

April 3, 2005

An Early Advocate of Stock Options Debunks Himself

By [CLAUDIA H. DEUTSCH](#)

FIFTEEN years ago, Michael C. Jensen, a professor at the Harvard Business School, wrote a paper with Kevin J. Murphy, then a professor at the University of Rochester, that trumpeted some pretty radical ideas for the time. Compensation systems, they posited, prompted chief executives to add revenue, not to increase profit, pay dividends or otherwise reward long-suffering shareholders. Their suggestion was to make stock options a big component of top management's pay, ensuring that they do well only if shareholders do well. "It seemed a way to tie managers tighter to the mast," Professor Jensen recalled recently.

Of course, it turned out to be anything but. In far too many cases, stock options tempted managers to pick strategies, schedule deals and investments, even juggle the numbers, so that the company looked best when it came time to exercise those options.

So in 2001, Mr. Jensen, by then a professor emeritus, debunked his own theories in another paper, this time castigating the profusion of stock options in executive pay.

Mr. Jensen, now 65, is still not done with the subject. He has written a book about the issue, tentatively titled "C.E.O. Pay and What to Do About It," that the Harvard Business School Press has scheduled for publication next winter. In a telephone interview from his home in Sarasota, Fla., he expounded on his past and current thoughts.

Q. What made you interested in executive compensation in the first place?

A. All through the 70's and 80's, systems that rewarded bad things and punished good ones arose like moss on trees. Compensation committees rewarded executives for acting like bureaucrats, for growing the size of the company, even if they destroyed products and businesses and market value in the process. That's what led to the conglomerate craze and takeover premiums of the 60's - and why it took the raiders and buyout specialists to sort it all out in the 70's.

Q. So chief executives weren't earning their pay?

A. It's not that I thought C.E.O.'s were overpaid; in fact, I felt they were underpaid in relation to lawyers and other professionals. But it seemed they were paid in the wrong way, independent of whether market value increased or decreased on their watch. Stock options seemed the best way to create an automatic relationship between the reward to the shareholder and the reward to the decision maker.

Q. After you proposed this in the Harvard Business Review, the use of stock options grew rapidly. But then you soured on the idea. Why?

A. Compensation committees wrongly looked at options as free, and awarded too many to too many people. It diluted the stock. And most stock option programs still rewarded management for building the empire, not the actual value. There was no penalty for investing in projects that did not return the cost of capital. When those projects pumped up the stock, management got a big win - but the shareholders would have still done better if the money had been paid out in dividends.

Q. Lots of companies are switching away from stock options to outright grants of restricted stock. Does that solve the problem?

A. No. Say I offer you \$1 million in restricted stock - even if you think the stock will go down 10 percent, you're still getting \$900,000, and you're happy as a clam. I'd be handing over a large amount of wealth, yet penalizing executives only slightly for the decline in the value of the stock.

Q. So the maximum stock price is the holy grail?

A. Absolutely not. Warren Buffett says he worries as much when one of his companies becomes overvalued as undervalued. I agree. Overvalued equity is managerial heroin - it feels really great when you start out; you're feted on television; investment bankers vie to float new issues.

But it doesn't take long before the elation and ecstasy turn into enormous pain. The market starts demanding increased earnings and revenues, and the managers begin to say: "Holy Moley! How are we going to generate the returns?" They look for legal loopholes in the accounting, and when those don't work, even basically honest people move around the corner to outright fraud.

If they hold a lot of stock or options themselves, it is like pouring gasoline on a fire. They fudge the numbers and hope they can sell the stock or exercise the options before anything hits the fan.

Q. Are you suggesting that executives be rewarded for driving down the price of the stock?

A. I'm saying they should be rewarded for being honest. A C.E.O. should be able to tell investors, "Listen, this company isn't worth its \$70 billion market cap; it's really worth \$30 billion, and here's why."

But the board would fire that executive immediately. I guess it has to be preventative - if executives

would present the market with realistic numbers rather than overoptimistic expectations, the stock price would stay realistic. But I admit, we scholars don't yet know the real answer to how to make this happen.

Q. But then, does it really make sense to judge executives entirely by market value? Why not reward them for setting, and meeting, stretch targets for, say, revenue or profits?

A. It's too easy to game the target-setting process. Nobody has an incentive to provide accurate data or to worry about the company as a whole.

I knew a beverage company manager who deliberately underforecast how much product he could sell during holiday season; the company believed him and cut back on production. It lost a fortune in missed sales, but he got a huge bonus for exceeding his estimates.

I also knew some executives at an equipment company who shipped their product unassembled, so they could book the revenue in a particular quarter. The company spent a fortune on labor to assemble the product in the customer's warehouse. Profits suffered, but the executives got their bonuses.

Q. O.K., then let's stick with the idea of rewarding executives for creating market value. But is it time to abandon stock options and grants, and just link bonuses to stock price?

A. Not at all. A correctly designed option, adjusted for the cost of capital minus the dividends, would not pay off unless an executive really created incremental value. That means executives only get paid if shareholders are in the money, too.

And even better, why not give executives a chance to bet on their own strategies? Let them put their own money into projects they recommend. Or at least make them pay for stock options. If the stock is selling at \$100, make them pay \$10 for an option they can exercise at \$90. That way they at least have a downside.

That also gets to the question of repricing stock options when share prices fall. With most stock plans, that just gives management a heads-I-win-tails-you-lose situation. But it would be O.K. to offer to sell them more options at a lower strike price.

Q. What about indexing options to peer companies? Is it fair to penalize management when an entire industry is out of favor with investors?

A. Yes, it is fair. When you say, "I'll measure your performance relative to your peers in the industry," you remove the incentive to get the company in the right industry. Do you really want executives to say, "I don't care if we're in a declining industry; I'll get my bonus if we're the best."? With that kind of thinking, [I.B.M.](#) might have stayed in the typewriter business instead of moving into computers.

Q. Reformers want companies to expense options, or to let shareholders approve pay packages. How much of a difference will these changes make?

A. When boards stop thinking options are free, there'll be fewer options granted, and to fewer people. When companies were forced to recognize the present value of pension obligations and long-term health care provisions, they cut back on those plans.

Q. Does a company's compensation system weigh heavily when you are picking stocks to buy?

A. Hypothetically, it would. But I sold virtually everything I could in March of 2000, and I've continued to sell the illiquid holdings as they became freed up. I got out pretty much whole, and I've never gone back in.