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Share and share unalike

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Company bosses and, increasingly, employees love share options. But their economic drawbacks may outweigh their advantages

ONCE upon an Arabian night, sultans were paid their weight in gold. Today, such an approach to pay would leave the typical boss of a large American company sorely disappointed. Bosses now prefer to be paid in share options, which are far more valuable than mere metal. Tipping the scales—let's be kind, and ignore those boardroom lunches—at around 200 pounds, and with gold now at about $258 a troy ounce, the average chief executive of one of America's top 200 firms would take home just over $750,000 in gold. In fact, in 1998 he made a pre-tax profit of $8.3m by exercising executive share options, which give the right to buy a fixed number of his company's shares at a fixed price in what is now a rising market. At the end of last year, he also had total unrealised profits on stock options of nearly $50m.

Inevitably, such gigantic sums have provoked envy. AFL-CIO, the main American trades-union federation, points out that, thanks largely to share options, the average American chief executive now takes home 419 times the wage of the average factory worker. In 1980, he made 42 times as much.

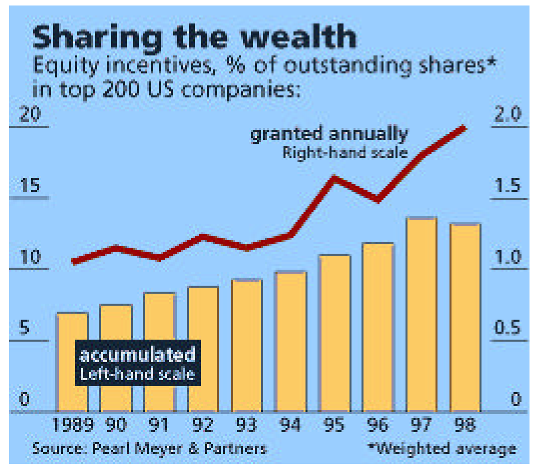
But put to one side questions of justice and inequality. Force down the thought that the chief executive's enormous share options may demoralise the deputy chief executive and make the company harder to manage. Ignore the bleating bondholder, who sees his risk rise as companies borrow to buy back shares to give to executives. The fundamental question is whether share-option schemes are doing what they were designed to do: aligning the interests of managers with those of owners, motivating bosses to do their level best by shareholders.

Are share options working? Are other shareholders seeing gains from handing over so much equity to their managers? Or are bosses receiving the largest peacetime transfer of wealth in history simply for being in the right job at the right time—namely, during America's strongest equity bull market ever? Indeed, could share options be encouraging bosses to behave in ways that are contributing to a bubble in share prices which, should it pop, will leave everyone worse off?

Options, options everywhere

Share-option awards to company bosses have grown at a breathtaking pace in America. (They have increased in other countries too, but even in Britain and France they are tiny next to America's.)

The 200 largest American companies granted shares and share options to employees amounting to 2% of their outstanding equity during the year to June 1998, according to Pearl Meyer & Partners, an executive-compensation consultancy. When these awards are added to those made in previous years, the total of shares and share options still "live" in incentive schemes at the end of 1998 amounted to 13.2% of corporate equity, or around $1.1 trillion (see chart). As recently as 1989, annual awards totalled about 1% of company shares, and all accumulated awards were 6.9%. Now, almost every big firm uses equity as a management incentive, up from around half ten years ago.



For some companies, the picture is even more dramatic. Last year, Apple Computer granted shares and options equal to nearly 18% of its total shares, Pacificare Health Systems made grants of 13% and Lehman Brothers awarded almost 12%. Lehman's total outstanding equity allocations to executives and other employees amount to over half its shares. Only Merrill Lynch, another Wall Street giant, has committed a higher proportion of its shares to equity incentives: nearly 53%. Fifteen of America's largest 200 companies have set aside more than a quarter of the shares they usually have outstanding.

While share options for lower-ranking employees have also grown quickly, most of the value goes to a handful of top managers. Chief executives have extended their lead, thanks to the birth of the "mega-option". These are options which, if used, would be worth at least $10m. In 1998, 92 of America's 200 leading chief executives (up from 34 in 1996) were given mega-options, with an average minimum value if exercised of $31m.

Using the formula to value options that was developed by Fischer Black and Myron Scholes, share-option grants accounted for a record 53.3% of the compensation given by America's top 100 companies in 1998 to their chief executives. This compares with 26% in 1994, and a mere 2% in the mid-1980s.

Cashing in

Company	Chief Executive	Gain on exercising options ($m), 1998*
Travelers	Sandy Weill	220.2
Intel	Andy Grove	49.0
Monsanto	Robert Shapiro	46.7
Morgan Stanley	Philip Purcell	36.4
Heinz	Tony O'Reilly	34.8
General Electric	Jack Welch	31.8
American Express	Harvey Golub	27.1
Bristol-Myers Squibb	Charles Heimbold	25.3
AlliedSignal	Larry Bossidy	23.1
Wells Fargo	Paul Hazen	20.2

Source: Pearl Meyer & Partners *Fiscal year ending March

To some, these statistics are grounds for celebration. Starting in the 1960s, there was growing concern that the split between those who owned big firms and those who ran them might be hurting the economy. Shareholders in public companies mostly had small stakes in each, and thus little ability to restrain managers from furthering their own interests, the argument ran. A thirst for power might lead bosses to pursue takeovers that expanded their empires but reduced the value of shareholders' stakes; a hunger for status might encourage them to build grandiose headquarters or fleets of executive jets.

Some economists argued that the solution was to make owners and managers as much alike as possible by paying a large part of the managers' remuneration in shares. Unlike most of economists' bright ideas, this one spread, though only gradually during the 1980s before taking off in the 1990s. Those urging better corporate governance supported it, and the bull market in shares convinced bosses of the potential benefits of this incentive to better performance.

At first glance, it has paid off handsomely. As executive share options and other share schemes have soared in America during the 1990s, so too have corporate profits and share prices. In 1998, the profits of companies in the S&P 500 share index were double what they had been in 1990. The index is now nearly four times higher than it was at the start of the decade. Surely, such spectacular gains justify paying bosses a fortune?

Alas, the relationship among these three trends is not the simple cause-and-effect that some economists and executive-pay consultants suggest. And the trends themselves are not all they are cracked up to be.

Only perform

First, it is hard to tell whether profits have, in fact, risen all that much, for the cost of most executive share-option schemes is not fully reflected in company profit-and-loss accounts. Attempts by the Financial Accounting Standards Board (FASB) to require firms to set the cost of options against profits were killed by corporate lobbyists in 1995. They argued that if the cost of option schemes were treated in that way, fewer of them would be awarded, fewer people would have reason to maximise shareholder value and the economy would suffer.

FASB did, however, manage to make firms include a footnote in their accounts detailing the share options awarded during the year. Smithers & Co., a research firm in London, calculated the cost of these footnoted options and concluded that the American companies granting them overstated their profits by as much as half in the financial year ending in 1998. In some cases, particularly that of high-tech firms (which tend to be generous with options), the disparity is even greater. For instance, Microsoft, the world's most valuable company, declared a profit of $4.5 billion in 1998; when the cost of options awarded that year, plus the change in the value of outstanding options, is deducted, the firm made a loss of $18 billion, according to Smithers.

Some maintain that these numbers exaggerate the problem: there is genuine dispute over how best to calculate and account for the cost of executive options. But this is quibbling. Warren Buffett, a well-known American investor, put the case succinctly for tightening the rules on share-option schemes in the recent annual report of his investment company, Berkshire Hathaway. "Accounting principles offer management a choice: pay employees in one form and count the cost, or pay them in another form and ignore the cost. Small wonder then that the use of options has mushroomed," he observes. "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

Bubble trouble

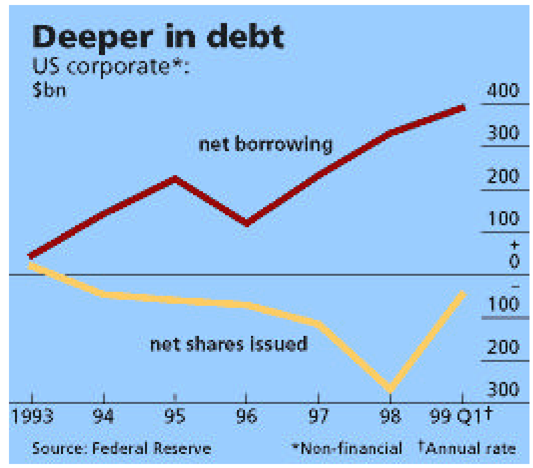
So much for profits. What of share prices? The price of an equity, in theory, reflects the profits that are expected in future. If reported profits have been overstated, investors may have overestimated future profits when valuing shares, and paid too much for them.

Most economists reckon that investors are not impressed by accounting twists and turns. Numerous studies have shown that the market usually responds only to "real" events. For instance, share prices were not affected when FASB recently required firms to account for health-care benefits for workers after retirement, a change that looked huge but made no difference to their real liabilities. Options are a real economic cost, and investors take that cost into account each time options are granted.

Now, they have no excuse not to do so; but was this always the case? In the mid-1990s, when the use of share options soared, the accounting problem received little attention. In 1996, for example, headlines in the financial press were full of rising corporate profits in America; yet, says Andrew Smithers of the eponymous research firm, if the cost of share-option schemes had been properly accounted for, it would have been clear that corporate profits had fallen from the previous year. This, he suggests, was the point at which a stockmarket bubble began to expand that has yet to pop.

There are other ways, too, in which share-option schemes may have helped to nudge share prices upwards. Companies are buying back their shares in the market in order for employees to exercise their options. In 1998, firms announced repurchases of $220 billion-worth of shares, compared with only $20 billion-worth in 1991. At the same time, they are borrowing more (see chart). Indeed, although net new issues have picked up a bit of late, many companies are still borrowing to buy back their own shares.

This seems strange at a time when shares are more expensive than ever before, and interest rates, though low in nominal terms, are high in real terms. Surely, it would make more sense to raise money by selling shares at current high prices—which is what bright investment bankers at Goldman Sachs have done in floating their firm and some other companies appear to be doing as well.



A recent study of share repurchases by George Fenn and Nellie Liang, of the Federal Reserve, found that much of the recent surge in buy-backs reflects an attempt to return cash to shareholders in a way that raises the value of executive stock options more directly than a simple increase in the dividend would do. Others see the buy-backs in a more sinister light. They say that companies often buy their own shares aggressively at times when the market looks about to tumble, thus helping to reverse its direction.

Perhaps this is all as it should be: managers spotting the chance to bolster their firm's share price and return cash to shareholders. On the other hand, managers with share options may be using their firm's resources to increase the short-term value of their own holdings. And that sounds suspiciously like the sort of abuse that many reckon went on before share options supposedly aligned bosses' interests with those of owners.

Though corporate profits may be duller than billed, and share prices a touch hyped, what of the claim that managers, thanks to the incentive of shares and share options, are working harder for shareholders?

All shall have prizes

It is hard to argue convincingly that most firms' improving fortunes in recent years are down to the efforts of managers as individuals or as a group. The American economy recovered from recession, interest rates were low, inflationary pressures were dormant, spending was strong because consumer confidence was high (due partly, it must be admitted, to high share prices). All these things were beyond the control of corporate bosses.

Nor does the link between executive performance and pay look rock-solid. Many top managers have got rich simply because their company's share prices rose in line with the market. A recent study by Kevin Murphy, one of the first economists to argue for paying bosses with shares, concludes that "there is surprisingly little direct evidence that higher pay-performance sensitivities lead to higher stock performance."

It is possible, of course, that share options encouraged most companies to become more profitable, and so some of the rise in the market as a whole reflected the additional efforts of the market as a whole. But American firms have mostly run a mile from share options designed to reward market-beating or above-average performance. One powerful reason for this is accounting rules. The cost of granting an option with a performance benchmark (one that specifies, for example, that a company's share price must outperform the average in that industry before its bosses collect) must be set against profits, unlike the cost of pure options.

One of the few firms to use rigorous performance-related options is Level 3 Communications. Its bosses cannot cash in their options unless its share price rises by more than the S&P 500; they then receive a rapidly sweetening deal as the gap widens.

Graef Crystal, an economist who specialises in executive pay, has calculated the impact a similar scheme would have had on all the S&P 500 companies between 1995 and 1998. Under a conventional option plan, 86% of chief executives would have received an average of $8m apiece over the period. With a scheme similar to that at Level 3, only 32% of them would have received a dime.

An indication of how little executives like having to perform for their money is the frequency with which share options are repriced when the firm's share price tumbles below the strike price originally agreed. When share prices plunged in the late summer of 1998, many firms repriced their options just in time to enjoy massive gains when the market rebounded. James Record, an analyst with SNL Securities, a research firm, found that 17 financial-services firms lowered their strike prices last autumn, by one-third on average; since then, their share prices have, on average, trebled.

Many Internet companies, their shares now fallen by half from their recent highs, are considering repricing their share options. They may be less lucky than their predecessors: FASB has changed the rules and, from later this year, the cost of repriced options must be written off against profits in the company accounts. Even properly accounted for, however, the fact that firms reprice managers' options reduces to nonsense the comparison of bosses with owners, who cannot write off downside risk so blithely.

The aim of share options is to increase the executive's exposure to the undiversified risk of his firm's shares, so that he faces personal financial hardship if its share price falls. Do these schemes really bind managers to their firms' fortunes?

Managers cannot sell their shares too quickly, for fear of panicking the market. But the number of executives selling is higher than before, according to Craig Columbus of Primark, a firm that tracks such share-trading. It is becoming the norm for bosses to sell a parcel of shares every quarter. And some figures suggest that top executives may be getting quietly out of the market while ordinary employees are keener than ever on entering it: though grants of shares and share options rose to a record level in 1998, the overall stock of shares in company incentive schemes did not, for the first year in over a decade. Since share options for lower-level employees have grown rapidly, it seems that their bosses may be reducing their stakes.

There are other ways, too, for managers to weaken the link between personal and corporate financial health. They may diversify their risk by holding a portfolio of different assets—if they have enough cash. Derivatives offer another route. In the early 1970s, when executive share options promised so much, financial derivatives were in their infancy. Now, according to a study from Arizona State University, executives are making increasing use of them to escape restrictions on exercising or selling their share options, especially when they know that bad news about their firm is pending. The rules governing the disclosure of such trades are ambiguous. Certainly, they are a fast-growing business for Wall Street investment banks.

Other options

It is possible that the problem of share options will sort itself out. If there is a share-price bubble, it will one day burst. If there is not, share prices are unlikely to keep rising so quickly in any event. Bosses' pay should fall to less audacious levels either way.

Even so, there needs to be much harder thinking about what to reward, and how much. Nell Minnow of LENS, an investment fund, now wishes that in the early 1990s, "when we asked for pay for performance, we'd been a lot more specific". A few more customised options with specific targets have recently appeared, though most of them, admittedly, accompany bigger-than-ever mega-options.

That leaves the question of how large the share component of a salary package needs to be in order to motivate its recipient. Would current pay-outs be less inspirational if they were half as big? Experience has shown that it is impossible fully to align the interests of managers with those of shareholders anyway. So why go so far down that road?

Ultimately, reforming executive pay in ways that encourage genuinely superior performance depends on two groups: institutional investors and auditing bodies. Big pension funds and insurers have the clout to make compensation committees be tough. So far they have barely used it. And accountants must create a level playing-field for all executive compensation. It is absurd that different kinds of share-option schemes have different accounting rules, and worse than absurd that most schemes are not written off against profits like ordinary pay. Investors and auditors may both be more willing to lay down the law in an earthbound stockmarket than in a perpetually rising one. It would certainly be the right option.