



THE PREVALENCE AND PROBLEMS OF TARGET DOLLAR PAY

Stephen F. O’Byrne, President of Shareholder Value Advisors Inc., notes that a new paper highlights the prevalence and issues related to target dollar pay

A new academic paper on ‘Value-Based CEO Equity Grants’ highlights a fundamental problem in executive pay: reliance on target dollar pay. ⁽¹⁾ The authors show that more than 70% of companies have target dollar pay for their CEO. When a company maintains target dollar pay, equity grant shares are determined by dividing the target equity grant value by the current price. As a consequence, the authors note, “a CEO whose firm has performed better receives fewer shares on the grant date. Such a relationship is problematic because it violates optimal incentive design.”

Key findings of the paper

The new paper has three key findings. The first is that value-based equity grants lead to weaker incentives. The authors find that “persistent value-based equity grants lower a CEO’s wealth-performance sensitivity by about 32%”. To identify companies with value-based equity grants, the authors

look for companies with fixed-value equity grants across multiple years, companies with preset pay structures (e.g., restricted stock, performance shares, and stock options each equal one-third of long-term incentive pay), or companies with “strict pay tracking”. Their control group is the companies that don’t fit into any of these categories. They say these companies have “share-based pay,” but don’t provide any evidence that they have annual fixed share-based pay.

The second key finding is that value-based equity grants lead to lower investment in research and development (R&D). The authors examine annual changes in R&D as a percentage of revenue. They find that the annual change is 0.88 percentage points lower at companies with fixed-value equity grants and 1.59 percentage points lower at companies with preset pay structures. The third key finding is that companies are more

likely to use value-based equity grants when they face greater retention risk. The authors construct a seven-factor ‘Retention Pressure Score’ and show that a higher ‘Score’ increases the likelihood that a company uses value-based equity grants.

Five ways to strengthen the argument for practitioners

The negative impact of target-dollar pay on incentives has been discussed in the practitioner literature for more than 30 years ⁽²⁾, but the vast majority of companies and compensation consultants still don’t see target-dollar pay as a problem. This new academic paper could have a big impact on practitioners if the authors made some changes to make it more understandable.

The first change is to recognize that cost control is the third key objective of executive pay. The authors say that “retention and incentives are the two

main goals of executive compensation.” In fact, there have been three basic objectives - creating strong incentives to increase shareholder value, retaining key talent, and limiting shareholder cost - since the rise of large companies in the late 19th century. Most companies and compensation consultants believe that the three basic objectives can be achieved if a company has a high percentage of pay at risk and sets target pay at the 50th percentile.

A high percentage of pay at risk ensures a strong incentive. Not allowing target pay to fall below the 50th percentile limits retention risk, and not allowing target pay to rise above the 50th percentile limits shareholder cost. Cost control is a compelling practitioner argument for value-based equity grants. The authors need to show why a high percentage of pay at risk does not ensure a strong incentive.

The second change is to recognize that practitioners use “competitive pay” as the concept that justifies target dollar pay. A word search on the SEC’s EDGAR database shows that the authors are far out of touch with practitioner language. One proxy statement in the past five years contains the phrase “pay tracking”; 4,210 contain the phrase “competitive pay”.

The third change is to recognize that stock price changes have two components: an industry component and a company-specific component. Adjusting grant shares to offset the industry component of the stock return limits retention risk and controls cost without any negative effect on the CEO’s incentive, because industry price changes are beyond management’s

control. This says that equity grants should be value-based versus industry TSR, but share-based versus relative TSR. The authors need to show that value-based equity grants reduce pay sensitivity to relative TSR.

The fourth change is to use wealth leverage to provide a more intuitive explanation of why target dollar pay undermines management incentives. Wealth leverage is the ratio of the percent change in executive wealth to the percent change in shareholder wealth. Executive wealth is stock and option holdings plus the present value of expected future pay. Target-dollar pay makes the present value of expected future pay beyond the current year independent of current-year performance. This means that a large part of executive wealth - 73% in a 2010 analysis of ExxonMobil CEO Rex Tillerson - has zero wealth leverage. ⁽³⁾

The fifth change is to recognize that the control group - companies with “share-based pay” - needs a much better definition. The authors say that companies should be like the control group, but the share-based pay companies are just the leftovers. They are the companies that don’t fit into one of the authors’ three categories of value-based pay. We know that they are not currently companies with annual fixed share-based pay because annual fixed share grants have largely disappeared. ⁽⁴⁾ They might be companies with front-loaded equity grants. But they may simply be companies that are too inconsistent to qualify for one of the three value-based pay categories, not companies where pay is highly correlated with stock price. Companies and compensation

consultants can’t imitate these companies unless they know more about their pay policies.

Target dollar pay: Conclusion

This new academic paper provides compelling evidence that a widely accepted pay practice - target dollar pay - reduces management incentives and discourages R&D investment. Companies, compensation consultants and institutional investors should read - and act on - this paper.

References

1. Jin Xu, Pengfei Ye and Cheng Zhang, ‘Value-Based CEO Equity Grants’, *Journal of Financial and Quantitative Analysis*, Vol 60, No 7, Nov 2025.
2. Stephen F. O’Byrne, ‘Total Compensation Strategy’, *Journal of Applied Corporate Finance*, Vol 8, No 2, Summer 1995.
3. Tillerson’s wealth leverage is only 0.35 even though 74% of his annual pay is performance based. See Stephen F. O’Byrne and S. David Young, ‘What Investors Need to Know About Executive Pay’, *Journal of Investing*, Spring 2010.
4. One study shows that the number of fixed share option grants for S&P 1500 CEOs declined from 122 in 2008 to 13 in 2023. See Ferrari, Jain, O’Byrne, Rajgopal & Reggiani, ‘Competitive Pay Policies in CEO Compensation’, available at SSRN/abstract=4407139.

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