

TOTAL COMPENSATION STRATEGY

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*"Total compensation shall represent competitive levels of compensation...
Performance-related pay shall be a significant component of total compensation
placing a substantial portion of an executive officer's compensation at risk."*

These statements from a recent Compensation Committee Report aptly express the dominant total compensation strategy of public companies today. This strategy is widely accepted as the most reasonable way to limit retention risk and control shareholder cost while still providing a strong incentive for management to maximize shareholder value.

The commitment to competitive compensation levels limits retention risk—that is, the risk that key managers will leave the firm for a better offer elsewhere—because total compensation opportunities are not allowed to fall below competitive levels. The same commitment also limits shareholder cost because total compensation opportunities are not allowed to rise above competitive levels. The commitment to maintaining a substantial proportion of total compensation “at risk”—that is, in the form of bonuses, stock options, and other incentive compensation—is thought to provide a strong incentive to maximize shareholder value—an incentive comparable to that of an owner with a substantial proportion of his wealth in company stock.

This article argues that the dominant total compensation strategy is fundamentally flawed and can never provide incentives comparable to those of an owner/entrepreneur who holds a large proportion of his wealth in company stock. The critical flaw

in the strategy is that, even though a very large proportion of *the current year's* compensation may be “at risk,” the commitment to maintaining competitive levels of compensation in all future years effectively ensures that a large proportion of the executive's *wealth* is not at risk. Incentives that approach entrepreneurial levels can be achieved only by total compensation strategies that make *the value of future compensation opportunities sensitive to current performance*.

But, strategies that provide strong wealth incentives will always lead to greater retention risk for poor performance or higher shareholder cost for superior performance than the dominant total compensation strategy. And this means that managers and directors who seek stronger wealth incentives must be prepared to make difficult trade-offs between stronger wealth incentives, greater retention risk, and higher potential cost to the shareholders. To help managers and directors in evaluating these trade-offs, this paper presents a new analytical framework—one that I call *total wealth incentive analysis*. This analytical framework can be used both to reveal the hidden and ill-considered trade-offs that typically underlie the dominant total compensation strategy, and to design compensation plans that provide strong, sustainable, and cost-effective wealth incentives.

TABLE 1

		Competitive Percentile	Market Pay Mix	Target Pay Mix
Salary	\$300	50	40%	30%
Target Bonus	\$200		20%	20%
Target Cash Compensation	\$500	60		
Target Option Value	\$500		40%	50%
Target Total Compensation	\$1,000	75		

THE DOMINANT TOTAL COMPENSATION STRATEGY

The foundation of the dominant total compensation strategy is the concept of annual recalibration to a competitive position target. The company adopts a competitive position target—say, the 75th percentile total compensation—and each year recalibrates its salaries, bonus plan targets, and number of option grant shares to provide a total compensation opportunity at the targeted percentile. Base salary and cash compensation can be targeted at the same percentile as total compensation, or, more commonly, at lower percentiles in order to provide higher leverage and a mix of pay that is more attractive to management and the directors than the market mix.

The company’s total compensation strategy can be (and in fact often is) summarized in a table (much like Table 1) that expresses the company’s target compensation percentiles and target pay mix. For example, in the case illustrated in Table 1, the firm has targeted the 50th percentile for salary, the 60th percentile for cash compensation, and the 75th percentile for total compensation. These targeted percentiles provide a targeted *pay mix* of 30% salary, 20% bonus, and 50% stock options. Despite the fact that these targets put 70% of total compensation at risk, the practice of annual recalibration, as I show below, leaves the company with a weak wealth incentive.

Recalibrating the total compensation program each year to maintain the target competitive percentiles requires adjusting the bonus plan performance target to a new level that represents current expected performance, and changing the number of option shares granted to reflect the current stock price. If, for example, the target operating profit for the first year is \$10 million, but performance deteriorates to a level where the expected operating profit for the second year is only \$5 million, the target operating profit for the second year must be reduced to \$5

million to ensure that the target bonus is the expected value of the bonus. Similarly, if the initial option grant required to provide an expected value of \$500K was 20,000 shares based on a stock price of \$50 (and a Black-Scholes value of 50%, or \$25 per option), and the stock price declines in the second year to \$25, the number of option shares granted must be increased to 40,000 to provide an option grant with an expected value of \$500K (because new at-the-money options are now worth only \$12.50 per share). If performance improves instead of deteriorates, the target operating profit must be increased and the number of option shares reduced to maintain the expected value of the bonus and option grant at the targeted competitive level.

These annual adjustments required to maintain the target competitive position have two important consequences. The first, and intended, consequence is that the expected value of the total compensation opportunity remains at a competitive level. The second, unintended but unavoidable, consequence is that *poor performance is rewarded* by an increase in management’s percentage interest in operating profit and stock price appreciation, while *superior performance is penalized* by a reduction in management’s percentage interest in operating profit and stock price appreciation. When performance deteriorates and the target operating profit is reduced from \$10 million to \$5 million, the target bonus share of operating profit is increased from 2% (\$200K/\$10 million) to 4% (\$200K/\$5 million). When the stock price declines from \$50 to \$25, the number of option shares granted is increased from 20,000 to 40,000. When performance improves and the target operating profit is increased to \$20 million, the target bonus share of operating profit is reduced from 2% (\$200K/\$10 million) to 1% (\$200K/\$20 million). When the stock price rises from \$50 to \$100, the number of option shares granted is reduced from 20,000 to 10,000.

As I demonstrate later, the “performance penalty” inherent in annual recalibration to competitive

The critical flaw in the dominant total compensation strategy is that, even though a very large proportion of *the current year's* compensation may be “at risk,” the commitment to maintaining competitive levels of compensation in all future years effectively ensures that a large proportion of the executive’s *wealth* is not at risk.

compensation levels makes it impossible for the dominant total compensation strategy to provide incentives that approach those of an owner who holds a large portion of his wealth in the form of a *fixed* percentage interest in the dividends and stock price appreciation of the company. It can also lead, as the compensation history of John Akers at IBM illustrates, to huge discrepancies between management compensation and shareholder gain. In Akers’ first year as CEO, the IBM board gave him an option on 19,000 shares exercisable at \$145. In subsequent years, as the stock price declined, they gave him larger and larger option share grants to offset the decline in the stock price and maintain the value of his annual compensation package at a competitive level. In 1990, the Board gave him an option on 96,000 shares exercisable at \$97. By the end of 1992, the Board had put him in a position where he would have realized an option gain of \$17.6 million just for getting the stock price back to the \$145 level at which he received his first option grant as CEO!

THE OBJECTIVES OF EXECUTIVE COMPENSATION

The dominant total compensation strategy is, as any total compensation strategy must be if it seeks to maximize the wealth of current shareholders, an attempt to balance four conflicting objectives:

- *Alignment*: giving management an incentive to choose strategies and investments that maximize shareholder value;
- *Leverage*: giving management sufficient incentive compensation to motivate them to work long hours, take risks, and make unpleasant decisions, such as closing a plant or laying off staff, to maximize shareholder value;
- *Retention*: giving managers sufficient total compensation to retain them, particularly during periods of poor performance due to market and industry factors; and
- *Shareholder cost*: limiting the cost of management compensation to levels that will maximize the wealth of current shareholders.

Each of these objectives is critical to the success of total compensation strategy, but every total compensation strategy must make trade-offs between leverage, retention risk, and shareholder cost. A strategy that relies on large stock grants can achieve substantial leverage with minimal retention risk, but only by accepting higher shareholder cost

than a strategy that relies on stock option grants. A strategy that relies on large stock option grants can achieve substantial leverage with limited shareholder cost, but only by accepting greater retention risk than a strategy that relies on stock grants. A strategy that relies on a high proportion of guaranteed compensation can achieve limited retention risk and limited shareholder cost, but only by accepting modest leverage.

Most companies and directors believe that the dominant total compensation strategy provides a reasonable balance between the four conflicting objectives of executive compensation. Indeed, the rationale for the dominant corporate compensation practice can be summarized as follows:

- It provides alignment because bonus and stock compensation is tied to operating and market measures of shareholder value;
- It provides substantial leverage because a large proportion of pay is at risk and gives the executive incentives comparable to those of an owner who holds a large proportion of his wealth in company stock;
- It provides retention because it gives the executive competitive compensation opportunities every year; and
- It controls shareholder cost because compensation opportunities are limited to a given percentile of the competitive pay distribution.

TOTAL WEALTH LEVERAGE

To understand why having a large proportion of the current year’s pay at risk does not provide incentives comparable to those of an owner who holds a similar proportion of his wealth in company stock, we need to focus on the value of management *wealth*, as opposed to current *income*, and its relationship to shareholder wealth. Management wealth is the value of its investment capital plus the value of its human capital. In other words, management wealth is the sum of (1) the value of current stock and option holdings; and (2) the present value of expected future compensation, including (a) salary, (b) bonus, (c) long-term incentive grants, and (d) pension.

Managers, like shareholders, try to maximize their wealth, not their current income. The true measure of the wealth *incentive* provided by a compensation plan is the sensitivity of management wealth to changes in shareholder wealth. More specifically, for any given change in shareholder

wealth, it is the ratio of the percentage change in management wealth to the percentage change in shareholder wealth. To illustrate, if a 10% change in shareholder wealth changes management wealth by 10%, management's *total wealth leverage* is 1.0. This is the total wealth leverage of a "pure" entrepreneur—one whose entire wealth is held in company stock; in such case, any percentage change in shareholder wealth causes the same percentage change in the entrepreneur's wealth.

If a 10% change in shareholder wealth causes a 7% change in management wealth, then management's total wealth leverage is 0.7. This would be the wealth leverage of a manager whose wealth consisted of 70% company stock and 30% the present value of future salary and benefits. This would also be the wealth leverage of an investor who holds a portfolio of 70% stock and 30% bonds in the same company. In this case, wealth leverage is easy to calculate. If the investor holds \$700,000 of equity and \$300,000 of debt, a 10% increase in shareholder wealth increases the value of the investor's equity by 10% to \$770,000 and the value of the investor's portfolio by 7% to \$1,070,000. The investor's total wealth leverage is 0.7 (= 7%/10%), which is equal to equity leverage (1.0) times the proportion of the investor's wealth held as equity, $1.0 \times 70\%$.

The total wealth leverage of a typical executive, however, is more difficult to calculate because the executive holds a more complicated portfolio—one that includes stock options, future bonus payments, and future option grants. Before I illustrate the use of wealth analysis in total compensation design, it will be helpful to lay some groundwork by first explaining:

- the need to measure wealth leverage on a present value basis,
- the leverage of options, and
- the importance of expected future compensation in management wealth.

The Important Distinction Between Present and Future Values

Total wealth leverage must be measured on a present value basis since wealth is a risk-adjusted present value that reflects different discount rates for future stock and option gains as well as for future salary, bonus, and long-term incentive payouts. "Future value" wealth changes do not provide a meaningful measure of leverage.

To illustrate this point, suppose that an executive holds a ten-year option exercisable at the current market price of \$50, and that the stock price increases by 10% over five years to \$55. The value of the option at the time of grant is \$31.82 (using the Black-Scholes model with a volatility of .350, a dividend yield of zero, and a risk-free interest rate of 8%), but declines by 17% to \$26.33 at the end of five years. These two price changes over the five-year period imply that the option has a future value leverage of -1.7 since the 10% change in shareholder wealth reduces the option value by 17%. That is, option values appear to move in the opposite direction of shareholder value.

This paradoxical result arises because the future value leverage calculation ignores the fact that the option has greater risk, and hence a higher expected rate of return, than the stock. To calculate a meaningful measure of leverage, we need to compare the change in the present value of the option with the change in the present value of the stock. The present value of the \$55 future stock price, assuming a 14% expected stock return, is \$28.57, or 43% less than the initial \$50 market price. The present value of the option, based on a 16.4% expected option return (from the Black-Scholes model), is \$12.31, or 61% less than its initial value of \$31.82.

This set of calculations reveals that the option's leverage is in fact a positive 1.4 (not a negative 1.7) since the percentage change in the present value of the option, -61% , is 1.4 times the percentage change in the value of the stock, -43% . This kind of present value analysis, unlike the future value analysis, confirms our intuitive sense that the option is more, not less, leveraged than the stock.

The Wealth Leverage Provided by Stock Options

The leverage of an option differs from the leverage of the stock in two basic ways. The leverage of an option can be much greater than 1.0 (and never less than 1.0), while the leverage of the stock is always 1.0. The leverage of the option also changes, unlike the leverage of the stock, as the stock price changes and also as the option comes closer to expiration. The leverage of an option declines as the option comes into the money and increases as the option falls out of the money and as the option comes closer to expiration. Table 2 shows the leverage of several different options for

The “performance penalty” inherent in annual recalibration to competitive compensation levels makes it impossible for the dominant total compensation strategy to provide incentives that approach those of an owner who holds a large portion of his wealth in the form of company stock.

TABLE 2

Exercise Price	Market Price	Option Term	Option Leverage
\$50	\$50	10	1.5
\$50	\$50	5	2.0
\$50	\$50	1	4.2
\$50	\$40	1	5.7
\$50	\$25	1	10.0

a company with an average volatility (.35) and dividend yield (3%).

The higher leverage of options plays a critical role in designing strong total wealth incentives because it makes it possible to design a total compensation program that offsets the effect of base salary (which has zero leverage) and provides total wealth leverage that equals or exceeds that of an entrepreneur. For example, if 30% of the executive’s total wealth is the present value of future salary, but the remaining 70% is held in options with a leverage of 1.45, total wealth leverage will be 1.02 ($= .7 \times 1.45 + .3 \times 0$).

Incorporating the Present Value of Future Compensation

The present value of expected future compensation can be a very large component of management wealth. It includes the present value of total compensation for the executive’s expected job tenure plus the present value of the executive’s future pension. Assuming a 5% growth in competitive compensation levels (and a risk-free rate of 8%), the present value of ten future years of competitive total compensation is more than 8 times the value of current total compensation. Adding the value of a pension equal to 50% of cash compensation increases the present value of expected future compensation to more than 10 times the value of current total compensation.

The size of expected future compensation is important because the recalibration feature of the dominant total compensation strategy makes expected future compensation completely independent of current performance. That is, the wealth leverage of the present value of expected future compensation is zero. And, when the present value of expected future compensation is 10 times the value of current total compensation and the company’s total compensation strategy makes the value of expected future compensation totally independent of current performance, total wealth

leverage will be very small even when current total compensation is highly sensitive to changes in shareholder wealth. For example, even if the leverage of current total compensation were designed to be 1.0, with annual recalibration *total wealth leverage* would be only 0.09 because current total compensation represents only 1/11, or 9%, of total wealth.

And this problem affects managers nearing retirement as well as those with longer time horizons. For, although the present value of total compensation for the executive’s expected job tenure diminishes as she approaches retirement, the present value of the executive’s pension increases. The present value of a pension equal to 50% of cash compensation can still be five times the value of current total compensation when an executive is close to retirement.

This basic analysis of the mix of management wealth and the leverage of options is helpful in understanding the fundamental flaw in the dominant total compensation strategy. But it is not powerful enough to guide the development of a new total compensation strategy. For that purpose, we need the ability to simulate the impact of *all* the key elements of total compensation strategy on total wealth leverage as well as their impact on retention risk and shareholder cost.

TOTAL WEALTH INCENTIVE ANALYSIS

To assess the leverage, retention risk, and shareholder cost implications of a total compensation program, we need to simulate the future payouts of the total compensation program across a set of future performance scenarios that reflect the range, variability, and probability of the company’s stock price and operating performance and then calculate total wealth leverage as well as measures of retention risk and shareholder cost. In practice, we can do this by creating a Monte Carlo simulation of 100 (or more) five-year future performance scenarios and then simulating the five-year payouts

TABLE 3

Percentile of Future Shareholder Wealth	5th Year Shareholder Wealth	Percent Change in Shareholder Wealth	PV of Total Wealth	Percent Change in Management Wealth	Total Wealth Leverage
30	\$49		\$3,050		
50	\$79	59%	\$3,790	24%	0.41
70	\$123	57%	\$4,670	23%	0.41

under the total compensation program for each scenario. The Monte Carlo simulations of future market value and operating performance are derived from—and thus are consistent with—the underlying assumptions of option pricing theory and discounted cash flow valuation.

For a company with a publicly traded stock, the future performance simulations are based on the current stock price, the historical volatility of shareholder return, the expected level of improvement in EVA® (that is, profit in excess of the cost of capital) reflected in the current stock price, and the historical volatility of year-to-year changes in EVA. For a private company or a business unit of a public company, performance simulations are based on the estimated market value of the company or business unit, the historical volatility of peer company shareholder returns, the level of the expected improvement in EVA that is reflected in the estimated market value, and the historical volatility of changes in EVA.

We use the future performance scenarios to simulate the future payouts under the total compensation program based on the actual bonus plan design and the specific provisions and grant guidelines of the stock option plan. We use the compensation simulations to measure *total wealth leverage* as well as *future retention risk* and *shareholder cost*. Total wealth leverage is based on a present value analysis using discount rates that reflect the risk of each element of the total compensation program. In some cases, especially where the expected job tenure of the management team is relatively short, our calculation of total wealth is based only on the present value of five-year total compensation. In other cases—for example, where the expected job tenure of the management team is much longer than five years and the company provides generous retirement benefits—our calculation of total wealth includes the present value of expected future compensation beyond five years as well as the present value of retirement benefits.

In either case, we measure *total wealth leverage* at each quintile or decile of the 100 future performance scenarios by calculating *the ratio of the percentage change in management wealth to the percentage change in shareholder wealth*. We measure future *retention risk* by calculating the expected value of total compensation at the end of the fifth year (based again on the actual bonus plan design and the specific provisions and grant guidelines of the stock option plan) and computing the *shortfall, if any, between expected and competitive compensation*. We measure *shareholder cost* by calculating *five-year total compensation* including salary, bonus, and long-term incentive payouts.

The Implications of the Dominant Total Compensation Strategy

These simulations allow us to assess the long-term implications of the dominant total compensation strategy. Let's assume, to begin, that the expected job tenure of the management team is relatively short and, hence, that the present value of five-year total compensation is a reasonable proxy for management wealth. Table 3 shows the total wealth leverage for the dominant total compensation strategy with a 30%/20%/50% mix of salary, bonus, and stock option value:

As shown in Table 3, the dominant total compensation strategy with 70% of pay “at risk” does not provide a total wealth incentive comparable to that of an owner who holds 70% of his total wealth in company stock. Under the most favorable assumptions, it provides a total wealth incentive comparable to that of an owner who holds only 40% of his wealth in company stock.

And if we lengthen the managerial time horizon, the plan provides even weaker wealth incentives. When we include the present value of expected future compensation for years 6-10 in the calculation of total wealth, the total wealth incentive provided by the same total compensation strategy (with 70% of

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TABLE 4

Percentile of Future Shareholder Wealth	5th Year Shareholder Wealth	Percent Change in Shareholder Wealth	PV of Total Wealth	Percent Change in Management Wealth	Total Wealth Leverage
30	\$49		\$5,770		
50	\$79	59%	\$6,510	13%	0.21
70	\$123	57%	\$7,390	14%	0.24

TABLE 5

Percentile of Future Shareholder Wealth	5th Year Shareholder Wealth	Percent Change in Shareholder Wealth	PV of Total Wealth	Percent Change in Management Wealth	Total Wealth Leverage
30	\$49		\$5,120		
50	\$79	59%	\$7,100	37%	0.62
70	\$123	57%	\$9,860	41%	0.72

TABLE 6

Percentile of Future Shareholder Wealth	5th Year Shareholder Wealth	Percent Change in Shareholder Wealth	PV of Total Wealth	Percent Change in Management Wealth	Total Wealth Leverage
30	\$49		\$4,550		
50	\$79	59%	\$6,890	51%	0.86
70	\$123	57%	\$10,880	58%	1.02

pay nominally “at risk”) provides a wealth incentive comparable to that of an owner who holds only 20% of his total wealth in company stock (see Table 4).

Designing Entrepreneurial Incentives

To create a total wealth incentive that approaches entrepreneurial incentives, total compensation strategy must be based on policies that make a substantial proportion of management wealth sensitive to current performance. These policies include *front-loaded* option grants, *fixed-share* option grant guidelines, and formula bonus plans.

As shown in Table 5, substituting fixed-share annual stock option grants for the conventional fixed-dollar, variable-share grants provides a total wealth incentive that is comparable to that of an owner who holds 70% of his total wealth in company stock. Thus, just taking this step alone has the effect of tripling the proportion of management’s wealth that is truly variable or “at risk.”

This stronger incentive, however, comes with higher retention risk for poor performance and higher shareholder cost for superior performance. Retention risk increases for poor performance be-

cause the expected value of the fixed-share options will decline below competitive option grant values as the stock price declines. If a 24,500 share grant provides a competitive option grant value when the stock price is \$50, it will only provide half of the competitive option grant value when the stock price is \$25. Shareholder cost for superior performance will also increase because management will still get a 24,500 share grant when the stock is \$100 or \$200.

To demonstrate how an entrepreneurial incentive can be designed and to highlight the retention and shareholder cost implications of a strong wealth incentive, it will be useful to take our program redesign one step further and show the implications of a front-loaded option grant of 245,000 shares (in effect, granting 10 years’ worth of options at the beginning of the manager’s tenure). As shown in Table 6, a total compensation strategy based on a formula-driven, fixed-target EVA bonus and a front-loaded option grant can provide a total wealth incentive comparable to that of an entrepreneur whose total wealth varies in exact proportion to changes in shareholder value.

But what are the retention and shareholder cost implications of providing such an entrepreneurial

TABLE 7

Percentile of Future Shareholder Wealth	5th Year Shareholder Wealth	Year 6 Market Total Comp	Year 6 Expected Total Comp	Percentage Difference
10	\$28	\$1,000	\$610	-39%
30	\$49	\$1,000	\$830	-17%
50	\$79	\$1,000	\$1,260	+26%
70	\$123	\$1,000	\$2,030	+103%
90	\$208	\$1,000	\$3,610	+261%

TABLE 8

Percentile of Future Shareholder Wealth	5th Year Shareholder Wealth	5 Year Total Comp (A)	5 Year Total Comp (B)	Percentage Difference
10	\$28	\$2,200	\$1,800	-18%
30	\$49	\$3,300	\$2,700	-18%
50	\$79	\$4,600	\$7,700	+57%
70	\$123	\$6,700	\$18,100	+170%
90	\$208	\$10,700	\$38,200	+257%

incentive? If we assume that the front-loaded option grant vests pro-rata under this program, the expected value of total compensation in the sixth year is the sum of base salary, the target bonus, and expected value of the option shares vesting in the sixth year. And, as shown in Table 7, there are substantial differences between competitive total compensation and the expected value of the executive's total compensation in the sixth year. In fact, if the firm performs very poorly, and the stock price falls to \$28 after five years, there will be an almost 40% difference between competitive levels and managers' expected total compensation.

Moreover, if we use the five-year sum of base salary and bonus payouts plus the spread on outstanding option grants as a measure of the total shareholder cost of the total compensation program, this alternative compensation strategy (column "B" in Table 8) has significantly higher shareholder cost than the dominant total compensation strategy (column "A" in Table 8). The higher cost will be incurred, however, when the shareholders are best able to afford it—when their shares have appreciated significantly.

As these comparisons of future retention risk and shareholder cost clearly show, there is no "free lunch" in total compensation strategy. The entrepreneurial leverage provided by the front-loaded option grant and EVA bonus plan implies both

greater retention risk for poor performance and higher shareholder cost for average and superior performance. While future retention risk can be reduced by increasing the size of the initial option grant, an increase in the size of the option grant will increase the shareholder cost of the total compensation program. Such difficult trade-offs are unavoidable despite the illusions fostered by the dominant total compensation strategy. The real issue is how to make the trade-offs wisely—that is, in such a way that they will maximize the wealth of current shareholders.

A NEW APPROACH TO TOTAL COMPENSATION STRATEGY

The real issues in total compensation strategy are not competitive position targets and total compensation mix. The real issues are:

- What are the wealth incentives created by the current/proposed program?
- What is a desirable wealth incentive?
- How should a stronger wealth incentive be "financed?"
 - Through greater retention risk?
 - Through higher shareholder cost?

We have already explained the analysis necessary to address the first issue, so let's now turn to the second and third.

To create a total wealth incentive that approaches entrepreneurial incentives, total compensation strategy must be based on policies that make a substantial proportion of management wealth sensitive to current performance. These policies include front-loaded option grants, fixed-share option grant guidelines, and formula bonus plans.

In an ideal world, the determination of the optimal wealth incentive would be based on the empirical relationship between wealth incentive and shareholder return. This would identify the point at which the incremental cost of a stronger wealth incentive exceeds the incremental increase in shareholder wealth.

Unfortunately, there is no systematic research on this relationship, in large part because few companies publicly disclose their policies for adjusting performance targets and option grant levels. In the real world, decisions about optimal wealth incentives still require thoughtful director judgment about the expected effects of stronger incentives on management performance. While many directors are convinced that entrepreneurial leverage has a dramatic impact on management performance, others—particularly those with small stockholdings—remain skeptical that stronger incentives will make management work harder or smarter.

While there is no controlled statistical study that proves that entrepreneurial leverage has a dramatic impact on management performance, there is relevant evidence for these uncertain directors to consider. One important piece of evidence are the internal studies of chain restaurant companies that operate both company-owned and franchised units. These studies suggest that wealth incentives that approach or exceed entrepreneurial levels have a very significant effect on performance. More specifically, the studies show that franchised units, which provide wealth incentives at entrepreneurial levels, significantly outperform company-owned units with total compensation strategies tied to competitive pay objectives.

A second important piece of evidence in thinking about desirable wealth incentives is the wealth incentives agreed to in circumstances where there is substantial “arm’s-length” bargaining over the terms of compensation. One important case of arm’s-length bargaining occurs when outside directors and significant shareholders play the lead role in negotiating a long-term compensation contract for a new CEO hired from outside the company. In these situations, we often find compensation contracts that provide wealth incentives that approach or exceed entrepreneurial leverage. Consider, for example, Michael Eisner’s original contract at Walt Disney. As I discussed in an earlier article in this journal (“What Pay for Performance Looks Like:

The Case of Michael Eisner,” Summer 1992), Eisner was given a contract at the outset of his tenure that gave him a large front-loaded stock option grant and a bonus equal to 2% of Disney’s profits after shareholders had been provided with a 9% return on equity. The total wealth leverage provided by the contract was 1.4. And, during a period in which the market value of Disney increased by \$12 billion, Eisner received some \$200 million.

Another instructive case of arm’s-length bargaining is the determination of the general partner’s compensation in private placement investment funds, such as leveraged buyout funds and venture capital funds. The general partner’s compensation typically consists of a 1% management fee, based on the total assets invested by the limited partners, plus a 20% interest in the ultimate profits from the fund. In addition, the limited partners normally demand that the general partner make an equity investment in the fund. (KKR, for example, typically committed about 1-4% of the equity in the funds for which it served as general partner.) The management fee is essentially the general partner’s “base salary” since it is based on the limited partners’ initial investments rather than the current value of their investments. When we model the general partner’s total wealth leverage, we find that it slightly exceeds entrepreneurial leverage even though the present value of the management fee represents 25% of the general partner’s fund related wealth (including the value of a 20% profit interest and a 4% equity interest).

Making the Trade-Off

Once the directors come to a consensus about a desirable wealth incentive, they must decide what combination of greater retention risk and greater shareholder cost should be used to “finance” it. Unfortunately, it is difficult to generalize about the optimal way to “finance” a stronger wealth incentive. The optimal trade-off between retention risk and shareholder cost depends on the difficulty of replacing the management team and the shareholders’ willingness to accept higher retention risk to limit the cost of management compensation.

To illustrate the process of making such trade-offs, consider the following case. The shareholders of a closely held corporation wanted to strengthen management incentives to ensure the continued success of the company as the original sharehold-

ers retired from active participation in management. The original shareholders had had very strong wealth incentives during the period they had built up the company, and they were eager to give the new management team a total compensation program that would make them feel, and act, like entrepreneurs. But entrepreneurial incentives were not the only objective of the shareholders. They didn't want to "give the company away" and felt that a 5% option interest was the most they should reasonably have to sacrifice to motivate the management team. They were also concerned about the volatility of the business and the retention risks of forcing management to make a big bet on the current value of the company.

Given these concerns, their initial preference was for a total compensation program that provided annual fixed-share option grants, building up to a 5% management team option interest over five years, plus an annual EVA bonus with a target opportunity of 30% of salary. To their surprise, however, our analysis showed that the total wealth incentives provided by this program were only half the level of entrepreneurial incentives. This finding created a difficult dilemma for the original shareholders. They could provide the new management team with a far weaker incentive than the one that had motivated them to build the business, but that was at odds with their basic objective of motivating management to replicate and extend their own success. Or they could increase the incentive by providing a much larger cash bonus opportunity, but they were afraid that management would then lose its focus on maximizing *long-term* shareholder value. Or they could reduce management's guaranteed compensation to enhance the relative impact of the stock option grants, but they immediately decided that that would alienate, not motivate, their management team. Or, finally, they could increase their "investment" in management com-

ensation by agreeing to surrender more than a 5% option interest in the company.

After much thought, analysis, and discussion, they decided that the last alternative was the best.

CONCLUSIONS

The dominant total compensation strategy has a very strong appeal for "fiduciary directors" with small stockholdings because it minimizes the risk of highly visible failure. Total compensation strategy can fail to maximize shareholders' wealth because it fails to provide a strong wealth incentive, but highly visible failures (the great concern of the fiduciary director) almost always involve retention or shareholder cost. When key managers leave to join a competitor, it is hard to convince skeptical shareholders that the company's total compensation strategy was based on a reasonable decision to accept more retention risk to limit shareholder cost. When managers receive very large incentive compensation payouts, it is hard to convince a skeptical public that strong incentives played a key role in the company's success. But failures of leverage (or alignment) are rarely attributed to total compensation strategy; they are lost in a multitude of other explanations for poor performance—bad strategy, tough competition, product development failures, adverse market trends, etc.

Directors who are large shareholders are far more aware that inadequate wealth incentives can be a much greater threat to shareholder value than management turnover or large incentive compensation payouts. The successful history of LBOs and the entrepreneurs who leave big companies to start small ones is largely a history of inadequate wealth incentives. It is time for all directors to abandon the illusions of the dominant compensation strategy and face up to the difficult decisions required to create the strong wealth incentives needed to maximize shareholder value.

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