PZENA Investment Management

FOURTH QUARTER 2020 FINDING VALUE IN ESG

A "one-size-fits-all" approach to executive compensation may place inordinate emphasis on a narrow set of metrics, overlooking important nuances. Engagement and stakeholder alignment should shape a more holistic approach.

As long-term shareholders, we prefer management teams that think with the same timeframe in mind. One corporate governance tool that is intended to help align the interests of management and shareholders is executive compensation. For us, this alignment is largely achieved when executive compensation plans have long-termism as the built-in assumption. With that as the premise, we make three observations:

1. Performance metrics matter but no one-size-fits-all
2. Pay analysis should be holistic
3. Engagement is key

As value investors, we invest in companies experiencing a unique set of problems. While some compensation metrics are better than others, this judgment is likewise made within the context of each company. For example, earnings growth might be an important metric for one company but lead to perverse incentives for another (high leverage, value destructive acquisitions, etc.). By the same token, the tenure of vesting and holding periods should be a function of the capital/liability cycle of the business.

To determine which metrics make sense for a given company, we look for whether they incentivize management actions in ways that ultimately address the value opportunity. We are wary of metrics that create loopholes for management to receive windfalls based on market movements largely out of their control. Industry-adjusted performance metrics control for this but the peer group selection must be robust. To the extent compensation metrics are heavily adjusted, it depends whether exceptional items net out over time. Stock price is perhaps the only consistently inferior metric because it can easily incentivize a short-term rather than long-term perspective.

While metrics for the executive team matter, so does the holistic pay package. Specifically, in terms of: 1) going beyond 'traditional' shareholder metrics to account for other stakeholders where appropriate (e.g. employee satisfaction, net promoter score, etc.); 2) all its components (pensions, clawbacks, etc.); and 3) how management has chosen to compensate rank-and-file employees. On the last point, some of the most serious failures of corporate governance have had less to do with C-level pay packages and more to do with a systemic culture of mis-incentivization throughout an organization.

Along these lines, CEO pay may receive particularly inordinate attention in compensation discussions. Pay should not be determined by any one person's definition of 'fair,' but instead by whether the incentives are sound and reasonable vs. peers. While there can be egregious outliers, these are easy to spot at the tails and are not the norm. There are also downsides to capping CEO pay (talent attrition) or mandating that it fall within a particular 'CEO to average worker' pay ratio (arbitrarily dependent on median employee skill level). A pay-ratio analysis serves more to highlight outliers than it does to articulate any profound truth.

Yet all this analysis becomes meaningless if shareholders do not have an ongoing and robust dialogue with management and the board. Generally speaking, we trust the board to do what is right for the company, but we do not shy away from productive dialogue on these (and other) issues where needed. This can be more complicated with emerging markets companies, as many lack responsiveness to shareholder concerns. To some extent we account for this by demanding a higher level of return for emerging market investments (reflected in the higher discount rates applied to emerging market countries), but all this further underscores the importance of using our voice.

In conclusion, there is no one right answer for how to think about executive compensation plans. A lot of it comes down to company-specific nuance which is why our investment analysts also lead the associated engagement and proxy voting efforts. If we had to pick one thing that consistently matters, it would be that incentive plans reflect the need for a long-term focus on business excellence. It is only with long-term thinking that the interests of shareholders and other stakeholders will be fully aligned.

FURTHER INFORMATION

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