LF: Laura Finn
JL: John Lukomnik

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LF: Hi and welcome to this edition of This Week in the Boardroom. I'm Laura Finn, Editorial Director for Digital Media with NYSE Governance Services and I'm pleased to welcome back to the studio John Lukomnik. John is the Executive Director with the Investor Responsibility Research Center Institute. John, thanks for coming back.

JL: My pleasure. I had such a good time last week.

LF: Last week, like you just mentioned, we talked about your newly completed research and I would encourage all of our viewers who didn't see it to go back, watch last week's episode, and then tune back in for this one because we are just going to jump right back into the research.

JL: Fair enough.

LF: Now we were talking about long-term value and alignment at the end of our last episode so what I'd like to ask you about that now is you've said that only a few CEOs are measured and compensated for long-term value creation for things like innovation, research and development, new products, etc. How do companies begin to fix that and are companies even willing to agree with you that they aren't paying for the right things?

JL: I think companies want to be able to long-term strategic planning. I mean you read all the issues about short-termism and long-termism. We referenced a study in our report done by McKenzie and the Canadian pension plan investment board of executives and board members in North America. It's very interesting, they feel the short-termism pressure and they know they shouldn't be yielding to it, but they are and so you get this paradox. The respondents to McKenzie's study say that moving to a planning horizon of four years or more would increase their financial returns eventually. But the reality was that 44% of the companies, almost half, have a planning horizon of two years or less, and 41% have another three or four years. So only 15% actually have a planning horizon of four years or more, which is what they say will be optimal. So you've got them knowing what's optimal but doing something different.

LF: Well I think too with long-term versus short-term it's a matter of semantics because people define those terms very differently as well.

JL: So let's say four years or more, or four years or less, based on what McKenzie's study found executives and boards themselves would want to do. So we avoid all the semantic issues. So what to do? Well the first thing, as we said last week, you're not measuring the right things, not measuring innovation, not measuring the capital efficiency. So measure the right things and measure them over the right periods. Now what the right things are will vary to some extent by company because you want to incent senior management to do the things that align with your strategic plan. So start with the business strategy. You don't start with executive compensation. You start with business strategy and you align the executive compensation to that. Focus on the drivers of sustainable growth, earning a return more than your cost of capital, innovating so as to drive future value, and over a performance timeframe that's more than the standard three years. By the way, 25% of the S&P companies don't even have three years performance metrics. They use rolling time vested options and that's not a performance driven three-year metrics. Now I'm not naïve. Such a course strays from the short-term templates that are crafted by some investors, some proxy advisors and some compensation consultants. But I will tell you every compensation consultant investor and investor that I've spoken to since the report came out said we're on the right track. The Counsel of Institutional Investors, which is a very influential group of investors, has said you want to align with your strategic timeframe. So I think what's needed is you can't just do it. I wish you could, but we live in the real world. You're going to have to spend some time and effort explaining what you're doing, how you're changing your timeframe, how you're changing your metrics to explain it to your investor corps. Now the advantage most large companies have is they know their top 20 or 50 investors very well. They don't change very much despite all the stats on total turnover. Their top investors tend to be the same quarter to quarter and they can begin to explain how their shifting this. The big funds are much more likely to _________. By the way, I think doing that strategy, aligning your compensation with your strategy, and then explaining it to your investors has two other benefits. It helps you select your shareholder base and it happens to be exactly what activists do. They look at your economic profitability by your operating unit. If you've done that yourself you're in a much better position in the future should an activist come calling.

LF: Now when we're talking about a longer-term view, the research report says one of the finding is that long-term performance is really medium term at best. Do you think compensation committees and their consultants are interested in giving a more long-term approach to exec. comp. packages?

JL: I think they are, but as I said I think they're a little concerned. The McKenzie study would suggest they are, the people that I have spoken to suggest they are. And there are reasons because payback from major innovations can take four or five or even ten years. I mean think about pharma, or biotech, or energy, or mining, or automotive, or heavy capital intense industries, there's a time period for that payback. As I mentioned last week, it took Apple eight years to bring the iPad to market. Now having said that, there is a huge install base of compensation consultants and investors – I'm not going to claim that my former brethren are innocent in this – and proxy advisors who like to use total shareholder return as...

LF: I wanted to ask you about that. Total shareholder return is called out in your research, but it sounds like an efficient way to create an exec. comp. package because you are paying an executive based on what the shareholders in theory should be getting.

JL: Alright let's talk about it. Total shareholder return is a post-hoc measure of the co-movement – that sounds fancy but it's really not – of stock price plus dividends compared with executive comp. So when you think about it that way there are a couple of obvious things. If incentive compensation is supposed to incent, it's hard to have a post-hoc measure. Secondly, if your stock price, let's forget about dividends for a second, stock price goes down 9% and your comp goes doesn't 9%, that's a perfect alignment. No one is going to be very happy. Your shareholders aren't going to be very happy, your senior management is not going to be happy, the board's not going to be happy. Finally, and perhaps most important, you can't measure to total shareholder return. If Russia invades the Ukraine, if the Fed changes monetary policy, all these exogenous factors will affect your stock price. And when you do try to manage your stock price, you can get in trouble through extraordinary buy-backs that are; sometimes buy-backs are very good, sometimes they're not, I'm not going to get into that discussion here. But you can do non-economic buy-backs just to try and drive stock price to hit a target date on your TSR. So TSR is a horrible metric.

LF: Which more than half of the companies you studied are using.

JL: It's uniquely ill suited, there's a huge install base, and what people say about it is well it's objective and it's measurable. That's true. It is objective and measurable. We're in football season, we're about to see the Super Bowl so let me give you the analogy. The classic stat in football is the 40-yard dash. If you lined up your CEO and timed a 40-yard dash, that's objective and measurable and has about as much to do with economic value creation as TSR does.

LF: Well John we are already running out of time, but after all of this talk about the pitfalls of TSR, where there any bright spots in the research?

JL: Oh yeah. Look, I am an American capitalist. I mean the fact of the matter is that 53% of the companies do create economic value. The other really interesting thing is there wasn't a sectoral bias in our findings, which means that good executive teams, good boards can drive value in virtually any sector over long timeframes. And as we sit here at the NYSE, that's a very good thing for America and the economy.

LF: What would you like before we close out for board members to take away from the research project?

JL: First I think they – I'll give myself a plug – they should go to IRRCI.org and read the report and make their own decision. All of our research is free so spend a couple of hours; it is a fairly dense report to be honest. We tried to make it easily readable but there's a lot of information. Make your own decision. If you decide that alignment is the way you want to go with TSR, great, go ahead and do it. You've made your own decision. If you don't, try and think about what the right metrics are over the right timeframe and then think about a strategy to mitigate with comp consultants and the proxy advisory firms and institutional investors. Let's not let the tail wag the dog.

LF: John, thank you so much for being here. I really appreciate it and we should let the viewers know that the second report on Say on Pay practices is also out on your website.

JL: It is.

LF: So make sure you check that report out as well. John, thanks a lot for your time today.

JL: My pleasure. Thanks so much Laura.

LF: And thank you for watching This Week in the Boardroom. I hope you'll join us again next week where we'll have another great web cast to help you be the best board member, CEO, or IR that you can be. Thanks for watching.

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