Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

Executive pay: "Show me the incentive and I will show you the outcome"

INVESTMENT INSIGHT | INTERNATIONAL EQUITY TEAM | November 2023

Modern capitalism suffers from the "principal-agent problem", given the differing interests of the owners of assets versus the corporate executives who manage them. The executive pay industry, with its complex packages of bonuses and performance shares, has evolved to try to align the interests of the two parties.

The pay industry has certainly succeeded in increasing the rewards for chief executive officers, who the Economic Policy Institute claims are now paid 344 times as much as a typical worker, in contrast to 1965 when they only earned 21 times as much.[1] We would argue that there is still progress to be made in making sure that this extra executive compensation is matched by improved alignment.

As long-term investors, we want the companies our clients own to have pay plans in place that encourage longer-term thinking over short-term opportunism. After all, we agree with Charlie Munger's claim that incentives drive outcomes. Our fear is that the wrong incentives, for instance excessive focus on earnings per share (EPS), can encourage management to take decisions that boost profits in the short run at the expense of their companies' ability to compound over the long run. This may be a consumer company cutting advertising, or a firm making large acquisitions that, while "accretive", i.e., boosting short-term EPS, deploy a large amount of capital at low returns. By contrast, when compensation is managed effectively, it aligns key decision-makers' behaviours with the company's objectives, encouraging better performance and long-term returns to shareholders.

As a result, we take the process very seriously, using our proprietary Pay X-Ray scoring framework to evaluate pay schemes, engaging with boards to improve them and voting against them where we are unhappy with the structures. Our attempts to effect change on pay schemes for the benefit of shareholders is helped by our well-resourced team and concentrated long-term holdings in the companies we cover. This allows us to invest

[1] Source: Economic Policy Institute report on CEO pay in 2022. Published 21 September 2023.

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"We favour incentive schemes that align goals with shareholder interests, structured on sensible and disciplined performance-based targets"

the effort and time required to improve pay schemes, and to get the access to boards to make our case. We have recorded successes, often after years of discussions, proving that perseverance can pay off. After all, we have been talking to companies about how they incentivise their executives for over 20 years, long before the concept of environmental, social and governance (ESG) investing came to the fore.

Asking the key questions

While there is no magic formula that can be uniformly applied to companies across all sectors and industries, we have established some principles based on our extensive experience of investment team-led engagement with companies about pay. We favour incentive schemes that align goals with shareholder interests, and which are structured on sensible and disciplined performance-based targets that cannot be easily manipulated in the short term. Looking beyond the technical details of each proxy, the fundamental questions investors should ask are:

- What kind of behaviour does the scheme incentivise: short term or long term?
- Are the incentives balanced, and do they make sense given the nature of the business—e.g., is a mature business incentivised to grow at the expense of returns? Is a growth business incentivised to underinvest, thereby missing growth opportunities?
- How could executive pay be gamed to the benefit of management? Can a seemingly good metric have negative side effects (e.g., can a cash flow key performance indicator disincentivise necessary capital expenditure)?
- Can we monitor management's actual behaviour to identify if the scheme is not working or is being abused?

Assessing pay with the Pay X-Ray

We created the Pay X-Ray some years ago as a framework for a comprehensive and rigorous analysis of company schemes. We do use proxy vote data providers as resources for our efforts, but are in no way bound by their recommendations, given our in-depth knowledge of the companies and their management. The Pay X-Ray splits the detailed scoring of the company schemes into the four buckets shown below.

1. **PERFORMANCE METRICS: WHAT IS MANAGEMENT PAID ON?**

   There are several measures we like, such as organic growth, margin and free cash flows. The ideal balance between them will depend on the strategic position of the company, for instance as it trades off growth and margin improvement. For consumer companies, we like any profit or margin metrics to be before advertising and promotion costs to remove the incentive to cut advertising to meet short-term profit targets. Generally, we are particularly keen to see return on capital included in the metrics, as it forces management to value capital and penalises low-return acquisitions.

   We are less enthusiastic about total shareholder return as a measure, especially when using a broad index as a comparator, as much is driven by sector rather than company performance. We are not fans of EPS, as that can be boosted by "accretive" acquisitions, even if they are at low returns on capital, or by levering up the company.

2. **DELIVERY MECHANISMS: HOW IS MANAGEMENT PAID?**

   Here we prefer the company to issue shares rather than options, as the asymmetry of options can favour excessive risk-taking, particularly once they are "out of the money". We also want those rewards to be performance shares, which require management to hit targets to get rewarded, rather than simple restricted shares—or "pay for stay"—where management merely has to avoid being fired to benefit.

3. **VESTING PERIOD: WHEN IS MANAGEMENT PAID?**

   This is a case of "the longer the better", in our view, as it encourages management to strive for the long-term success of the company rather than simply hitting short-term targets. Even a scheme with good pay metrics can be rendered useless by an insufficiently long vesting period. We also like issuance of the shares to be delayed until after the end of the performance period. This is most notable in the case of departing executives, as we have been burnt by management plumping up the business for the point of their exit, with the bill later due for their successors.

4. **SHENANIGANS: WHAT TRICKS ARE MANAGEMENT UP TO?**

   Along with the core metrics above, we worry about what we term "shenanigans"—the games management can play to get paid out. These include changing targets ex-post where there are "adverse circumstances" (you won't be surprised to hear that we do not find many cases where targets are toughened when the environment helps a company), targets that are too easy or where the numbers are not disclosed, ex gratia payments to management on top of the stated schemes, and massive payments for failure when management is dismissed.

Investment team-led engagement and voting are crucial tools

We look for companies to achieve a positive Pay X-Ray score, but also for signs of improvement. The results feed into our engagements with the companies. As much as 25% of our company engagements year-to-date (as of 30 September 2023) have included conversations on executive pay. As mentioned, we are privileged to gain access to management given our significant assets under management within concentrated portfolios: In our global portfolios, we hold at least 0.5% of the companies' free floats in 70%-85% of the holdings in our strategies.

In addition to talking to companies about pay, we vote on it. In the first half of 2023 we voted on 244 compensation-related proposals for 78 of the companies held across strategies we manage. We voted against 51 of these, or 21% of the time. Furthermore, 47% of the time we voted against management on at least one compensation-related proposal (37 companies).

The most common and often high-profile votes involve approving the compensation of a company's executive officers. These can be on an individual basis or for the whole executive team, depending on the company's jurisdiction. With occasionally eyebrow-raising sums involved, in our view the quantum of pay needs to be assessed both absolutely and relative to stated targets. There were 79 such proposals at companies held across our strategies in the first half of 2023, and we voted against 35 of these (44% of the time).

We don't restrict our voting to pay plans. If, having previously voted against a compensation proposal, we wish to underline our point, further escalation may include voting against the election of committee members. During the first six months of 2023, we voted against the election of the chair of the compensation committee at three different companies due to ongoing concerns with their pay plans. For one of these companies, our escalation went a step further: We also voted against the election of two directors who were members of the company's compensation committee.

Pay is a key instrument in incentivising management to operate in the long-term interests of a company and its shareholders, given the principal-agent problem. It is therefore critical for boards and management teams to get it right, and for active long-term investors to hold company boards accountable for their actions through a programme of monitoring, engagement and voting. This is why we take our fiduciary responsibilities in this area so seriously.

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DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able generate after laying out the money required to maintain or expand its asset base.

Return On Capital (ROC) is a measure of a company's efficiency at allocating the capital under its control to profitable investments, calculated by dividing operating income by total capital.

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