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Dispelling the Myth That Options Help Shareholders

Investors' hard-earned money is not the only thing that has been lost since the technology stock bubble went pfft. Also gone is the credibility of a host of bull-market conceits. They include the hilarious notions that new-economy companies would be invulnerable to the traditional economic cycle, that valuations were not important when it came to buying stocks, that the invention of the Internet rivaled that of electricity.

Here's another truism to throw onto the slag heap: Stock options are a boon to shareholders because they motivate management and align the interests of investors with those of executives.

The greatest damage to this theory has been done by companies that reduce the strike prices of their stock options after their shares have plummeted. Option repricings, as they are called, are quite simply a gift to management and workers that outside shareholders do not receive.

Companies that reprice their options have typically argued that doing so is necessary to keep treasured executives from leaving for sweeter packages elsewhere. Implicit in this argument is the belief that an exodus of executives would hurt the company.

But a new academic study, to be presented at the annual meeting of the Academy of Management starting on Aug. 5 in Washington, indicates that companies that reprice options actually show higher levels of executive turnover later. More important, the study found no evidence that the repricing of options was associated with improvement in the financial performance of the company.

The authors of the study were three academics at Indiana

University's Kelley School of Business — Catherine M. Daily, S. Trevis Certo and Dan R. Dalton. They studied repricings at more than 100 companies in 1997 and 1998 and compared the companies' results with those of similar concerns that did not reprice.

They found that in the first year after a repricing, chief executive turnover at the companies was 16.3 percent, versus 4.7 percent at companies that had not repriced. By the end of 1998, companies that had repriced options clocked chief executive turnover at 25.5 percent. Those with no repriced options had turnover of 10.5 percent.

Top management turnover below the chief executive level was also much higher at companies that repriced, the study found. By the second year after a repricing, that turnover was nearly 41 percent, versus 28 percent at companies with no repricings.

Investors who suspect that option repricings are decidedly anti-shareholder will also find confirmation in another study to be presented at the academy's meeting. Timothy G. Pollock, Harald M. Fischer and James B. Wade at the University of Wisconsin at Madison concluded that repricings were more likely at companies with powerful, entrenched chief executives who also head their boards of directors. Repricings are less likely at companies where the chief owns a lot of the stock.

Despite this and other research proving stock option repricings to be an egregious transfer of wealth from shareholders to management, companies and boards continue to approve such plans. The Investor Responsibility Research Center reports that 59 companies repriced options this year, as of June 15. That was far higher than the 31 that repriced in all of 2000, but down from the 312 that did so in 1999.

With the main argument for repricings — executive retention — now demonstrably false, it will be fun to see how companies justify these shameful tactics in the future. But justify them they must. For stock options are the drug of choice among American executives. And like any addiction, this one is exceedingly hard to kick.