Institutional Investor

Did the Hedge Fund Model Create an Incentive Bubble?

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Incentive compensation plans at thousands of U.S. corporations follow a structure that the alternative investment industry made fashionable. Financial markets now dictate executive compensation on the assumption that financial markets faithfully reflect executive performance. But new research declares this assumption false and dangerous.

Writing in the March issue of the *Harvard Business Review*, Mihir Desai nailed timely grievances to the front door of the church of incentive compensation. The title of his article, “The Incentive Bubble,” should resonate with Citigroup shareholders who recently dealt a stiff rebuke to CEO Vikram Pandit by clamping down on his paycheck.

As the Mizuho Financial Group professor of finance and the senior associate dean for planning and university affairs at the Harvard Business School, Desai attacked deeply held religion in executive suites. While underscoring his own fidelity to shareholder capitalism, Desai tagged blame for a looming economic catastrophe to the dubious notion that incentive programs align interests of managers and shareholders.

Far from aligning interests, skewed incentives put capitalism at risk. “The twin crises of modern American capitalism, income inequality and governance crises, are traceable to the growth of these incentives contracts,” Desai says. Incentives disrupt allocation of financial and human capital, not least wealth distribution that spurred the Occupy Wall Street movement. “In the last 15 years it has been mediocre to be a shareholder, very good to be a manager, and extraordinary to be an investment manager. I’m not sure that’s sustainable,” says Desai.

The emperor has no clothes, he warns. Boards of financial and nonfinancial firms alike have surrendered performance evaluation and compensation to financial markets that cannot disentangle skill from luck. According to Desai, “that basically says ‘I don’t know if you are a good manager. I’ll just see what the market says.’ But over short horizons markets can’t figure out who’s good and who’s not.” Short horizons spur poor decisions in pursuit of windfalls. Because managers take home piles of money often enough, a warped sense of entitlement dulls any motive to fix the problem.

One culprit stands out. “The underlying problem is pension funds,” Desai says. “They are outsourcing their monitoring and investment functions in order to avoid responsibility when things go wrong.” If results fall short, pension managers can point fingers. But even good results by private equity funds are suspect. “Think about the illiquidity they impose on investors,” says Desai. “Private equity funds lock up assets for several years. Then they report they did slightly better than the S&P. But they used leverage and were illiquid for several years. Benchmarking for those factors can make returns look significantly worse.” Like his fellow academics Eric Stafford at Harvard and Jakub Jurek at Princeton, Desai contends that after adjusting returns for multiple risks over realistic time spans, hedge funds that post good records actually destroy value.

Remedies exist; they just go against the grain. Board members must resume responsibility and accountability for CEO evaluations. That’s not to say reject all advice and benchmarks that outside consultants can furnish, but rather for board members to roll up their sleeves and take a much harder look at what a CEO has actually accomplished each year in excess of average performance. Forget the idea that managers should automatically participate when stock prices gain. Instead, restore restricted stock and vesting tied to longer tenures. A fresh look at indexed incentives might advance this goal.

Meanwhile institutional investors must lean against a headwind of incentive compensation, Desai argues. Stakes are far too high to ignore misguided faith in incentives. At best, no matter what advocates say, incentive programs cannot cause alpha to sprout. Those who say otherwise fail to measure risk properly. At worst, Desai warns, a resulting economic imbalance will trigger the next crisis before we’re dug out of the last one.