Unfortunately, early vesting and exercisability can also create a much shorter focus than the company intends. Many managers and executives now commonly spend inordinate amounts of time focusing on short-term stock prices to figure the "right time" to exercise options and capture the gain. Recognize that implicit in these deliberations is the fact that these people are searching for stock prices that are unsustainable and therefore reflect a perceived high point. The compensation culture that has developed around stock options seems to have produced a counterproductive, short-term bias.

Moreover, we have found that individuals who hold exercisable but "out-of-the-money" stock options experience considerable frustration—more so than individuals whose plans do not allow them to exercise options on similar stock for several years. Stock option participants who

EXHIBIT 4  
Illustration of Stock Option Repricing/Additional Grants

Assumptions		
1. Equity pool is 100,000 stock options granted @ \$60/unit		
2. Industry sector and peers decline 50% in share value		
3. Company stock declines from \$60 to \$40 (-33%)		
If absolute stock performance is:	and relative stock performance is:	then percent of stock options repriced and/or new grants made would be:
100% of grant price	200% of peer group	100%
75%	150%	100%
67% (assumption #3)	X 133%	89%
50%	125%	63%
40%	100%	40%

hold unexercisable options seem to better accept the long-term nature of awards and the potential for option gains several years in the future.

From a motivational and retention perspective, companies gain little from allowing early vesting and exercisability. In general terms, vesting should be longer than the 3- to 4-year pro-rata approach of equal vesting each year often found in the marketplace. Moreover, and more fundamentally, stock options should not be exercisable for a much longer period of time. If companies desire to remove a portion of the lottery element, they should base stock option awards on relative performance, and the options should not normally be exercisable for at least 4 to 5 years in the future.

Establishing a longer period before executives could exercise grants would be one concrete step companies could take to emphasize that stock options are intended to reward long-term shareholder value creation and not short-term price volatility. In delaying exercisability for current employees, companies would also need to rethink the terms for exercise of options by former employees. It would appear to be a reasonable tradeoff to allow former employees a longer period to exercise vested options in return for lengthening the period before current employees could exercise grants. In this way, exercisability is

not tantamount to losing the value of vested variable awards for former employees.

## Conclusion

The concept of linking long-term compensation to shareholder returns is widely accepted—and totally appropriate. It has taken a long time for corporations to learn how to focus on creating value, and we certainly do not want to take a step backward by uncoupling compensation from value creation. It is disappointing, however, to realize that the primary long-term incentive device today, conventional stock options, is so fundamentally flawed from a design and implementation perspective.

The good news is that companies are recognizing the problematic issues associated with conventional stock options and are beginning to adopt different approaches. On the one hand, we expect that, for now, companies will continue to work with the design features of conventional stock options to make them more effective—so long as accounting rules put relative-performance incentives at a disadvantage. On the other hand, we predict that the next few years will bring a return to greater use of cash-based long-term plans because these plans can provide an exciting way to focus management's attention on strategic objectives and to reward excellent performance.

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