THE OPTIMAL DURATION OF EXECUTIVE COMPENSATION: THEORY AND EVIDENCE

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Three Olin Business School professors have developed a new formula corporations can use to calibrate executive compensation packages.

The measure, pay duration, characterizes the short-term and long-term compensation options for corporate leaders. It has long been believed that short-term pay motivates chief executives to allocate firm capital in a way that quickly boosts companies’ share price but may not lead to sustainable growth. When the pay duration framework is applied to past compensation data, the result is a number of suggestions that can help companies better align executive pay with the best interests of the corporation and shareholders.

The paper “The Optimal Duration of Executive Compensation: Theory and Evidence” was born out of the need for an empirical measure to quantify compensation packages, the authors wrote. Without a model, the idea that short-term executive pay can negatively affect the long-term prospects of a company is merely an intuition.

Co-written by Radhakrishnan Gopalan, assistant professor of finance; Todd Milbourn, Hubert C. and Dorothy R. Moog Professor of Finance; and Anjan Thakor, John E. Simon Professor of Finance, the paper received the 2011 Olin Award for research that is relevant and applicable to business. Public and regulatory scrutiny of high executive payouts in the wake of the financial recession has focused attention on the compensation process. The model could prove useful to those who sit on corporate board compensation committees, Olin Award judges said.

The professors compute pay duration as a weighted average of the vesting periods of pay components including salary, bonus, option grants and restricted stock. The weight for each part is equal to the fraction of that component in the executive’s total compensation. Once the professors developed the pay duration model, they tested it by analyzing compensation data including all stock and option grants to all named executives of firms in the S&P 1500 index from 2006 to 2008.

Their findings:

- Pay duration should be longer for leaders of firms with more liquid stocks and with less variability in analyst earnings forecasts.

- Optimal pay duration is longer for executives at firms with smaller boards and smaller nonexecutive director shareholdings and for executives with lower shareholdings.

- Pay duration should also be longer at firms with a higher entrenchment index, which is a measure of several corporate governance provisions that lessen the ability of shareholders to influence decision making within a company.

- Executives with short-duration compensation contracts appear to act myopically compared with those with long-duration compensation. For example, an executive with shorter-duration compensation is more likely to cut research and development budgets, which lowers potential future growth but makes the company’s balance sheet look better in the short term.