Building a Balanced Incentive Portfolio

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The bull market in many parts of Asia has been declining with a suddenness that has left management and investors confused and reeling. After all most two years of irrational market exuberance when almost any strategy worked, companies are facing the challenge of certain Asian economies beginning to show signs of slight reduction in GDP growth whereby headed towards a maturing growth mode versus a historical "growth only" mode.

With the increased volatility of the stock markets, each correction (up or down) in stock price adds another element of mystery in how the markets value organizations in many corporate boardrooms. As a result, many organizations have concluded that over the long-term (which in Asia is defined as 12-18 months), the primary business strategy will be execute on the lofty promises made to the markets and investors. In this environment where strategy execution is ever more precarious, demanding talented, experienced managers and visionary leaders. But the challenge becomes how to retain these executives, motivate them to achieve new strategies, and reward them for their success? The challenge is even greater given the use of long-term incentives is still in its infancy stage in many parts of Asia, and long-term incentives are what each executive wants as they have seen their Western counterparts get rich of such incentives in the similar growth phase of the mid to late 1990's.

Executive pay in Asia is changing by the minute. Long-term incentives and in particular stock options have been the incentive vehicle of choice for the past several months for most private and public companies. However, many investors are questioning the alignment of stock options with the operational performance of the business as all of them have a strong pay for performance mindset. With this mindset, companies are beginning to look at alternatives on 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. We have identified six Incentive Imperatives that should be evaluated relative to your company's culture and strategy, and built into a balanced combination of incentive vehicles.

Six Incentive Imperatives

Organizations typical try to get only one or two benefits from their stock option investment. But, now with the increasing sophistication of the design of incentive vehicles, we can get five or six benefits for the same economic investment in compensation. The typical benefits for organizations from incentives are as follows:

1. Motivate the Upside: Give management a significant stake in the growth in the company's stock price or value. Stock options were and still are an excellent way to accomplish this.

2. Protect the Downside: Shareholders don't want management to concentrate solely on increasing the stock price. They also want them to safeguard current value. Incentives should cause management to feel shareholders' pain if stock prices fall. Full value restricted shares or owned shares help achieve this goal.

3. Create an Ownership Stake: Most boards and CEO's agree that management should have a significant personal ownership stake in the company – real ownership that substantially affects an individual's personal wealth. Incentive plans should be structured to help generate and facilitate this ownership stake.

4. Reward Real Performance: Rewarding stock performance is not enough. Long-term incentives should establish long-term financial goals and reward long-term financial performance.

5. Retain Top Talent: Incentives should be structured with "deep hooks" that cause significant financial pain if an executive leaves prematurely. This can easily be accomplished simultaneously with other objectives.

6. Compete Effectively: Perhaps it goes without saying, but the total package should provide competitive payouts that are in line with competitive performance– median pay for median performance; 75th percentile pay for 75th percentile performance; etc.

Weighting the Alternatives

The directors' job is to work with management to create a Balanced Incentive Portfolio that achieves the Six Incentive Imperatives in a cost effective and relatively simple way. This requires balancing tradeoffs between the different Imperatives.

Six Incentive Imperative

Assembling the Portfolio

Many companies are trying different combinations of incentive vehicles to achieve their balanced portfolios. To create an organization's ideal portfolio, one should consider how well each vehicle achieves the various Incentive Imperatives and which of the Imperatives are most important to the organization. Bear in mind many companies are finding that different portfolio mixes are optimal for different employee groups.

Incentive Vehicle	Motivate Upside	Protect Downside	Create Ownership	Reward Performance	Retain Talent	Compete Effectively
Options	*X*		*X*			*X*
Time Vested Restricted Stock/Units		*X*	*X*		*X*	*X*
Performance Shares	*X*	*X*	*X*	*X*	*X*	*X*
Performance Cash				*X*	*X*	*X*

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The balanced incentive portfolio also allows you to vary compensation based on organizations levels and positions within those levels. Each level in the organizations and subsequently each department might have a different mix of goals and performance measures.

Incentive 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 and owner managers 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. By assessing the current and future allocation of incentive pay relative to our incentive imperatives, we believe that organizations can develop customized solutions tailored not only to an organizations strategy, culture, and risk orientation, but also to an executive's own risk and reward profile.