

Why link executive pay to share price?

The Covid-19 crisis has demonstrated that share prices are not determined by executives, so why then are so many executive remuneration schemes linked to this measure?

This is the time of year when companies sent out their annual report which include their remuneration report. These days they are long, complex and almost always include two elements; one that relates bonuses to share price performance (usually referred to as TSR, Total Shareholder Return) and another that gives executives free share options if these and other targets are met.

The health and economic crisis created by the rapid spread of the Covid-19 virus has led to sudden and large falls in share prices virtually across all stock markets and is a painful reminder of the systematic risk for equity investors from macro- economic events that are unforecastable and beyond anyone's control. Such events are quite separate from the specific risk associated with an individual stock such as product obsolescence, over indebtedness or even fraud that are the flip side of holding equities for good returns over the long term.

The concept of modern remuneration practices is that good managers will be incentivised to perform even better if they hold equity in the business they run, and that their performance can be measured by the returns of those shares over defined periods of time.

However, this crisis has demonstrated with brutal clarity that even the most brilliant executives of an individual company will find their business, and the share prices of their companies, completely devastated by events totally beyond their control.

They will also see unrealised gains from previous bonuses totally destroyed as share prices, and the value of the unexercised options, obliterated by the carnage in quoted markets. To some extent executives will be able to salvage something by resetting the next set of options to lower levels in line with current share prices which gives them a head start.

But this illustrates the fundamental problem of linking executive pay to something that they cannot control. Indeed, there are reams and reams of legislation and rules that are designed precisely to prevent directors manipulating share prices.

An American political adviser once said that no crisis should ever be wasted. Those are sound words and this one should be used to totally restructure executive pay to make it clear and simple. The government is stepping in to prevent widespread failures of listed companies. The quid pro quo for that should be the removal of all mechanisms to manipulate executive targets, such as earnings per share (adjusted or not) through share buybacks and remove the distortions created by rewarding staff through share options that give them a one way bet on volatility. Heads they win, tails the shareholders get diluted.

Executives are the agents of the shareholders, the principals, to run the business in their best interests, i.e. the long term benefit of the owners. The ambition of executives should not be to maximise the share price in the short term, possibly aided by government interventions such as QE, and then cash out leaving long-term investors diluted year after year by newly issued shares to the lucky few. If executives want to become shareholders they can do it like everyone else by risking their own cash, not by being granted free options that have no downside.