

By Stephen O'Byrne

# Wealth leverage: a key governance tool

**W**ith pay disclosures now commonly running 5,000 words or more, top management pay programs are astonishingly complex. As a result, directors often struggle to find analytical tools to manage pay program complexity. Use of 'tally sheets' that provide a comprehensive measure of total compensation is becoming more widespread, but few directors end up developing a comprehensive understanding of management's incentive to increase shareholder value. One important incentive-measurement technique that directors should be familiar with is wealth leverage. But what exactly is wealth leverage, how is it measured and how can directors use it to make better governance decisions?

Wealth leverage is the sensitivity of management wealth to changes in shareholder wealth. Management wealth is measured as the present value of expected future pay, including future salary, bonus, equity grants and pension, plus current stock and options holdings. (For simplicity, this example ignores non-company-related wealth.) Managers, like investors, are motivated by prospective changes in their wealth, not just current year cash. A manager's annual wealth return is the change in wealth during the year plus cash received, divided by beginning wealth. Cash received includes salary, cash bonus and proceeds from stock sales. Wealth leverage is calculated by taking the ratio of management wealth return to shareholder wealth return.

A 'pure' entrepreneur who has 100 percent of his wealth in company stock has wealth leverage of 1.0 because any given percentage change in shareholder wealth results in an equal percentage change in the entrepreneur's wealth. A manager who has 50 percent of his wealth in the present value of expected future salary and 50 percent in stock will have wealth leverage of 0.5 because half of his wealth changes by the same percentage as shareholder wealth. But a manager who has 50 percent of his wealth in the present value of future salary and 50 percent in the present value of future bonus typically will have wealth leverage of 0.1 or less, not 0.5.

Why having 50 percent of pay at risk is so different from having 50 percent of wealth in stock will be explained later, but the weakness of percent of pay at risk as a proxy for incentive strength is a key reason why directors need to focus on wealth leverage.



## Good for shareholders and for management

Wealth leverage for top-level managers at public companies can be estimated using historical proxy data and publicly available financial data. Accounting Professor David Young of INSEAD in Paris, France and I conducted a study in 2005 in which we calculated top management wealth returns for S&P 1500 companies from the years 1995 through 2004. We estimated wealth leverage for each company by calculating the regression trendline relating the annual management wealth

return to the annual shareholder return net of market and industry factors. This study showed that top management wealth leverage for the median company was 0.4, indicating that a 10 percent increase in shareholder wealth increases management wealth by 4 percent. The study also showed that 85 percent of wealth leverage for the median company comes from stock and option holdings, with only 15 percent from current year pay or changes in the present value of expected future pay.

For director decision-making, it is more useful to measure wealth leverage as a weighted average of wealth component leverages because it provides a measure of current wealth leverage rather than a measure of average wealth leverage over a long historical period. With this methodology, wealth leverage is equal to stock percent of wealth x stock leverage + options percent of wealth x option leverage + present value of expected future compensation percent of wealth x pay leverage. Stock leverage is easy: just 1.0. Option leverage can be calculated using the Black-Scholes model. On average, it's about 1.6. Pay leverage is more difficult, because it is

necessary to measure the sensitivity to current year performance of current year pay, next year's pay, year [+2] pay and so on. While we do not know exactly what next year's pay will be, and are unable to measure its sensitivity to current year performance, we can estimate it by measuring the sensitivity of current year pay to last year's performance. Similarly, we can estimate the sensitivity of year [+2] pay to current performance by measuring the sensitivity of current pay to year [-2] performance. When we did this analysis for S&P 1500 companies, we found that median pay leverage was about 0.55 for current year pay but -0.05 for year [+1] pay and even closer to zero thereafter.

### It's not you it's the policy

The rapid drop-off of pay leverage is a product of companies' pay policies. Most companies have competitive posi-

## KEY INCENTIVE ISSUES FOR DIRECTORS

- ▶ **The average company does not measure and manage the incentive provided by stock and option holdings.** Often, percent of pay in equity, vesting, retention requirements and security leverage each have a much bigger impact on wealth leverage than current year pay leverage. Yet these factors receive far less attention than the determination of the current year pay level.
- ▶ **The average company pursues pay policies that strip the present value of expected future pay of all incentive.** A competitive position target is justified in the name of retention, but it is an inefficient way to manage retention risk because it pays too much to retain poor performers and too little to retain superior performers. Fixed-share equity grant guidelines provide much stronger incentives than competitive grant guidelines because current performance affects future pay.
- ▶ **The average company pursues pay policies that cause top-management wealth leverage to rise as a manager approaches retirement.** As a manager approaches retirement, stock and option holdings typically increase and the present value of expected future pay, which has very low wealth leverage, declines. However, there is no good reason for top managers to have weak incentives early in their tenure but very strong – perhaps too strong – incentives at the end.
- ▶ **The average company pursues pay policies that give the CEO different (usually much higher) wealth leverage than other members of the top management team.**

tion targets, such as 50th percentile pay, that make compensation opportunity completely independent of past performance. If the company does poorly, equity grant shares are adjusted upward to offset the decline in the stock price and to maintain a competitive grant value. Because current year pay is only about 10 percent of the present value of all future pay on average, increasing the percent of pay at risk has a relatively modest impact on wealth leverage even though it might substantially increase current year pay leverage. This condition is why a high percent of pay at risk does not necessarily ensure a strong incentive.

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