Pearl Meyer

Video Transcript: Compensation Alignment for Long-Term Growth

Christopher Clark: NACD just came out with a Blue Ribbon Commission Report, the Board and Long Term Value Creation. The focus was directors should rethink short term activities and long term value creation. It's easier said than done and that's why I brought two experts in today, David Swinford, the president of Pearl Meyer and Charles Elson of the Weinberg Center. Welcome, gentlemen.

David Swinford: It's good to be here.

Christopher Clark: Given what I just said, one way to address that alignment issue is to create a culture, both on management and the board's side of ownership and I'd like to know if you agree or disagree.

David Swinford: I think it's important to create a culture of ownership by actually creating ownership in the top management team and even among the directors. I think the examples that we think of when we talk about great companies that have been consistent performers over time, all of those companies have top management teams that hold significant share of stock, whether they're founder companies, companies that are sort of, you know, really growing rapidly on the value curve, the key managers always have a big investment in the company and behave like investors in the company. And I think we're always looking for management teams to behave as if they have the same kind of stake in it as shareholders, to be truly aligned with shareholders.

Christopher Clark: That's good. Charles, you've never been bashful.

Charles Elson: Not at all, I've always believed long term that the best companies like with David are entrepreneurial companies and the problem with large scale organizations come when they lose their entrepreneurial [spirit] and they become bureaucratic and managerial and they lose their ability I think to be flexible and to grow. And the key to a successful business is maintaining that sort of structure. And the question is how. I think that number one, the managers have to have a lot of stock in the company that their personal wealth is tied up ultimately in the success of failure of the company and you achieve that through restricted stock or long term stockholdings by the executives. Same thing goes for directors and so I believe directors should be paid in stock, directors need to affirmatively purchase stock coming into the company and I think ultimately, that will create A, a great managerial environment that has an entrepreneurial [edge] to it that ultimately will produce long term value.

David Swinford: One point I'd like to make there is that most boards have established stock ownership guidelines for their top executives and for the board members and those guidelines for the CEO look like five or six times annual salary typically and for directors, it looks like three to five times the annual cash retainer. It's recognized that those levels of stock ownership are actually well below the average ownership of CEOs or directors in Fortune 500 companies and they're pretty conservative compared to what I think Charles and I are thinking about in terms of the ownership that really causes that entrepreneurial behavior and that kind of focused investment in the company of effort, as well as money. So five or six times for a CEO is still a very conservative number, I think we're probably thinking about numbers that are considerably bigger than that.

Christopher Clark: Dave and Charles, given what we just said, how do you best measure long term value creation?

David Swinford: I think TSR is the ultimate measure of value creation from an investor's perspective when you think about you are evaluating the performance of the company and the management team. I don't think TSR is a very good incentive measure and I think we confuse the two. The reason why incentive measures are effective is that there is information within them as to what needs to be done and there is line of sight, people who are participating in the plan can see what it is they need to do to influence that measure. And TSR is subject to an awful lot of other things so over the long term, TSR is a great evaluation tool, a great measure of performance, it's a pretty lousy incentive device.

Christopher Clark: And I think this is evidenced by your recent work with Cornell.

David Swinford: We did a bunch of work with Cornell on the top executive compensation, all NEOs for the last 10 years and we found that there was no difference between companies that used TSR as a performance measure and companies that did not in terms of revenue growth, earnings growth, return on capital, or even TSR itself. It's sort of nonentity in terms of causing performance to happen.

Christopher Clark: Charles, you're an active board member. Do you see any nuances in what Dave just said?

Charles Elson: I agree with Dave. I think ultimately the value of how you've done will be reflected in the long term stock price of the company itself. It does come out in the wash. A good job does get reflected in the valuation of the company. Now obviously you're going to have to judge someone on the short term, whether you keep them or don't keep them as a manager.

Christopher Clark: The ultimate rule.

Charles Elson: Ultimate rule.

David Swinford: And I think that, you know, it's important to look at things like that while we're ignoring the day to day or week to week fluctuations in the stock price, you have to have a general sense of whether or not the market believes that your performance and your long term plans are credible. And if you start to see annual incentive plan results that are radically different from that, rather than say hey, they delivered the annual business plan, that was our agreement, we pay them happily, I think we need to start saying what is the disconnect between what the market sees as our long term value creation proposition and what we're seeing as our annual results because the result of that annual plan should always be driving you toward your long term strategic objectives.

Christopher Clark: Dave and Charles, I want to thank you for bringing not only real magic to the panel but to this conversation. It's not an easy one. I know that some of this has gone from an art to a science but back to art again, but I wanted to thank you on behalf of NACD. If you'd like to learn more about this subject, I'd urge you do a couple of things, read the NACD Blue Ribbon Commission Report on long term value creation and the board, go to the pearlmeyer.com site or actually go to the Weinberg Center website and I think it will carry this conversation a little further. I'm Chris Clark and this is BoardVision.