

viewpoint

REVISITING STOCK OPTIONS

As the competition for executive talent in the automotive industry intensifies, companies must find more effective ways to reward and retain key talent. One traditional compensation incentive is the use of stock options. While a number of recent developments are working to make stock options less attractive, actual ownership in company stock is always 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 issues.

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 nearly every financial performance measure (e.g., return on equity) is higher when the CEO has higher stock ownership.

Take total shareholder returns (TSR) as an example. In past years, TSR averaged 0% for companies whose CEO owns little or none of their stock, compared to 20.7% for companies whose top executive holds significant equity.

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

Stock options provide some alignment, but not as much as actual stock ownership. A number of factors can drive current stock prices below the original option grant level, resulting in "underwater" stock options. Stock options are a possible tool in a long-term incentive portfolio, but the days where they are the only tool are clearly behind us.

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

The majority of Fortune 500 companies, including many

leading automotive companies, have executive 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 changes in governance requirements and market scrutiny of executive pay.

What levels of ownership are considered appropriate?

It's typical for a company to ask a CEO to own five times their salary level in stock. For direct reports to the CEO, the multiple might be between two and four times their salary. For other upper executives, typical amounts are one or three times the annual salary level. Some companies actually require these levels of stock ownership, while others consider 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. An MSPP is a pretax nonqualified purchase arrangement involving deferred salary or bonus payments with a company match.

For other employees, broad-based employee stock purchase plans can be put in place to allow employees to buy stock—sometimes at a discount to market value.

Should companies revisit their approach to stock options?

We think so, and for good reason. Historically, there were favorable accounting reasons to grant stock options versus other programs that might provide better alignment with company performance. However, recently proposed accounting changes will level the playing field, resulting in more emphasis on plans that better balance the company's needs while providing for executive incentives.

The key is to accurately identify and offer incentives that make the most sense for your company—and those aren't necessarily the same as what the rest of the industry may be doing.

For more information about Watson Wyatt Worldwide's executive compensation research and services, please contact Dominic Andwan at (248) 358-7703.