

viewpoint

EXECUTIVE STOCK OWNERSHIP

Stock options have been a part of executive compensation packages for decades. Wall Street gyrations have made options less attractive recently, but actual ownership in company stock is becoming increasingly important.

The reason: Companies whose executives hold significant equity perform better than those with executives who don't, according to research by Watson Wyatt Worldwide. Dominic Andwan, a Watson Wyatt executive compensation consultant, discusses the trend.

Why is stock ownership important?

Nobody washes a rented car. But when you own it, you maintain it. Real share ownership allows for real downside risk. It places executives and other employees on equal footing with the company's shareholders.

There are many variables that impact company performance, of course, so we don't mean to imply definitive causality. But when you hold everything else constant, executive and employee stock ownership does matter.

How does executive stock ownership relate to company performance?

Watson Wyatt Worldwide tracks the connection annually through our executive pay research studies. We consistently find that return on equity, return on assets and growth in earnings per share are higher when the CEO has higher stock ownership than when the CEO owns little or no stock in the company.

The most startling difference is in total shareholder return. Last year it averaged 0% for companies whose CEO owns little or none of their stock and 20.7% for companies whose top executive holds significant equity.

Aren't stock options a good way to build executive stock ownership?

They provide some alignment, but not as much as actual stock ownership. Recently, factors such as the recession have depressed stock prices sufficiently to drive current stock prices below the original option grant level. We estimate that 66% of the CEOs in the auto industry have "underwater" stock options for at least one of the past three years in which the options were given.

Why not simply require executives to own the company's stock?

Nearly half the companies in the *Fortune* 500 have execu-

tive stock ownership guidelines in place covering executives at different levels in the organization.

Another way to encourage executives to accumulate shares is to require that a minimum percentage (such as 50%) of their stock option gains be converted into actual stock ownership. We expect to see more use of ownership guidelines, given new governance requirements and scrutiny of executive pay.

What levels of ownership are considered appropriate?

It's typical for a CEO to be asked to own five times their salary level in stock. For direct reports to the CEO, the multiple might be between three times and five times salary. For other upper executives, typical amounts are two or three times the annual salary level.

Some companies actually require these levels of stock ownership. Others treat them as recommendations but will exclude executives from future stock option grants if they don't meet the guidelines.

How can other employees be encouraged to own stock in their company?

For relatively senior managers, a management stock purchase plan (MSPP) is common. It is a pretax nonqualified purchase arrangement involving deferred salary or bonus payments at a discount or company match.

For other employees, a Section 423 Employee Stock Purchase Plan, or ESPP, can allow employees to buy stock at a discount of as much as 15% during a specified purchase period.

Should companies revisit their approach to stock options?

We think so. Historically there were favorable accounting reasons to grant stock options vs. other programs that might provide better alignment with company performance. But possible accounting changes would level the playing field, and there will be more emphasis on plans that better balance the company's needs while providing for executive incentives.

The key is to offer incentives that make the most sense for your company—and those aren't necessarily the same as what the rest of the market may be doing. Sometimes you need to zig when the others are zagging.

For more information about Watson Wyatt Worldwide's executive compensation research and services, please contact Vicki Kozlowski at (248) 358-7918.