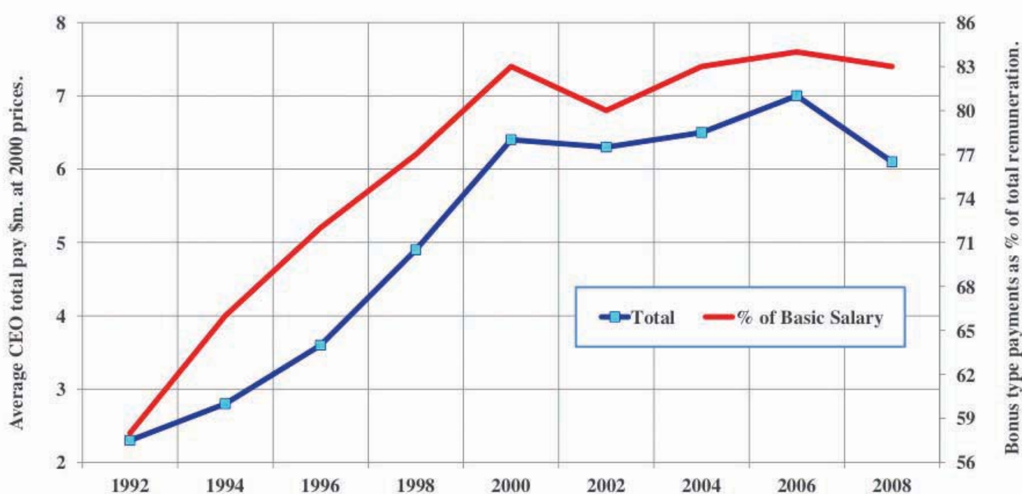
Remuneration – It's Broke, So Fix It

Economist and asset allocation advisor Andrew Smithers shows how current remuneration practices are damaging the economy.

Adam Smith taught us that some qualities of individuals that are not necessarily admirable, such as greed, can nonetheless have beneficial outcomes for the economy as a whole. But he also emphasised that this was not always or necessarily the case. Those of us who admire liberal democracy and believe that capitalism is both essential for it to flourish and productive of huge benefits for the economy, should therefore be concerned when, as today, the benefits that we receive from capitalism are being greatly diminished by distortions in its operation. We need to mend the problem as quickly as we can, lest those who are temperamentally ill-disposed will blame capitalism itself for the current grit we have allowed into its workings and will seek to damage the golden egg-laying goose. The well-disposed should therefore aim to reform rather than deny the ills from which capitalism is currently suffering.

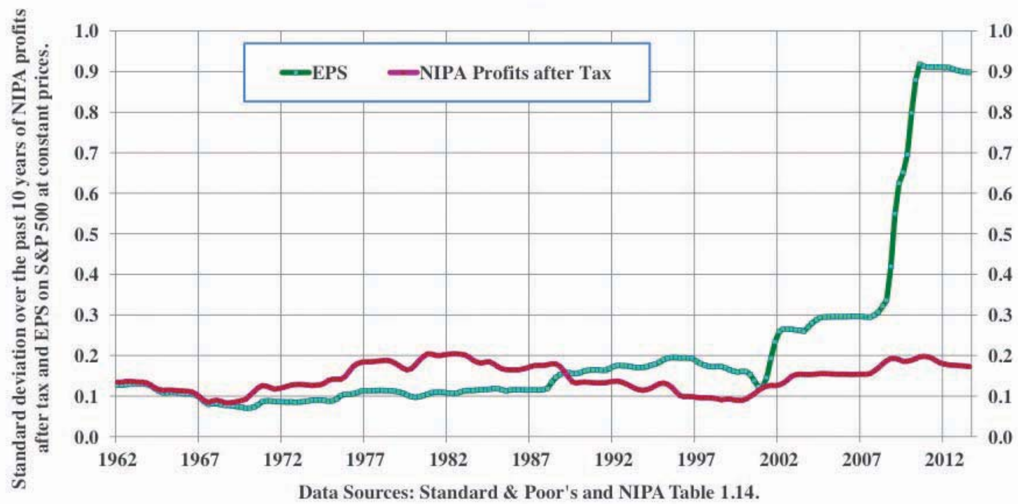
In the UK and the US there has been a revolution in the way management is remunerated, both in terms of the total amount and through the massive increase in the proportion of that total which comes from bonuses and options. Managements therefore behave differently than before. This should cause no surprise. The purpose of incentives is to influence behaviour.



The change has been fairly recent. As I illustrate in Chart 1, US data show that between 1992 and 2008 chief executives' average bonuses and similar extras rose from $1.3 million to $5.0 million, measured at constant prices, and increased from 57 per cent of basic salary to 83 per cent - see *CEO Compensation* by Carola Frydman and Dirk Jenter, NBER Working Paper 16585 (December 2010).

Unfortunately there are two problems with the new incentives. First, they are ill-designed to meet their apparent objectives. Second, economists have failed to notice the impact that the changes in incentives and the consequent changes in management have had on the economy.

The new way managements are paid was designed "to align the interests of managements and shareholders" and this was meant to happen by issuing options and paying profit-related bonuses. The effect was completely different, because the value of the options and the bonuses depends not on the growth of profits but on their volatility.



When new CEOs are appointed, they seek to depress profits on their arrival, so that they will receive large bonuses from their subsequent recovery. In downturns managements that survive will do the same, arguing that profit targets which are out of reach provide no incentive. This is usually accepted, so their targets are "rebased". The incentive to publish volatile profits therefore increases massively with the change in management remuneration and this is exactly what has happened. From 1952 to around 2002 the volatility of the profits shown in the US national accounts was almost identical to that of the EPS on the S&P 500 index. Chart 2 shows that the latter are now five times more volatile. This desire for volatility works therefore in practical terms for executives. The widely used Black-Scholes model also shows that the value of an option depends on the volatility of the share rather than its long-term return.

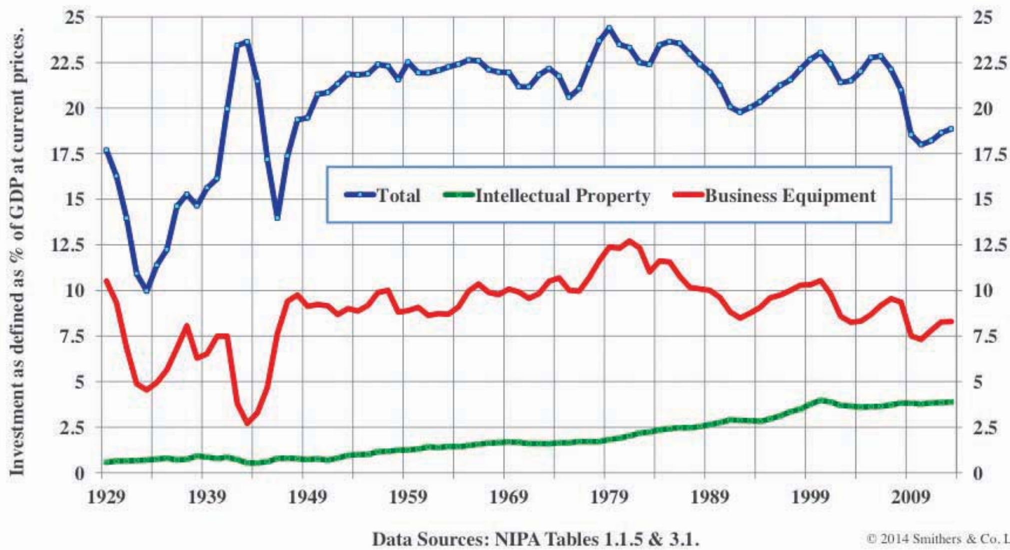
The problems for shareholders depend on their time horizon. Short-term investors have benefited as corporate buying, which is designed to boost management pay, has also boosted share prices in the short-term. Long-term investors should be getting worried. Recent research shows that unquoted companies, which include the subsidiaries of foreign companies, invest twice as much as quoted ones. If this continues, then the latter are likely to do relatively badly over time – see *Corporate Investment and Stock Market Listing: A Puzzle?* by John Asker, Joan Farre-Mensa and Alexander Ljungqvist (April 2013) ECGI, Finance Working Paper. This should be of particular concern to index-trackers, who will lose out to those who invest, by some route or other, in unquoted companies.

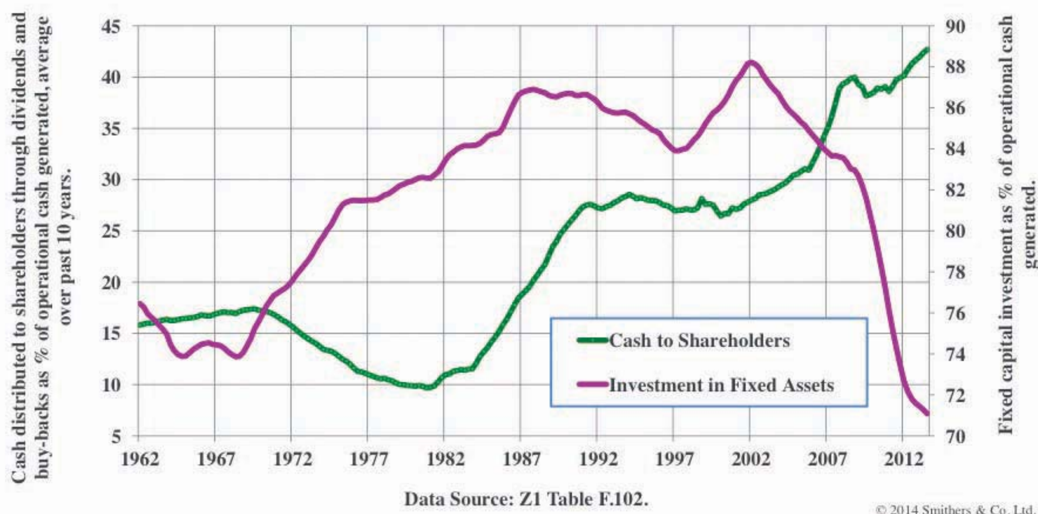
Shareholders who want to judge the success of the companies in which they invest also face growing problems. The reason that profits, as published, have become much more volatile than those in the national accounts is the increased use of "write-offs", which reduce companies' equity and increase future profits. A write-off is not just an admission that profits have been overstated in the past; it's a promise to try and overstate them in the future. Write-offs increase RoEs both because equity is reduced and future profits are increased.

Companies with high RoE are praised by analysts and this is reflected in the reputation of their management and directly or indirectly in their pay. This encourages bad practice and poor outcomes. RoE in Anglophone economies has begun to resemble tractors in communist Russia. Just as targets for production encouraged the output of vast numbers of tractors which broke down, so targets for RoE serve to improve the published figures at the expense of a decline in the information they convey.

The new way of paying management is not only bad for long-term shareholders and for the validity of published data, it is also bad for the economy. The change in management remuneration has thus resulted in lower levels of investment, wider profit margins and more volatile profits than would have been found under previous arrangements. As the incentives are greatest in publicly quoted companies, we should expect this change to be found most strongly in them and this is exactly what we do find. (I have already quoted research that shows that quoted companies invest only half as much as unquoted ones, despite being of equal importance in the economy.)

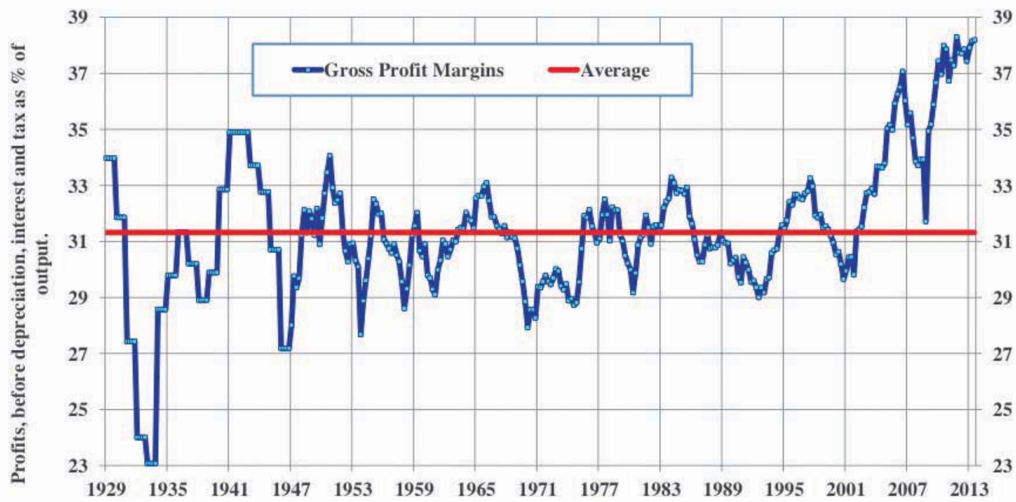
Chart 3 shows that investment in the US has fallen to its lowest level since 1947. It is not currently sufficient to replace the capital stock, so that capital consumption currently exceeds investment. There are several bad explanations or excuses for this lack of investment. It is, for example, often claimed that companies are seeking to deleverage. This is obviously nonsense. US companies are buying back equity at over 2 per cent of GDP each year and this of course pushes their leverage up.





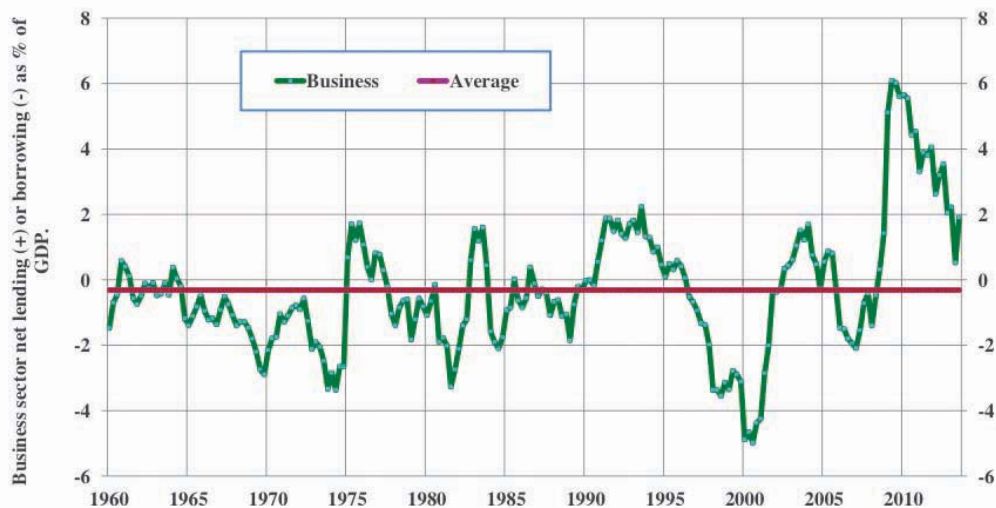
As Chart 4 shows, US companies over the past decade have decided to spend a record low proportion of the cash they generate in capital investment and to return to shareholders a record high proportion by way of dividends and buy-backs.

It is common practice today for companies to monitor their competitors in an attempt to outperform them or at least keep pace. This generally involves maintaining a close eye on relative sales, as one of the key risks that face companies is losing market share. Companies which have uncompetitive prices or relatively high production costs are most at risk. On the other hand, underpricing and investment to reduce future costs depress current profits, earnings per share and returns on equity. Managements therefore live in an uncertain world in which they have to make judgements about the unknown and unknowable future. These involve balancing the longer term risks of losing out through high prices and low investment against the short-term costs of low prices and high investment.



The change in remuneration has altered these risks from the viewpoint of management. The rewards of taking greater long-term risks with their company's future by pushing up prices and investing less have been massively increased by modern pay structures. The result is exactly as one would expect. Managements favour the short-term and take greater long-term risks. So business investment is low and profit margins, as Chart 5 illustrates, are exceptionally high.

By pushing up profit margins and investing little, companies have become net lenders to the rest of the economy, as I show in Chart 6, rather than the net borrowers which has been their normal behaviour in the past and which we should expect as businesses rely on both equity and debt to finance themselves.



In the economy as a whole savings have to equal investment so, if a sector of the economy which is usually a net investor becomes an habitual saver, then the government will probably have to run a fiscal deficit in order to prevent a slump. (This may not be necessary if the problem can, for instance, be exported by the country running a permanent current account surplus.)

This has not been possible for the US; the change in the business behaviour has meant that the government has had to run a large and continuous fiscal deficit. Standard Keynesian economics holds that fiscal deficits are purely temporary affairs because entrepreneurs recover their animal spirits and, with the resulting recovery in investment, businesses return to their usual position as net borrowers. This has not yet occurred. It appears that the change in management behaviour has meant that the need for a fiscal deficit in the US has moved from being a cyclical to a structural problem, which it will be difficult to rectify without reform to the current system of management incentives.

We need to change the way senior managements are paid. The present system has had benefits for short-term shareholders by pushing up share prices, but it is against their long-term interests; returns to investors will be poor both because high share prices produce low longer term returns and because quoted companies are being penalised by underinvestment when compared with unquoted ones. The present system is also damaging the economy, both because low investment produces low growth and because it causes the fiscal deficits to be structural rather than merely cyclical, so that bringing down these deficits to sustainable levels risks returning the economy to recession.

There are many ways in which the current perverse management incentives could be reformed so that investment is encouraged and the fiscal deficits brought under control. But such reforms will not be introduced unless the need for them is widely discussed. I am therefore grateful for this opportunity to draw readers' attention to the problem.

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Andrew Smithers founded Smithers & Co in 1989. Before that he ran S G Warburg's asset management business for many years (now part of Merrill Lynch Investment Managers/BlackRock). A regular financial commentator and columnist, and author of several academic publications, his most recent book was published in September 2013 and is entitled The Road to Recovery: How and Why Economic Policy Must Change, click on the following link: *http://www.amazon.co.uk/The-Road-Recovery-Economic-Policy/dp/1118515668/ref=sr_1_1?ie=UTF8&qid=1391525285&sr=8-1&keywords=the+road+to+recovery+how+and+why+economic+policy+must+change*

ECB AWARDS LAUNCHED

ClearView Financial Media, publishers of *Executive Compensation Briefing*, take great pleasure in announcing the launch of its first annual awards programme, culminating in a prestigious event in London in September 2014.

The awards will recognise excellence and achievement in every aspect of executive remuneration in the UK, with an emphasis on corporate governance, compliance, effective communication and stakeholder engagement.

It is particularly apt that this important event will take place as quoted companies start reporting under the new legal framework, in force from 1 October 2013. The remuneration landscape is changing fast and it is right that this should be recognised. And attention from investors, advisors, regulators, the government and, not least, the media, is at all-time high levels.

Companies from the FTSE 100 to AIM, consultancies and law firms from multinationals to individuals, investors and their advisors; all will have their part to play. Independence, integrity and relevance will be the watchwords of the assessment process, undertaken by panels of distinguished judges drawn both from the corporate world and its advisors.

For more information please click here.