ILLUSTRATION BY NATHALIE BEAUVOIS

Gauging the New Normal of Total 'Stakeholder' Return

Conversation facilitated and edited by Judy Warner

On the fourth day of the 2018 NACD Global Board Leaders' Summit, a deeply experienced director joined with what some of our NACD members might describe as a rising rock star of a compensation consultant. I listened in as they talked about some of the emerging issues in executive pay. Phyllis J. Campbell, vice chair of the Pacific Northwest division of JPMorgan Chase & Co., serves on the board of Alaska Air Group and on the advisory board for diversity at Toyota North America. She also serves on NACD's Advisory Council for nominating and governance committee chairs and was a member of the 2016 NACD Blue Ribbon Commission on Building the Strategic-Asset Board. John V. Trentacoste is a partner and chief operating officer of Farient Advisors, an executive compensation, performance, and global governance advisory firm based in Los Angeles and New York. Among the issues Campbell and Trentacoste discussed were how deep into an organization compensation plans should go; the shifting balance of compensation and equity as competition to recruit and retain talent becomes more acute; the changing mindset of boards toward their own composition; and how to plan for emerging C-suite roles such as a chief data officer. Highlights from their hour-long conversation follow.

Campbell: As a board, we're sometimes wired to look in the rear-view mirror and say, well, what we did yesterday has brought us this success today. But we know that's not necessarily what's going to bring us success tomorrow. The question I would raise to a comp consultant is, What role do we have as a board to engineer the company for growth and transformation? Is this a new area for comp consultants?

Trentacoste: What we see more of is digging deeper into the organization from a philosophical level to understand how incentives cascade. What are the metrics? What have been the outcomes, and are they aligned with what we're trying to create as an organization from a cultural perspective?

Campbell: Everybody's in a war for talent and we're all talking about it. How do you help your clients think about that in this new environment with a tight labor market and less skilled folks, especially in the technology arena where the war for talent is particularly acute?

Trentacoste: A lot of what's on the board agenda is backward-looking. How did we do? Did we structure things properly? How much did we spend versus budget? All of which are important questions to ask, but the issues of the day really necessitate looking forward two or three years out, the most important aspect of which is assessing what talent will the company need for the long-term sustainability of the business. How do you translate the pay strategy that you have right now, understanding that some benchmarks haven't even come up to the positions that you're going to need to compensate for? And more pay isn't necessarily the right answer—well-designed pay is.

Campbell: In today's competitive market, the war is mostly for technology talent. I've seen some companies, Microsoft being one, that have announced retention bonuses for almost all tech talent. What do you think about things like that, or do you advise clients on that? Because everybody's competing for software engineers these days, which is a tough situation to be in.

Trentacoste: Unfortunately, retention awards, mega grants, [and] one-time bonuses are likely to become more in vogue because some have been supported by large investors. Some of the numbers that we're seeing are astronomical. There will be a point, however, where there is a reversion back to normalized pay practices, and it's likely going to be when, perhaps, the robustness of the private capital markets dries up a little bit.

Campbell: CEO succession or top management succession in today's environment is something all boards are struggling with, especially at old-line companies that are transforming or being transformed. In my experience, it's difficult for boards to really sit down and take a clean-sheet approach to the next CEO because boards want to develop talent from within. Talent that you know is always better than talent that you haven't seen. What's the construct you use to think about the next generation of talent?

Trentacoste: Assess diversity. Ask yourselves, Do we have management that reflects the markets in which we operate or the markets in which we may operate? Do our customer bases map to how we're thinking about the board and how we're thinking about management? Finally, there is the skills assessment. What are the skills, capabilities, and competencies that are going to get us not just through this period of disruption but allow us to elevate to the top in any disruptive environment? You may not know where you need to be, but you know who will help you get there. That's the kind of framework that most companies should be using. I'm curious what you think, Phyllis.

Campbell: You do have to start by cleaning the board's house. This is a new arena for boards in that we used to look at term limits or age limits. But now the board mindset has changed amid a lot of shareholder pressure, which is good. We're asking much more strategic questions and then mapping them back to board skill sets and composition. Performance evaluations of individual directors have been much more prevalent in the boards I'm on around the question of whether you are really relevant for the future of this business as a director. I'm really encouraged by the trends I'm seeing. Many boards are stepping up to push director skill sets and performance.

John, to touch on another subject, so many companies are either being sued or called out particularly on gender pay disparities. What's your advice to clients on how to think about pay equity and diversity and inclusion and all the issues that seem to be at the fore today?

Trentacoste: We're advising our clients not to be afraid to show the data to the comp committee, get their feedback, and really explain the process of defining the philosophy around diversity. What are your goals? What are your milestones? Where are there pockets of mis- or underrepresentation in the organization? The idea is how to target education and development in these areas to

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a certain population. Where internally can we push high potentials and high proficiency into those roles to create a more well-rounded organization? Then the board's responsibility or the committee's responsibility is to put this on the agenda either semiannually or annually and to check progress or milestones.

Campbell: It's interesting from a director's perspective as chair of a governance and nominating committee. In my conversations with various institutional investors, probably most prominently Vanguard and BlackRock, they ask questions about pay and equity philosophy and what the diversity and inclusion strategy is of the company.

Trentacoste: Absolutely. Often the pressure from investment capital is much swifter than regulation, and in many cases better in getting outcomes that are shareholder- and issuer-friendly. I'm encouraged by what we're seeing. Discussing how the board gets ESG [environmental, social, and governance] literate is really a great topic. However, that applies to disruption too. Boards need to be literate.

Campbell: Just looking at pay and equity data is not enough in and of itself, because if you look at different grades of jobs, you will see more women in staff jobs. Then that causes the board to ask the question, Where are the women in the jobs where they are getting operational experience that leads to the next promotion? Answering those kinds of questions takes time and maybe an advisor to push a little bit more with the compensation committee, and therefore push the rest of the board, therefore push management.

Another point is the number of companies that have announced they have achieved gender pay equity. I look at that and ask, Where were the comp committee and the advisors? My criticism is essentially aimed at technology companies where largely there are still no women in senior management. If I were a board member there, I'd dig much more into that before I put out a press release saying we're at pay equity. That doesn't tell the story. I'm curious what you think about this.

Trentacoste: I would never push a client to make that pronouncement. What I would do is push them to make a disclosure around the process to let stakeholders know that it is important to them and they are tracking it. The gender pay gap is not going to change overnight, but the fact of the matter is that it is a joint effort by management and the board that says something about the culture of the organization.

Campbell: But would you help push on the second set of questions?

Trentacoste: Yes, the process should be disclosed, but I also think representation is important and strategies around getting your workforce to be more diverse. What is happening? Where are the successes?

Campbell: One other question that came up yesterday was about non-financial metrics and comp plans. On one of my boards, some of the examples of non-financial metrics that we use are customer satisfaction and safety. Some companies use employee engagement scores, which is interesting. Do you see an increase in the number of non-financial metrics?

Trentacoste: I do. I believe non-financial metrics help paint a more holistic picture of the operational performance of a business. Most often these measures are in the short-term incentive plan, which is really your operational incentive plan. How did we operate the business over the past year? We have found this especially useful in research we've done around companies that are trying to drive toward a consumer experience that are being disrupted from omnichannel pressures. These non-financial metrics help keep management's eye on the ball of generating a good customer outcome as well as a good employee outcome. Non-financial metrics really help tell that story.

Campbell: Another question I've been asked is how often should a board switch comp consultants. I can give you my perspective, but I would be interested in what you see from the other side.

Trentacoste: I'm more interested in the buyer's perspective.

Campbell: I think it is changing. It used to be more perfunctory. If you came in, brought us the right pay data, helped us establish the peer group, and maybe asked a few questions about talent, everybody was satisfied as long as the fees weren't outrageous and the chemistry was good. What I see changing is all of these strategic issues that we've been talking about.

It's rare now to see a comp consultant who can help the board think about pay and talent and succession in light of the strategy. I think there will be much more of a premium on consultants in your arena who are thinking more broadly about the issues of how a company succeeds in a disruptive environment. Comp committees and boards will demand more in the future than we're demanding today, which will encourage more change to happen. What do you see?

Trentacoste: I'm encouraged by your comments. I think events are driving companies to change comp consultants. Like with auditors, there is a benefit to a long-term relationship that provides the consultant with context to the way in which things are done, because in many cases the tenure of the consultant may outlast that of many of the executives.

Events that should trigger either looking around or thinking about making a change are when your comp plan has become too defensive and not offensive enough. I meet with comp committee chairs and human resources folks all the time. They tell me about their business strategies. They tell me about how they're being disrupted. The one question I ask: Is your compensation plan as it's designed today defensive, or are you on offense?

Campbell: Particularly amid a war for talent.

Trentacoste: Exactly, and most plans are uniformly defensive. Also, peer group and plan assessment, benchmarking, and goal setting all link to one another, and the linkages need to be understood. If they're not singing together, what you have is very discordant.

Campbell: Well, who are you benchmarking yourself against? That's a key question, especially today in retail. Is Macy's Nordstrom's competitor? Or is it Amazon? The important point is as you think about what business you are in, think about what business you should be in.

Trentacoste: Peers are instructive, but there's so much judgment that needs to go into thinking about the organization design of the future, because we are going to be paying for jobs that we have never seen before. How do they fit into the structure of the organization? Where do they sit in terms of scope, impact, and criticality? How are we going to find them? Do they need different incentive plans? The world is changing. Companies are being disrupted. Everyone recognizes that homogeneity in pay is doing many companies a disservice, but there seems to be a "first-mover" disadvantage in pay that prevents truly tailored incentive plans.

Campbell: Boards need to spend a lot more time on agendas. There's very little time to really sit back and reflect as a board about how should we look at areas differently. The board has to carve out enough time on, first of all, strategy. Secondly, the board needs to think about its own composition and whether it has engineered itself to be forward-thinking enough to transform the company. I'm not sure in all cases that's true. The board and management have to look at their own processes first to allow enough time to think out loud, ask the alignment questions, and then push you folks more on what work needs to be done to support all of this.

That's the big takeaway for me—how the board reengineers its own thinking and processes with management to stay relevant. Then you've got to figure out what comp consultant best aligns with that. If our current comp consultant is just doing the check-the-box stuff, then you've got to find somebody else who can help you think out loud. But you can't do our work for us and keep asking the questions. It gets annoying.

Trentacoste: That's why we are part private investigator and part cartographer. We need to give boards a compass to make decisions that are fully informed because, at the end of the day, we can give you our opinion, we can give you the data, we can show you where it's been done in the past. Hopefully, we give comp committees and boards enough conviction to stand by their decisions and inform them enough that the decisions they're making are strategically attuned to value creation and stakeholder value creation, not just shareholder value creation. The TSR that should be considered is not just total shareholder return. It has to be total stakeholder return. It's not a fad. It's not going to dissipate in a year. It is the new way businesses have to be conducted in this century in order to be competitive, in order to be good corporate citizens, and in order to stay relevant.

John V. Trentacoste

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