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The Crystal Report on Executive Compensation

Stephen O'Byrne: A Serious Thinker About Compensation

by Graef Crystal

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Steve O'Byrne is a mild-mannered man, but get him on the subject of what passes for contemporary practice among the vast majority of compensation professionals, and a distinct edge appears in his voice.

That's because those compensation professionals hardly ever engage in serious social research. They rarely make an effort to identify incentives and incentive practices that can be shown to be seriously correlated with increases in shareholder wealth. Instead, they turn the Biblical admonition on its head: Not "Do Unto Others" but "Do What Others Do!"

Steve is one of those outliers in the data set – people who really do conduct serious social research.

And he is uniquely qualified, given his solid-gold educational training as a mathematician, a CPA and a lawyer. Formerly with Towers Perrin and after that, Stern Stewart & Co., he now heads his own Larchmont, New York-based company, Shareholder Value Advisors Inc.

The Way Most H.R. Professionals Think

The thinking of so many HR professionals was never made more clear to me than on the day John F. Kennedy was assassinated. I was then a junior corporate compensation executive at General Dynamics Corp., the major aerospace firm, which at that time was headquartered in Manhattan.

A few minutes after the terrible news broke, I received a call from my boss' boss, the corporate head of H.R. He said: "Quick, call 20 other major companies in New York and see if they are going to give their employees time to go to church this afternoon." Why I was not fired for insubordination, I will never know, but I shot back: "Algie, I'm not going to do it. What difference does it make what other companies are doing? Make a decision."

This sort of behavior is what Steve O'Byrne decries.

Consider what passes for conventional wisdom among compensation directors and compensation consultants:

- You establish a comparator group, which usually consists of similarly-sized companies in your own industry but often also includes key companies in other industries.

- You trade data with each company and determine its total pay for a variety of executive positions. Total pay generally includes the estimated present value at grant of long-term incentives. If the incentive is an option, the Black-Scholes model is employed.

- Then you submit some recommended pay figures to your board compensation committee. If the committee is targeting the average, you give them the comparator group averages. If the committee is targeting, say, the 75th percentile (i.e., the top 25 percent of payers), you give them those figures.

- You generally avoid confusing the committee with details concerning the distribution of pay within the comparator group. So far as the committee is concerned, the average is the average, and almost every company's pay for a given position is within spitting distance of that average.

- You almost never tell the compensation committee about the comparator group medians. Because of the way pay figures are generally distributed, medians are almost always significantly lower than averages. And your bosses (or clients), as a result, have an inordinate distaste for medians.

- But, most important, here's one more thing you don't do. You don't specify the conditions – say, how your company is performing – that ought to establish where your company's pay is – or should be -- vis a vis your competitors' pay. That whole subject of pay-for-performance just floats somewhere in the compensation committee meeting room but is rarely tethered down.

Bill Marriott Weighs In

Consider the Black-Scholes model. One of the key factors in determining the present value of a stock option is the market price of the company's stock on the date of grant. Other things equal, the higher the market price, the higher the option's present value. And the lower the market price, the lower the option's present value.

Now let me recall a conversation I had many years ago with Bill Marriott, the CEO of Marriott International Inc. I served as his compensation consultant for more than 20 years, the longest period I served any client.

I had just presented my recommendations for forthcoming annual stock option grants when Bill interjected: “Seems to me that I got 200,000 shares in my last grant. Now you want to give me only 100,000 shares. What’s going on here?” I explained to him that his company’s stock price had nearly doubled since he last received an option grant and that after adding an escalation factor for ever-rising executive pay, 100,000 shares was the proper grant. At least it was the proper grant according to the Black-Scholes model.

Well, to Bill Marriott, that answer made no sense. “Wait a minute”, he objected, “our stock has almost doubled, so the way I see it, it’s going to be harder for me to engineer a big future increase in our stock price – much harder than if our stock hadn’t moved at all. So it seems to me, you ought to be giving me 300,000 shares, not 100,000”.

The Perversity of the Black-Scholes Model

The Black-Scholes model is indeed perverse to most non-mathematically-inclined CEOs. They can accept the notion of fewer shares when their company’s stock price declines, but the quid pro quo is more shares when it rises. Yet the Black-Scholes produces precisely the opposite result.

But as Steve O’Byrne sees it, that automatic acceptance of Black-Scholes results is one of the key factors that helps to destroy any future relationship between pay and performance. What it does, assuming the compensation professional has “done the numbers right”, is to assure, at least when it comes to the present value at grant, that the company will pay the average in good years and bad.

If Steve were advising Bill Marriott, he wouldn’t likely go along with increasing his option grant to 300,000 shares from 200,000 shares. But he definitely would not cut it to 100,000 shares. No, he would likely leave the grant at 200,000 shares.

“Wait”, says our hypothetical compensation professional. “You do that, and our competitive positioning will soar. And the shareholders will go crazy”.

To that, Steve’s answer would be: “Duh! Yes, Bill Marriott’s pay positioning will soar. But his stock has increased hugely, so why shouldn’t his pay positioning soar? Hello? Isn’t that called pay for performance?”

And guess what? Suppose Marriott International’s stock had dropped in half since his last option grant. By giving Bill Marriott the same 200,000-share option grant as he received the year before, and not the 400,000 shares the Black-Scholes model would suggest, his pay positioning would drop. And that’s exactly what should happen.

It’s true, of course, that if a company’s stock continues to soar wildly, the use of a “same number of option shares” approach will eventually send the CEO’s compensation out of sight. So at some future time, you may have to reset things. But that’s a pleasant problem to contemplate.

Focusing on the Norm

As Steve puts it: “The whole system is over-focused on competitive pay entitlement and under-focused on measurement and strong incentives.”

Think here about the fact that when I use multiple regression analysis to account for why one CEO makes more than another, I almost always find two factors that are strongly correlated with pay:

- The size of the company, typically measured by its net sales.

- The degree of risk incorporated in the CEO’s pay package. I measure this by calculating the ratio of option present value to total pay, on the theory that stock options constitute the riskiest form of pay.

But what hardly ever turns up as a statistically-significant predictor of pay in my multiple regression analysis is a factor for performance, e.g., the company’s return to shareholders during the fiscal year.

Why not? Because, as Steve correctly points out, the compensation director is “norming” pay to the competitive averages and is not taking account of the company’s performance.

As a result, Steve observes: “A lot of companies unwittingly offer incentives for valueless growth”. That’s because every compensation professional has seemingly absorbed in his DNA the dictum that if the company becomes larger, you have to pay more, notwithstanding that, at the margin, you are actually losing money on the incremental sales volume.

Current practice, in fact, may do more than simply reward for valueless growth. Think of the number of option shares that compensation professionals will shortly decide are needed to be granted in 2009, after applying the Black-Scholes model to stock prices that have been sent into the sub-basement. If there is no judgment applied here, your typical CEO may receive an enormous number of option shares in 2009, far more than he received in 2008, due solely to that drop in market prices. And if the market rebounds in the next few years, those enormous number of option shares will release a tsunami of option gains. If you think ordinary American are pissed now over high executive pay, fasten your seatbelt.

Indeed, things may get even worse than that. Reasoning that so many past option grants are now badly underwater and feeling the need to provide more motivation to dispirited executives, not a few compensation committees will go further even than the Black-Scholes model would suggest and make some “consolation” mega-grants.

What is needed, Steve thinks, is stronger direction by board compensation committees. Not just "pay the average". But pay the average for average performance. And pay at the 10th percentile for lousy performance. And pay at the 90th percentile for great performance. And define what you mean by performance – and not just at the end of the year and after the fact. And stop concentrating on rewarding for size, for Steve's "valueless growth"

Steve O'Byrne is performing important research that should get compensation committees and compensation directors "doing pay-for-performance", instead of just talking about it in airy terms.

You can see some of the fruits of his research by going to his website, www.valueadvisors.com.

Steve is my longtime friend. I outranked him at Towers Perrin (in largest part because I am some 16 years his senior). I was supposed to be a mentor to him. But the truth is more the reverse: He has been a mentor to me for many years.

2009 marks GRAEF Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.