Executive Compensation and Company Performance

You may have read about executive pay ratios, which compare CEO compensation to that of the company’s median employee. Disclosure of these pay ratios made headlines recently when an SEC rule mandated by the Dodd-Frank Act took effect. While there are a variety of views on the significance of pay ratios, Parnassus believes that executive compensation as a whole is an important topic for investors to consider. Here’s what we think about it.

UNDERSTANDING COMPENSATION STRUCTURES
In addition to salary, executive compensation includes both short-term and long-term incentive components. Short-term incentive plans (STIPs) provide compensation for performance relative to annual metrics that are often related to income growth and operational performance. Long-term incentive plans (LTIPs) are generally designed to reward progress toward strategic goals over a longer period, typically three to five years. Some common measures used in LTIPs include total shareholder return (TSR) as well as earnings and returns measures.

PUTTING THE COMPANY FIRST
While companies in different industries have different comp structures, in all cases the compensation plan should incentivize behaviors that drive the business forward, protect shareholder value and avoid undue risk taking. Generally speaking, Parnassus prefers packages that put more weight on objective performance measures than on discretionary goals. However, it makes sense to include some targets that involve qualitative judgment, such as progress in building an effective senior management team or improvements to corporate culture. We also think goals on diversity, labor and human rights, environmental impacts, community relations, predatory lending and other ESG issues should be addressed in compensation structures.

ANALYZING THE INCENTIVES
When evaluating executive compensation, Parnassus considers whether the incentive structure is encouraging the CEO to take excessive risks or put their personal interests ahead of what’s best for the company. This is key information because the actions of the CEO can greatly impact the direction of a company.

We question compensation plans that frequently change metrics for the sole purpose of ensuring that an executive meets their targets or that are structured to pay CEOs for results that are not related to tangible progress for the company and its shareholders. For example, TSR is a commonly used metric that rewards growth in the overall stock market that may not be correlated with the financial health of the company.

FOSTERING SUSTAINABLE GROWTH
All company stakeholders benefit when compensation plans guide management to make the best decisions for the future growth of the business. While pay ratios alone offer limited insight into the quality of a company’s executive compensation plan, their disclosure may draw attention to this important issue.
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