

# Incentive Options

*Create a balanced portfolio.*



by Donald P. Delves

**E**XECUTIVE COMPENSATION is changing.

Stock options, once the preferred incentive, have fallen out of favor, due in part to pending accounting rules that will require an expense for options. With this change, companies are shifting how they assess and reward performance.

What incentives will best motivate executives and other employees? The answer is a balanced incentive portfolio. By offering a combination of incentives, each tied to specific goals, you can tailor-make compensation packages that put the right amount of pay at risk in order to motivate people. Rather than rewarding only an increase in the stock price, a balanced portfolio seeks to align people with company goals and with the interest of shareholders. It engages people's commitment by specifying what they have to gain if the company achieves specific targets, and what they stand to lose if it does not.

With a balanced incentive strategy, you can determine the optimal mix of cash, options, restricted stock, and other incentives that best meet your goals and match your strategy and culture. Whatever the choice, equity-based incentives will play a key role. The chance to earn a stake in the company remains a powerful incentive. An equity interest ties an individual's wealth directly to the company's fortunes. When something is earned, not merely given, there is a greater emotional connection. Equity interests offer a reward for what is done and an incentive for innovation that makes the company grow.

## Risk and Reward

How much risk should be incorporated into a compensation package to motivate people without making it seem impossible to achieve? And, what reward is appropriate?

Most people are risk-averse. Given

the choice of a sure thing or a gamble, they opt for the sure thing—even if the gamble is potentially more valuable. That's why most people prefer a regular paycheck, health-care benefits, a pension, and a long-term career, rather than the risks of being an entrepreneur.

In addition, companies have their own risk tolerances. Risk, in this context, means making calculated investments in innovations or new ideas. Certain risk is needed to produce the next generation of creative ideas or product innovations, but too much risk can be counterproductive.

Putting certain elements of compensation at risk (meaning it has to be earned by achieving stretch goals) will motivate people. If not enough pay is at risk, people will not have much incentive to go beyond what is expected. If too much pay is at risk, they might "swing for the fences" instead of getting the base hits and runs the company needs to thrive, grow and win.

## The Balanced Portfolio

I see three areas of balance: 1) ensuring that compensation includes the right risk to motivate people to go beyond the minimum of what is expected without having so much risk that it either discourages effort or fosters unhealthy decisions; 2) balancing long-term and short-term risk, rewarding profitability and growth, and managing the tradeoff between investing in the future and maximizing short-term profits; and 3) focusing more on financial performance, less on stock performance.

To create greater balance in each of these areas, companies can take a portfolio approach. This improves both the appeal and the efficacy of the compensation system. For each company, there is a right portfolio of incentives that will

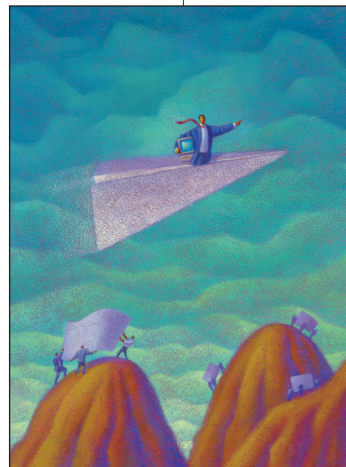
foster the desired level of risk-taking and proactive management by the executive team. With a portfolio approach, companies can adjust the mix and offer the right amount of incentives—which may vary by division, department or position—to take healthy risk.

Compensation packages should also be viewed from the perspective of what has been given in the past. It is not just annual compensation that affects behavior; it's the total wealth and potential wealth that has been created by incentives given over the years.

Board members should be asking, "How much will each executive's personal wealth be impacted by changes in the company's stock price or performance?" because the personal wealth effect may impact an executive's behavior more than the effect of annual compensation.

## Better Performance Measures

An important component of the balanced incentive portfolio is the ability to



specify the performance measures that will be the basis of the compensation program. Companies can choose which performance measures—such as profit growth, market share, or return on investment—they believe are the most important to their goals. Or, they may choose other targets that are not directly related to

company performance, such as community citizenship or environmental stewardship. Once you identify these measures, prioritize them for the short-, medium- and long-term. Then target certain measures to emphasize for each timeframe.

The balanced portfolio also allows you to vary compensation based on position. Each position might have a different mix of goals and performance measures.

Develop customized solutions tailored to your strategy, culture, and risk orientation. Incentives can boost growth, profitability, and success. **EE**

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**Action:** Use various incentives to boost performance.