Executive Pay: Fact vs Opinion as Reflected in Research, Media Coverage, and Advisory Policy

Research by the London School of Economics – Academia and the Press Weigh In

London School of Economics (LSE) report entitled 'Head-hunter methods for CEO selection' – published in the Journal of General Management, Vol.41 No.1 Autumn 2015. Findings subsequently published in UK press March 5-6, 2016

The purpose of the LSE research was to determine how head-hunters decide who is a suitable candidate for an executive role. This qualitative, interview-based exercise covered issues such as desirable characteristics, career path, references, and fit with the board. Throughout the research, participants were very open and willing to share their comments and as such this allowed the researchers to include comments on areas that were not the stated primary subject of the investigation, in particular CEO pay and performance.

Comments on CEO pay and performance are not, in fact, research findings, nor are the opinions expressed by interviewees supported by hard evidence, but it is these quotes which were taken by the media [*The Guardian*, *The Independent*, and *The Observer* on March 5-6, 2016] and which were included in news articles. This distinction is not clear until the conclusion on the final page of the report. The quotes and opinions highlighted by the media as a 'groundbreaking study' and a 'damning indictment' (to quote *The Guardian*) are from two firms highly critical of CEO pay and performance. We do not know whether these views are shared by all head-hunters ('search firms'). That would require further research. The reliance on a small subset of participants puts an element of doubt in our minds as to whether this research truly reflects the majority.

As for the core findings about the general process adopted by search firms in selecting which candidates to put forward, we were concerned by two issues in particular. Firstly, the keenness of boards to make conservative choices and secondly the lack of knowledge of the performance of candidates. It is worrying to hear that boards are taking a restrictive approach in selecting candidates, focusing on those individuals who have a proven track record in very similar circumstances to their own. In an ever-changing market and with such a variety of company cultures, it seems short-sighted of boards to rely purely on prior performance as opposed to selecting individuals who are best placed not only in terms of skills but also culture and drive. This reluctance of boards to be different is a theme we see in our own specialist area of executive remuneration. We are all too familiar with boards wishing to replicate the pay policies of their peers rather than develop policies driven by their own company needs.

The search firms' lack of knowledge on candidates' performance was similarly concerning. We recognise that it is by no means a simple task but to willingly acknowledge that there is little effort made in this area (as the majority of search firms contacted for the research did) is disconcerting. As a firm, we invest significant efforts in measuring CEO performance. No single measurement in isolation can judge performance, but it is possible and certainly worth the time. Our UK CEO Value Index is one such tool. It measures value added (through share price appreciation, dividends, and share buybacks) per pound paid to the CEO. This simple rule of thumb helps shareholders to understand the CEO's value and their returns.

Whilst the LSE report does not show search firms in a particularly favourable light, we are not concerned. The process could be improved, no doubt, but the ball is firmly 'in the court' of boards if they wish to demand more from candidates. We note that around two thirds of FTSE 350 companies promote internally to fill the CEO role rather than hiring externally. This reliance on succession planning is very positive, in our view.

ISS Pay-for-Performance Guidance – The Proxy Advisor's Shape Pay Strategy

Institutional Shareholder Services (ISS) is a global proxy advisory service with over 1,600 institutional clients and around 8.5 million proxy ballots executed each year. They apply their corporate governance views to recommend to clients how to vote. With their scale and client list, they exercise a significant influence on investor voting behaviours on executive pay policy and design.

Recently, ISS announced adding a new pay-for-performance (P4P) methodology to their existing qualitative review process this year. It is important that companies, investors, boards, and remuneration committees understand this new approach as it will have a significant impact on the way ISS makes its recommendations on remuneration resolutions.

The new approach relies on three measures: relative degree of alignment, multiple of median, and pay-to-total-shareholder-return (TSR) alignment. Our overwhelming concern with the new quantitative analysis is that it encourages companies to do exactly what their size and sector peers are doing in terms of policy and calibration. To be different would be to risk a poor rating and this seems to do a disservice to all involved.

We continue to argue that the best outcome for shareholders will be when companies establish pay policies that are driven entirely by company strategy. We fully agree that over a long period of time TSR is the best measure of value creation. Empirical research from Pearl Meyer and Cornell University, however, shows there is no evidence that using TSR in an incentive plan leads to increased firm performance. Given the focus on TSR from both institutional shareholders and proxy advisory firms such as ISS, it is understandable that many remuneration committees feel compelled to prominently include TSR as a metric in their long-term incentives.

Both the relative degree of alignment and multiple of median measures rely on analysis of the company vs a peer group formed by ISS. Peer groups are determined by company size, sector, and location. In the first instance, the reliance on size in establishing a peer group is concerning and if observed by companies could result in an overwhelming relationship between size and pay a relationship which arguably exists to a certain extent today but one which we would not want to reinforce.

Looking more specifically at the actual analysis performed we note that the pay-TSR alignment measure does not measure the sensitivity of CEO pay to performance. Instead it indicates the degree to which CEO pay has changed more or less rapidly than shareholder returns over the same period. It is not clear though what ISS believes is the right balance for companies or how they would arrive at that figure/range.

Similarly, the pay regression analysis relies on the single pay figures published annually by companies. Figures are taken for each year over a five-year period and compared to TSR regression over the same period. This means pay (particularly for years one and two) is likely to appear ‘out of sync’ because it captures realised long-term incentives for performance delivered in a prior period.

Despite this, the UK has some of the highest governance standards in the world. Investors develop their own governance policies on remuneration and we hope they continue to be guided by these policies rather than rely solely on proxy advisory services (and certainly not by incendiary and possibly inaccurate media coverage). The idea that one body might be able to dictate remuneration policy, would make others, including the companies themselves, powerless to change.

We believe that executive remuneration should be diverse and tailored to each company—something that can only be achieved if companies are willing to be different and if a range of opinions can be heard. Last AGM season, ISS had an average influence equivalent to a 24% shareholder, which is not overwhelming but is sufficiently significant that companies need to take heed of the new policy and think about the implications for their own policies and business. That does not mean, however, that conforming is the right answer. We advise our clients to be informed and weigh critical inputs, but do not let these dictate your remuneration strategy.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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