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Higher Executive Pay Doesn't Mean Fewer Jobs: Graef Crystal

Dec. 10 (Bloomberg) -- There's a common belief out there that the more a chief executive gets paid to maximize shareholder return, the more likely he'll eliminate jobs -- lots of them -- to get the company's stock price higher.

Wrong. Research I have done doesn't support the notion that CEOs make their millions from stock options and free share awards on the backs of their workers.

The research also shows that the longer a CEO has to wait for his compensation rewards, the more he'll concentrate on long- term performance -- as opposed to short-term fixes -- and that helps create more jobs.

My study group consisted of 195 members of the Standard & Poor's 500 Index. All had fiscal years that ended Dec. 31 and all had at least 10 years of employee headcounts and stock-price histories.

I first tried correlating percent changes in total employee headcounts in 2002 versus 2001 against total returns for the one- year period ended Dec. 31, 2002. Despite all the anecdotal evidence about layoffs causing runups in stock prices, I found no correlation whatsoever. From that, I concluded that those stock- price spikes that occur after a layoff are quite transitory.

I then repeated my correlation analysis but changed the window of measurement to five years from one year. That prompted a significant and positive correlation: 9 percent of the changes in employee headcount were related to five-year total returns to shareholders. And that showed the higher the returns, the higher the headcount.

My Conclusion

Finally, I did a third analysis, this one using a 10-year time window for both change in headcount and total return. The relationship became much stronger. Fully 22 percent of the headcount changes could be explained by 10-year total returns.

To be sure, a correlation of only 22 percent is by no means perfect, in that 78 percent of the changes in headcounts have nothing to do with total return. Still, in the world in which I operate, 22 percent counts as a strong relationship; the likelihood of the result having occurred purely by chance is less than 1 in 10,000. Pollsters should do so well.

My conclusion: Giving top executives incentives for total return doesn't work against creating jobs in the U.S. economy and even helps to create jobs if executives are required to earn the bulk of their reward through truly long-term performance.

Long-term Incentives

Yet those findings collide with what are euphemistically called long-term incentives, because they aren't very long term at all.

Consider stock option grants, the most widely employed form of long-term incentives. Using data covering 2,918 option grants made during 2000 through 2002 to CEOs running U.S. companies with 2002 net sales of \$1 billion or more, I found that 56 percent of those options become fully vested within three years of grant dates. Increase the period to four years, and the percentage leaps to 85 percent. And 97 percent of all options are fully vested within five years. (Information here was drawn from databases prepared by Equilar Inc., an independent provider of executive pay data.)

For an example of how a long-term incentive can be transformed into a short-term incentive, we have Leonard Schaeffer, the CEO of WellPoint Health Networks Inc. In 2002, he received an option covering 400,000 shares. Although the option contained the usual 10-year term, thereby making it look like a long-term incentive, the fine print showed that one-sixth of the shares became vested in just six months, with further one-sixth portions becoming vested every six months thereafter. Thus, after three years, all 400,000 shares would be up for grabs.

If WellPoint's stock price were to jump sharply early on in the option's 10-year term, Schaeffer could immediately pounce on that stock surge and cart away millions. But what would that have to do with long-term performance? Precisely nothing. Yet it is that very long-term performance that is the most beneficial, not only to long-term shareholders, but also to job creation.

The Right Way

For an example of the right way to do things, there is Steven Reinemund, CEO of PepsiCo Inc. In 2001, he received three different option grants. The first, covering 605,672 shares, provided that no shares could be exercised for three years. The second, covering 750,000, provided that no shares could be exercised for five years. And the third, covering another 750,000 shares, provided that no shares could be exercised for 10 years.

How, you might ask, can you grant an executive an option with a term of 10 years and then tell him he can't exercise any shares for 10 years? At best, he would have just one day to make his exercise, i.e., the last day of the option's term. PepsiCo got around this problem by extending the term of this third option to 15 years.

Now that's the way things should be done. Reinemund isn't going to become wealthy on short-term upticks of PepsiCo's stock price. He is only going to become wealthy if PepsiCo's returns to shareholders are excellent and over a very long period. And, as my study has shown, it takes a very long period for total returns to have a significantly beneficial effect, not merely on shareholders, but on workers, too.

Win-Win

Extending the periods before which options can be exercised to a minimum, say, of five years, and better yet, to perhaps seven or eight years, isn't going to win any popularity contest with CEOs and other senior executives. They want to make their money as soon as they can, the long term be damned.

But changes like this ought to be imposed by boards.

I know Milton Friedman says that businesses should be run only for the benefit of their shareholders, and without regard to the interests of employees or the communities in which the businesses operate. Yet transforming what are now short-term incentives masquerading as long-term incentives into true long-term incentives can produce a rare result: A win-win for both shareholders and employees.

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