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Follow the Money

Understanding Management Compensation

Why is it important to understand how company management is compensated?

At a very basic level, we believe that incentives matter. As Bill Priest likes to say, "show me how someone is paid, and I can tell you how that person will behave." Presumably, executives want to maximize their compensation, so any time you are thinking of investing in a company, you should want to know what incentives those executives are responding to, because that will tell you what kinds of actions they are likely to take.

How can managers evaluate management compensation? What are the most important factors to look at?

A company's annual proxy statement contains information about how management is compensated, usually breaking it down into how the annual component is determined versus how the long-term, deferred compensation works. When you first think about this, it seems like it's not all that complicated – don't all companies just want management to do a good job? Well, yes, but things get tricky when you have to define what constitutes a "good job." Is it growing the company's revenue? Growing the earnings? Earnings per share? Generating a market-beating return on the stock? These might all seem sensible, but each will lead to very different kinds of behavior from management. And not all of that behavior is necessarily in the interests of the firm's shareholders.

For example, if you give management an incentive plan based on growing revenue or earnings, it may lead a company's executives to go out and look for acquisitions. Buying another business is usually a quick way to increase the size of your revenues and often your earnings. But buying another business means spending capital, and that capital is not free. Let's take a CEO who's company generates a billion dollars this year in free cash flow. If he or she takes that billion

dollars and buys another company and, a year later, the company's earnings have grown by 20 million dollars, are the shareholders better off? That 20 million dollars in added profit looks nice (particularly if the incentive plan is based on earnings), but it represented a 2% return on the billion dollars spent to get it. The shareholders would have been better off if the company had paid out that billion dollars to them. They could probably have earned more than 2% on the money by investing it elsewhere.

Some metrics that might seem sensible can be gamed by management. Take earnings per share. Even if profits aren't growing, management can produce an increase in earnings per share by buying back some stock and reducing the share count. Is buying back stock the best use of the company's cash flow? In some cases, it might be, but if management has incentives to grow earnings per share they may choose to do a buyback even when there might be better uses for that cash that would grow the profits in the long run (and represent a good return on investment) but which might not pay off for a few years. Similarly, management can manipulate a firm's return on equity (ROE) higher without doing anything to actually improve the business, simply by issuing debt to buy back some stock, which will reduce the denominator in that ROE calculation (and make the firm risker in the process). So be careful using ROE as an incentive.

In general, we prefer to see companies use return on invested capital (ROIC) as a metric for incentive pay. Management's job, at the most basic level, is to take a firm's capital – all the capital, not just the equity – and earn a return on that capital that beats the cost of the capital. That's how you grow the value of a business. And that's what you should be providing incentives for management to do.

Ultimately, the goal of incentive compensation, from the shareholders' point of view, is to align management's interests with theirs. Using total shareholder return (often abbreviated to TSR) might seem like it does that, and in general we would say this is not a bad metric, but it assumes that management knows what is required to make the stock perform well. And sometimes management might simply have misguided notions about that (like, say, thinking that simply growing the earnings per share or raising the ROE creates value).

What are the relevant benchmarks when comparing companies across industries and countries?

Standards and practices do vary somewhat across industries and across countries –usually for a good reason, because not every kind of business works the same way. To take an example that is close to home, asset management firms face a challenge that, say, food companies do not – how can you retain the assets in an investment strategy when the lead portfolio manager inevitably gets to retirement age? One asset manager that we evaluated for the Quality Capital Reinvestment strategy had an interesting approach. Their long-term incentive plan sets aside some compensation until retirement. But it does not pay out all of that deferred compensation immediately when the manager retires. The payout takes place over a multi-year period, and varies depending on how much of the strategy's assets remain with the firm over that time. That creates an incentive for a manager to set up a succession plan that the clients buy into, which benefits the firm's shareholders. Regardless of these kinds of industry-specific nuances, the basic principle remains the same: you want the incentive plan to encourage managers to think about earning good returns on the firm's invested capital that are sustainable over the long term.

How did COVID impact companies' incentive plans?

COVID did constitute a bit of a curveball. For many businesses, targets for a whole host of variables that seemed achievable when they were set in late 2019 – whether it was revenue, profit, or unit growth – became completely unattainable when COVID hit a few months later and people stayed home. Now you might think, well, that's a shame for management, but that's just the way things happen sometimes; nothing we can do about it. But it does raise a question, namely, what is it we want to reward management for? You could argue that we want to reward managers for making good decisions about the things they can control and, if things happen that are completely beyond their control, they should not necessarily suffer for that. Part of this argument would be that good management skill is rare, and there is a competitive market for it, so you need to pay people with that skill well even in an unusual scenario like COVID, where they were powerless to really do much, because otherwise you might lose

them to another firm. Others would say that “moving the goalposts” mid-year is not justified, that regular workers suffered during COVID even though it wasn’t something they had any control over either, so why should management be treated differently? We did see this issue come up at a few companies, and we think reasonable people can come to different conclusions on whether making changes mid-year was justified, depending on the circumstances. But it raised an interesting philosophical question about what it is we reward managers for.

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