CFA Centre for Financial Market Integrity/
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Breaking the Short-Term Cycle

Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value

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INCENTIVES AND COMPENSATION

Much attention is currently directed at corporate executive compensation, but a more thorough approach to addressing short-termism requires appropriate incentive policies and practices for corporate executives, asset managers, analysts, and others.

Although the current median tenure for CEOs of Fortune 500 companies is approximately five years,[11] the actions and decisions of these CEOs often have much longer consequences. To be properly structured, incentives should reflect the upside potential *and* downside risk of management actions and should align management interests with those of shareowners. One way companies can encourage long-term value creation is by basing the *majority* of executive compensation on long-term performance measures, even if such terms extend beyond the tenure of the executives themselves. (The definition of "long term" varies largely by industry, and therefore, incentive measures should reflect specific industry operating characteristics. Typically, in this context, long-term is considered to range from three to five years and should not be less than two years.)

Progress in long-term "pay for performance" is being made. In 2006, 57 percent of Business Roundtable companies indicated that the use of performance criteria has increased as a component of overall executive compensation. This is a notable increase from 49 percent in 2005 and 40 percent in 2004. Moreover, among the companies placing greater emphasis on performance, 20 percent use primarily long-term goals, 73 percent use a mix of long-term and short-term goals, and only 7 percent emphasize only short-term targets.[12] The Panel's recommendations seek to advance this progress.

In January 2006, the SEC proposed new guidelines for executive compensation that would greatly enhance the disclosures U.S. listed companies must make concerning the compensation of their highest paid executives. Greater disclosure should allow asset managers and all investors to better understand whether corporate executive compensation packages provide the proper incentives to manage for the long term. The Panel encourages asset managers and institutional investors to develop rigorous processes for the thorough review of corporate executive compensation packages.

Similarly, evaluating the performance of asset managers against a quarterly benchmark is counterproductive to conditioning them as long-term investors. When asset managers are evaluated and compensated primarily on the basis of quarterly metrics, they may pressure companies into the same short-term thinking or increase volatility by regularly trading in and out of company securities in an effort to capture short-term profit. The Panel thus believes that a significant portion of incentive pay for asset managers should be measured by long-term (three to five years) metrics similar to those used at the companies in which they invest. To confirm this longer-term focus, asset management firms should provide investors with more information about their incentive structures.

INCENTIVES AND COMPENSATION RECOMMENDATIONS

1. **Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests. Compensation should be structured to achieve long-term strategic and value-creation goals.**

Although proposed SEC requirements on executive compensation will provide shareowners with greater transparency as to the components of management compensation, it is ultimately up to the companies themselves, their boards, and their shareowners to make sure that the interests of management are aligned with those of shareowners. All three panels identified executive incentives that focus disproportionately on short-term objectives as a key driver of short-termism.

Additionally, stock ownership guidelines should require all executives and directors to hold a *meaningful* amount of equity in the company at which they serve. "Meaningful" in this context can be defined as an amount that makes it economically material to the individual that a company succeed in the long-term.

2. Align asset manager compensation with long-term performance and with long-term client interests.

Evaluating asset managers quarterly almost ensures that many will fall short of the benchmark because of unpredictable short-term events, near-term stock market swings, and transaction fees that ultimately penalize returns to investors.

As much as possible, incentive pay for asset managers should be measured by long-term metrics in order to promote a long-term investment horizon. The Panel recommends that asset managers investigate ways to link asset manager pay to performance—in much the same way the Panel encourages corporations to rethink corporate executive pay to better reflect long-term performance. An example would be tying manager incentives to multi-year performance. By creating more transparent links between asset manager pay and long-term performance, asset management firms will help ensure fund shareowners that asset managers are paid for performance, not asset gathering.

Asset managers should also be encouraged to commit a *meaningful* portion of their own wealth to the funds they manage in order to tie their compensation directly to the wealth they create for fund shareowners.

3. Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.

Asset managers and investors have long called for more transparency from the companies they evaluate and in which they invest, especially in the areas of executive compensation. Similar incentive disclosures are severely lacking in the managed funds industry.

The Panel calls on asset management firms to more closely link incentive compensation to long-term performance. Because most investors in mutual funds have a long-term investment horizon, asset management firms should strive to provide investors with more information concerning asset manager incentive metrics and incentive structures. Greater transparency concerning the incentive structures of asset managers will go a long way toward reassuring investors that the interests of asset managers run parallel to their own.

Although hedge funds do not fall under the same regulatory rubric as mutual funds, hedge fund managers should strive to assure long-term investors (e.g., those that agree to lock up their funds for a prolonged period of time) that the fund managers are fairly compensated on the basis of long-term results through use of incentive fees and other methods of tying fees to long-term performance.

4. Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.

The new SEC guidelines for executive compensation disclosures should provide all shareowners with better tools for evaluating whether corporate executive compensation packages properly link pay to performance and provide executives with the incentives to manage for the long term. The Panel encourages asset managers and institutional investors to closely examine corporate pay packages to ensure that incentive plans are aligned with the long-term interests of shareowners.

