Executive Compensation

Addressing the Asymmetry in Pay and Performance

This research paper defines a framework to assess executive remuneration. This encompasses linking total remuneration to acceptable levels relative to average wages and house prices. It also assesses whether remuneration structures are linked to sustainability measures, determined by appropriate short term and long-term incentive schemes. It separates the structure for compensation between traditional CEO's as stewards of capital, and business developers or entrepreneurs, the true owners of risk capital. It then reviews shareholder engagement to determine whether shareholders are too passive in determining executive pay. Finally, it looks at CEO tenure to assess whether longevity actually improves shareholder returns.

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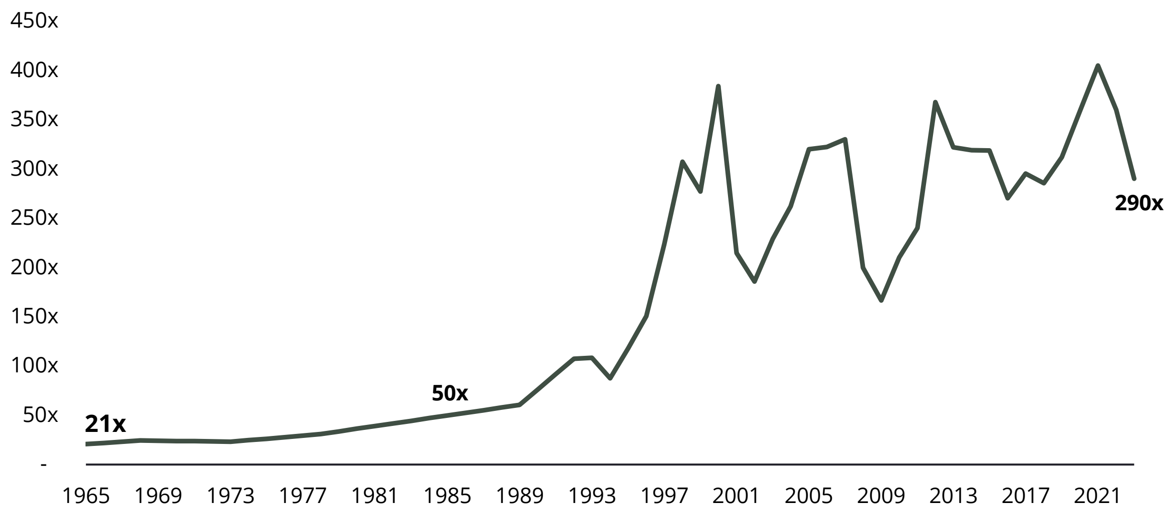
Executive Compensation

The rapid rise of executive compensation over the past 30 years has been widely documented and analysed. Figure 1 highlights just how dramatically total compensation for CEO's has risen relative to average workers. CEO compensation was 21 times average worker's salary in 1965, while by 2023, it had increased to 290 times, after peaking at 389 times during 2021. This data is US centric, having been taken from the largest 350 US publicly listed companies and measures average annual compensation of workers in the industries that the top 350 firms operate in. It's fair to say that during the 20 years from 1985 to 2000, when average CEO salaries really started to grow exponentially, the average worker put up with it because their standard of living is rising as well, as was the market capitalisation of the companies being managed. The debate on excessive pay oscillates between weak corporate governance and powerful managers setting their own pay, to the argument of efficient markets, in which the market effectively sets the price of managerial talent.

The debate regarding CEO salaries starts when the average standard of living is falling and when social unrest can cause serious damage to the fabric of society. While this is one step removed from the process of investing in equities, it runs to the core of how modern societies function, and by extension, how and where capital is allocated to selective industries. For confidence to be restored in capital markets, CEO and management compensation needs to be as transparent as possible, in both strong economic conditions and poor ones. Currently, we see asymmetry with the risk reward pay off under current incentive schemes, i.e., CEO's still get rewarded for failure, through large base salaries that ensure a standard of living disproportionate to whether they are successful or not. Executive pay consists of various components, salary, annual bonus - or short term incentive plans, payouts from long term incentive plans, option grants, share grants as well as contributions to superannuation schemes, various perquisites (perks) and often very favourable severance packages. The rapid increase in total compensation has occurred as a result in the shift in relative importance of these components over the past 40 years. In fact, the biggest difference in pay trends between the US and Australia has been the very liberal use of stock options granted in the US, particularly through the tech bubble of 1998-2001.

Figure 1: US CEO to Worker Compensation Ratio



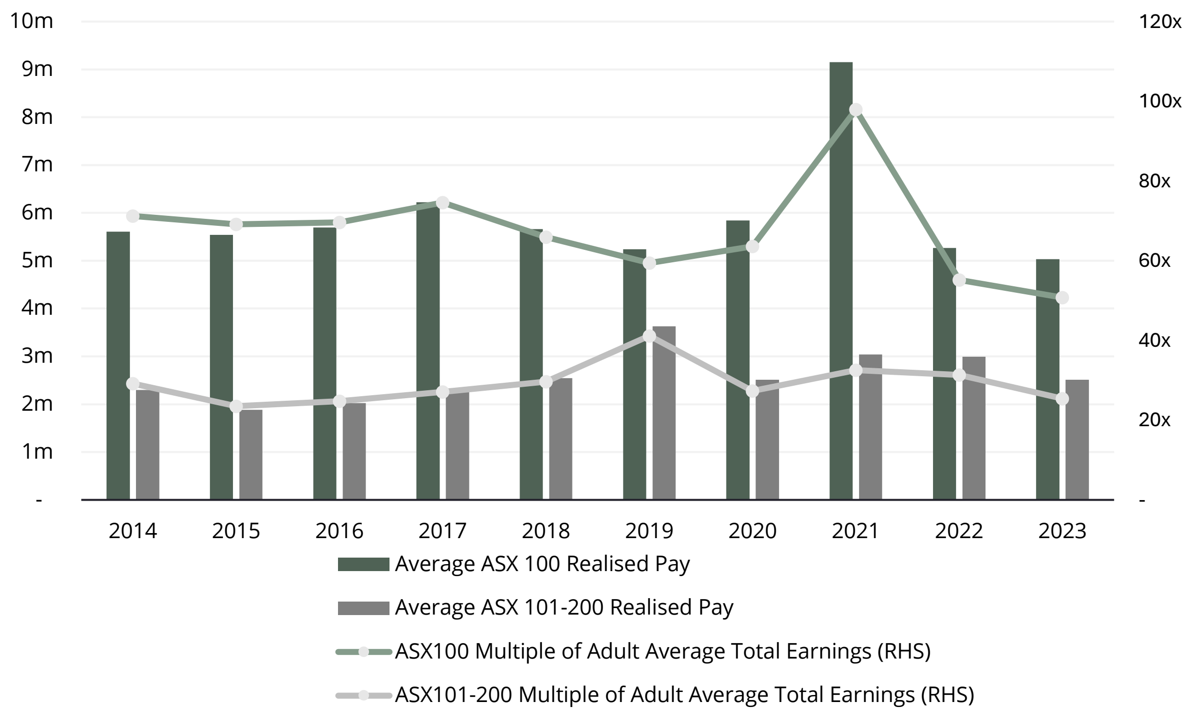
Source: EPI

Australia

Figure 2 illustrates a similar trend in Australia. Unfortunately, we don't have the same data available for a longer term look at Australian compensation trends, relative to average salaries, although, it is dependent on the size of the company. The top 100 companies have CEO compensation ranging between 40-100 times the average worker salary, although the data only goes back to FY14. Clearly the reason for the higher compensation for larger companies is a combination of the sheer size of the organisation, thus the complexity of managing the various stakeholders and corporate governance functions attract a risk premium, and a function of having more "at risk" salary in terms of performance pay. Looking down the market cap spectrum at the 101st to 200th constituents of the ASX 200, the average CEO compensation equates to between 20-30 times the average salary. The difference between larger and smaller companies for total compensation usually lies in the higher incentive programs for large cap companies.

Broadly speaking - based on 60 years of relatively consistent pay structures (refer Figure 1), where CEO compensation ranged between 20-50 times the average worker pay, we use this as a rule of thumb to assess whether CEO compensation is in fact, excessive. While we are strong believers in the use of incentives schemes, the rapid growth in base salaries of CEO's is something that we find concerning. The asymmetric risk reward outcome - whereby a base salary of $2-3m suggests compensation is still rewarding a CEO regardless of outcomes. We feel that broadly capping maximum CEO base salaries as a multiple of average worker's salary, while ideological, would create an environment where less tension was created between CEO's and employees and other stakeholders. It certainly should be considered as part of the compensation debate.

Figure 2: ASX CEO Pay to Average Adult Earnings



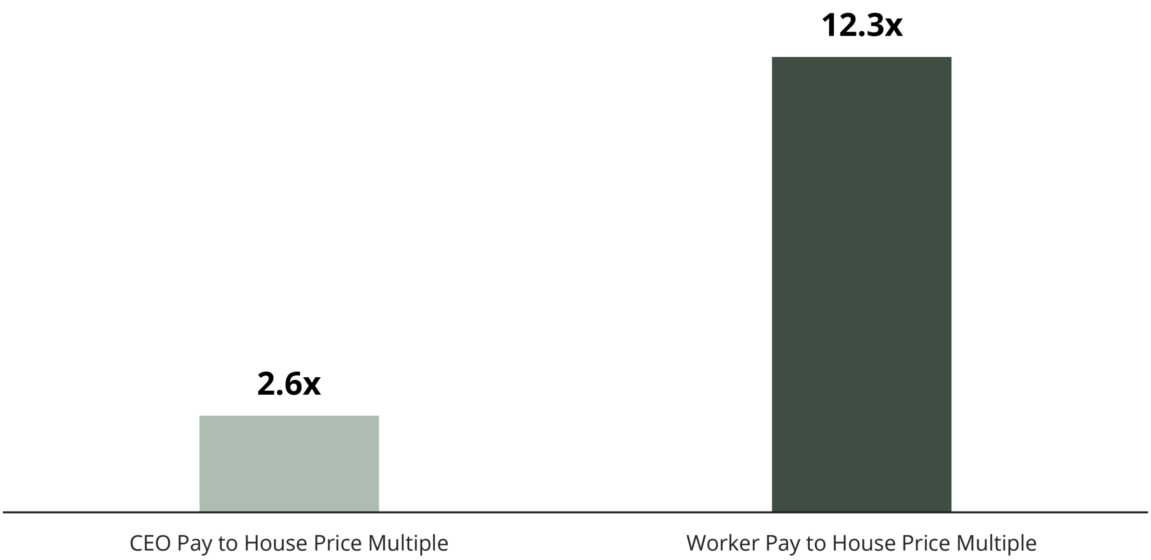
Source: ACSI

Executive Compensation and Housing

We have endeavoured to construct an index as to how affordable executive housing is relative to executive salaries, in the same way that median housing is viewed relative to median incomes. For consistency, we have used the median house price of Melbourne relative to the median income in Melbourne. In August 2024, the median house price in Melbourne was $930k and the median salary was $75k, leaving a house price to income ratio of 12.3 times, seen in Figure 3. Historically this ratio has trended between 8-16x times, as a measure of how affordable housing is. This is slightly below the current Australian capital city median of 13.5 times, i.e. it cost the average person 13.5 times their salary to buy a house. For executives, we have used the median salary of CEO's at the top 100 ASX listed companies and then as a proxy for executive housing, used the median of houses sold from $10m-$100m in FY24. i.e. the top 0.29% of houses sold. We realise that many CEO's live in Sydney and that Sydney, on average, is more expensive than Melbourne. We used Melbourne simply because we had more confidence in the data provided and with the proviso, that the top 154 houses sold are a proxy for executive housing, as it provides an example of ultra-high-end pricing commensurate with that of a CEO.

Constructing this index, where the median house price of executives in 2024 ($13.5m) compares to the median pay of the ASX100 CEO of $5.1m, sees the house price to income ratio of just 2.6 times, i.e. it cost the average executive just 2.6 times their annual pay to purchase an 'executive' house vs the 'average' worker 12.3 times. As discussed, this analysis has flaws due to the average CEO tenure, after tax income is materially lower, undeniable pressure in the top position and much of that total compensation being 'at risk'. This still suggests that like other measures, executives are very handsomely paid.

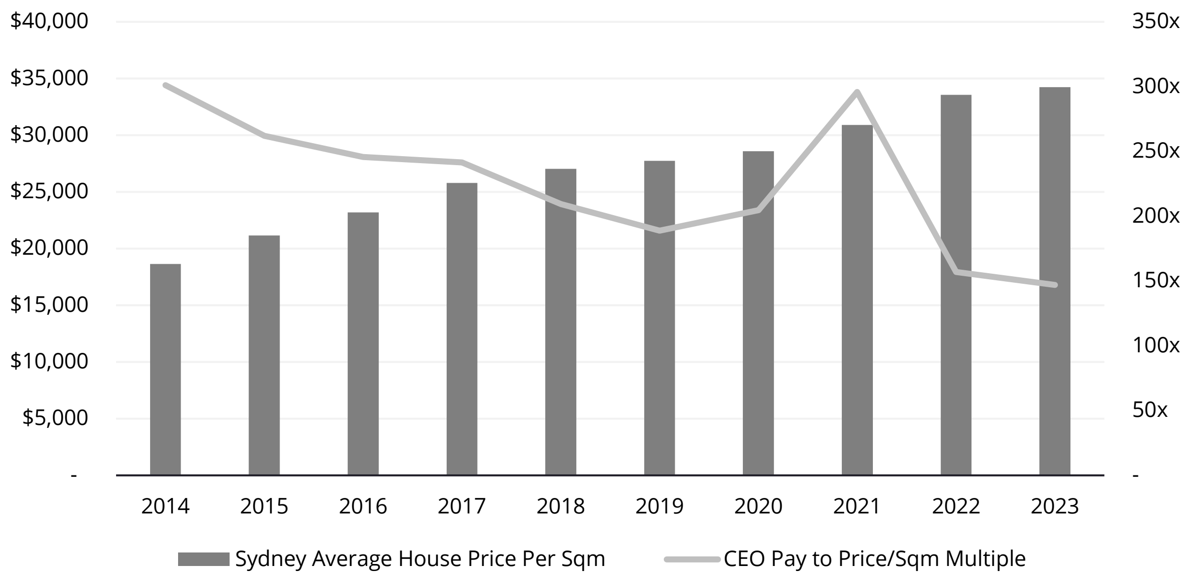
Figure 3: 2024 Melbourne Pay to House Price Multiple



Source: ABS, Marshall White, PropTrack

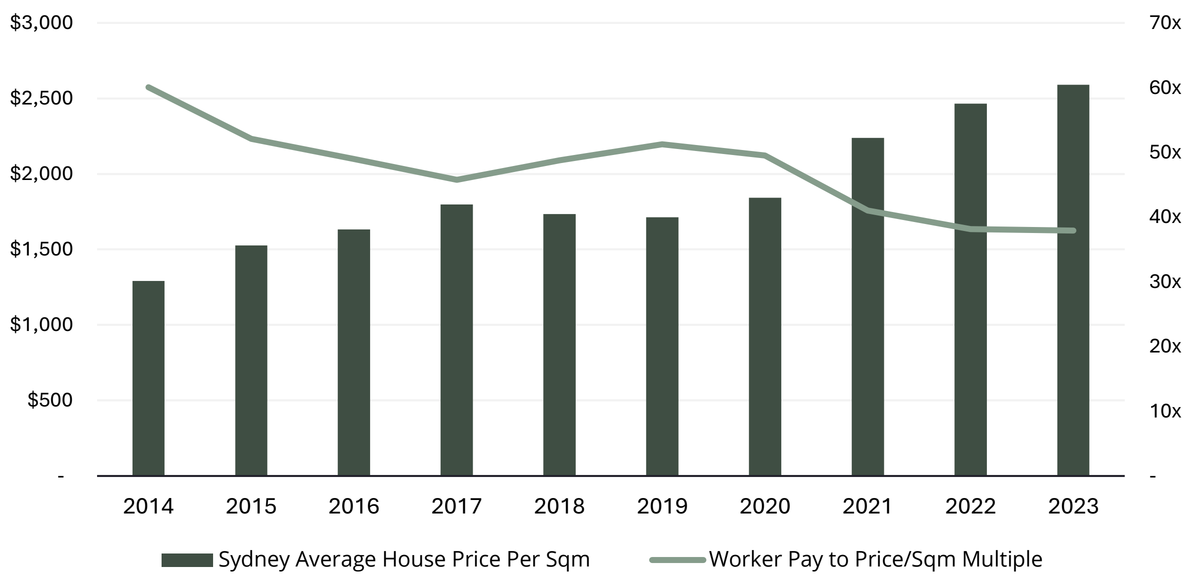
Given the prevalence of CEO's that live in Sydney, we have also constructed an index to show the house price purchasing power of CEO's relative to the average worker. For executives, we have used the average salary of CEO's at the top 100 ASX listed companies and then as a proxy for executive housing, used the average per square metre 'prestige' house value sold in Sydney. As seen in Figures 4 and 5, in 2023, the average CEO pay to price/sqm multiple, was 147 times, whereas the average worker's multiple was 38 times. This indicates that even accounting for differences in respective house prices, CEO's have approximately 4 times greater house price purchasing power than that of an average worker. Again, this suggests that like other measures, executives are very handsomely paid.

Figure 5: CEO House Prices and Pay



Source: ABS, Knight Frank, Domain

Figure 4: Average Worker House Prices and Pay



Source: ABS, Knight Frank, Domain

So simplistically, is there a right number? Demographia International releases an International Housing Affordability survey each year, and for 2023, Australia was one of the most unaffordable nations, with the median house price, at 9.7 times the national wage. For reference, Sydney is the second most expensive housing market in the world at 13.8 times, while Hong Kong is the most unaffordable housing market, with the average house costing 16.7 times the average wage.

By way of comparison, Pittsburgh in the US is the most affordable housing market at 3.1 times, while Singapore, at 3.8 times is one of the most affordable large cities globally.

According to Demographia International, a ratio of less than 3 times rates as affordable. In Australia we have a situation whereby executive housing is affordable by this definition, while average housing is extremely unaffordable. Simplistically, if we used 3 times the salary as an "affordable" house, with executive housing in 2024 at $13.5m, it would suggest that the average ASX100 executive wage should be no more than $4.5 vs the $5.1m in 2023. Of course this is only a very basic measure, but it does illustrate the divide between executives and average workers.

Before we start assessing incentive structures for executives, which have been a large part of rising compensation plans, it is also relevant to look at base pay for executives, relative to average workers, see Figure 6. We find the average base wages for Australian workers has risen by 26% over the period to 2023, versus the 4% decline for ASX100 CEO's. This trend is a reversal of the previous decade (where CEO pay growth substantially outpaced average worker growth), however we find the multiple of average worker pay as excessive and believe it should be considered as part of the broader debate around executive compensation.

Figure 6: Executive Pay vs Average Worker Pay 2014-2023

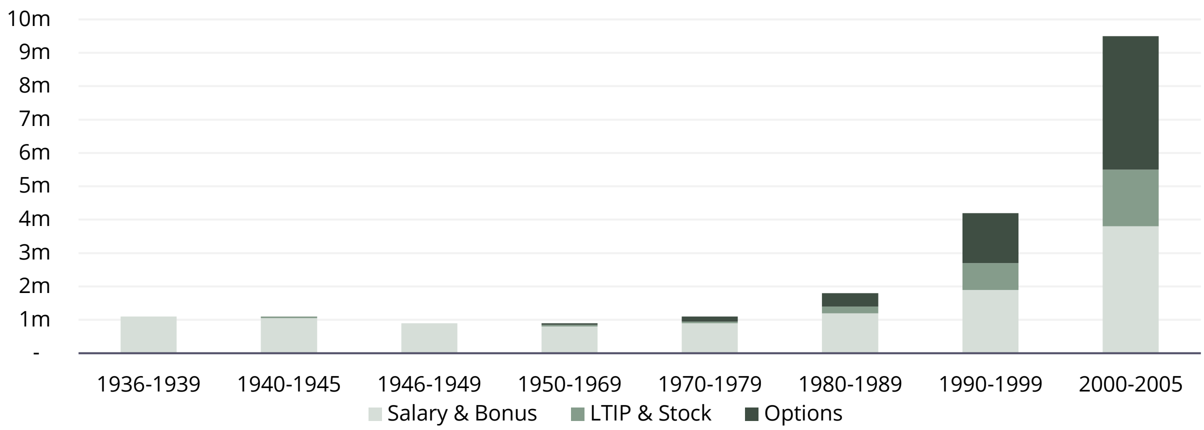
Year	ASX 100 CEO Base Pay	Worker Average	CEO Pay Multiple (x)
2014	$1,810,000	$78,780	23
2015	$1,715,087	$80,158	21
2016	$1,790,000	$81,812	22
2017	$1,770,480	$83,491	21
2018	$1,788,000	$85,800	21
2019	$1,764,900	$88,140	20
2020	$1,675,689	$91,936	18
2021	$1,810,427	$93,444	19
2022	$1,741,724	$95,420	18
2023	$1,743,474	$99,112	18
2014-2023	-4%	+26%	-

Source: ACSI

Trends In Executive Pay

As seen in Figure 7, the rapid increase in grant of CEO 'performance options' has been a key reason behind the US average CEO remuneration jumping so quickly from the 1980's to the early 2000's. The purpose of the option compensation structure was to tie remuneration directly to share prices, thus giving executives direct motivation to increase shareholder value. This is well and good in rising markets but offers less incentive in falling markets. In any case, the excessive use of options was curtailed in 2004 (in the US) when the option grants had to be expensed.

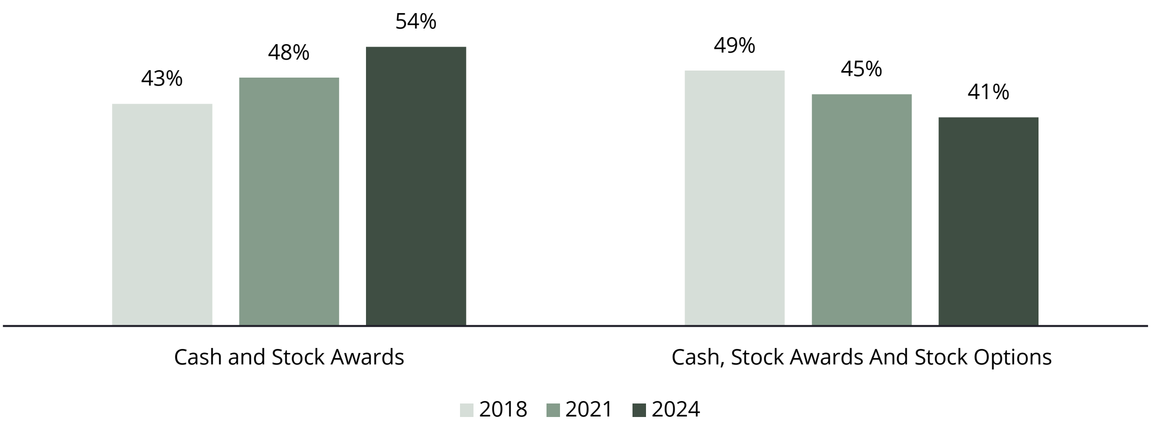
Figure 7: USA - Total Remuneration of CEO's rebased to 2000 Dollars



Source: Carola Frydman and Dirk Jenter, CEO Compensation, August 2010

Since then, the composition of CEO compensation has shifted away from the use of stock options and toward 'realised' or vested stock awards. In 2006, stock options accounted for just over 70% of stock-related pay in realized CEO compensation, in 2022, stock options were only 34%, with vested stock awards accounting for the rest. It is worth noting that while stock options represent a much lower proportion of total CEO compensation than in the past, they are still commonly used, especially in the S&P 500. According to a 2024 proxy disclosure, just over half of S&P 500 CEO's received cash and stock awards only, but just more than 40% reported a compensation structure that includes a combination of cash, stock, and stock options (the latter figure was 49% in 2018), as seen in Figure 8.

Figure 8: S&P 500 Use of Stock Options is Declining

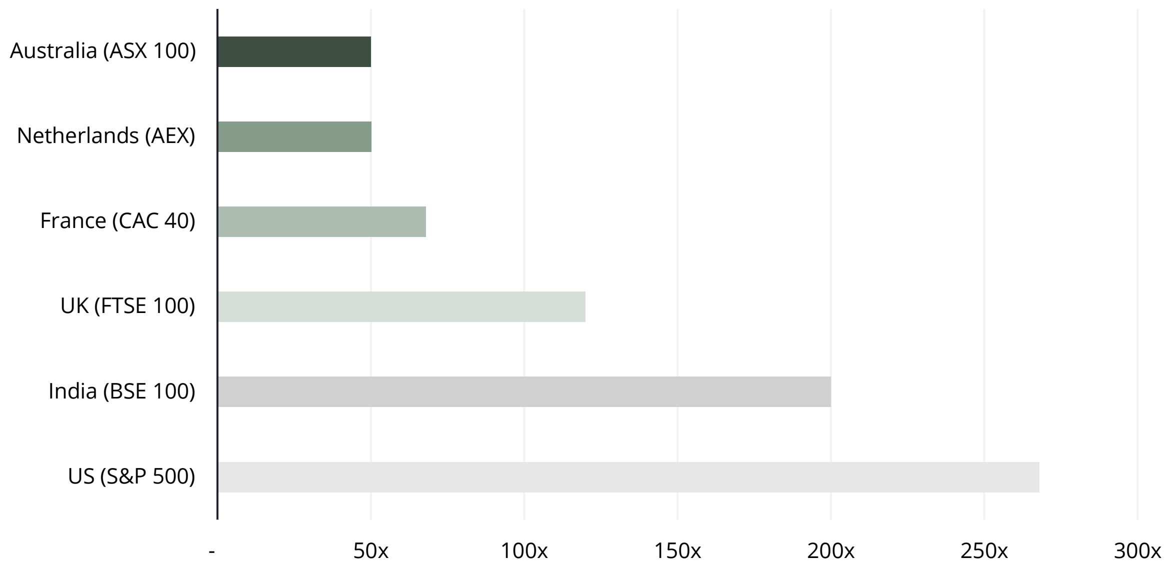


Source: ESGAUGE/The Conference Board

In Australia, the tax treatment of options, which are to be fully valued at the time of issuance, and thus the corresponding capital gains tax paid upon award (as opposed to the sale and realisation of profits) has seen the use of stock options minimised for executive compensation, although they are still common in smaller cap names, particularly amongst mining executives.

The other noticeable trend is highlighted in Figure 9, which compares the average executive salary to worker compensation in offshore markets across key benchmark indices. In 2023, for Australia, this ratio was at the lower end of international peers, suggesting that Australian peers get paid less than their international counterparts (relative to the average worker).

Figure 9: Executive Pay to Average Worker Multiple



Source: Diligent

However, U.S. firms tend to be larger and exhibit higher levels of institutional ownership than their international counterparts, both of which are strongly associated with higher CEO pay. The median market cap of the S&P500 is approximately A$56B, far greater than that of the ASX 100, with a median market cap of approximately A$10.3B. Therefore, when controlling for factors such as size, growth opportunities, TSR, institutional ownership, as well as macroeconomic conditions (GDP growth and GDP per capita), the U.S. CEO pay premium is smaller than commonly perceived, averaging 23% higher than that of international peers.

Additionally, equity-based compensation is consistently and significantly higher for U.S. CEOs relative to both G7 and nonG7 CEOs, indicating the distinct role of equity-based pay in the U.S. compensation structure as a key driver of the US ‘pay premium’.

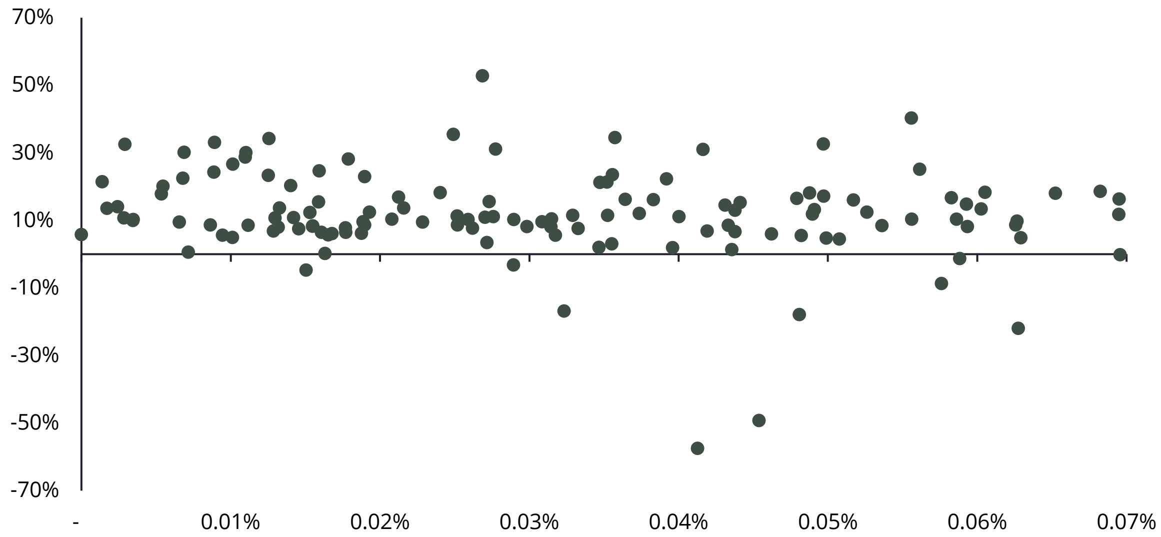
Broadly speaking, there has been a willingness to “pay up” for international talent in Australia, given executives are now a global commodity, combined with an increase in the cost of living in Australia relative to other international destinations.

Long-Term and Short-Term Incentive Plans – Do they work?

Measuring the incentive effect of CEO compensation has been a key focus of academics since the 1950's. Do they actually work? Shareholders are seeking a CEO to act in their best interests, so how does the moral hazard of this alignment work? In part, the optimal incentive strength depends on parameters that are unobservable, such as the CEO's own risk tolerance, CEO's independent wealth and the marginal product of CEO's effort...i.e. if a CEO is being paid $7m, will they work any harder if they get paid $8m? So clearly incentive pay is important in aligning interests, but how to set optimal incentive structures is the secret to a successful compensation plan, which is arguably unique to each individual.

Analysing ASX 200 companies from FY15-FY24, we found 1) there was no relationship between the level of executive pay and both Return on Equity (arguably the most important metric to shareholders); and 2) there was no relationship to Total Shareholder Return (TSR = share price plus dividends). We controlled for market capitalisation, (shown in Figures 10 and 11) as clearly there is a size bias in looking at executive compensation. Even in adjusting for this, there was no correlation for ROE or TSR. There are multiple other studies suggesting the same fact - that the only significant determinants of executive remuneration are firm size and complexity.

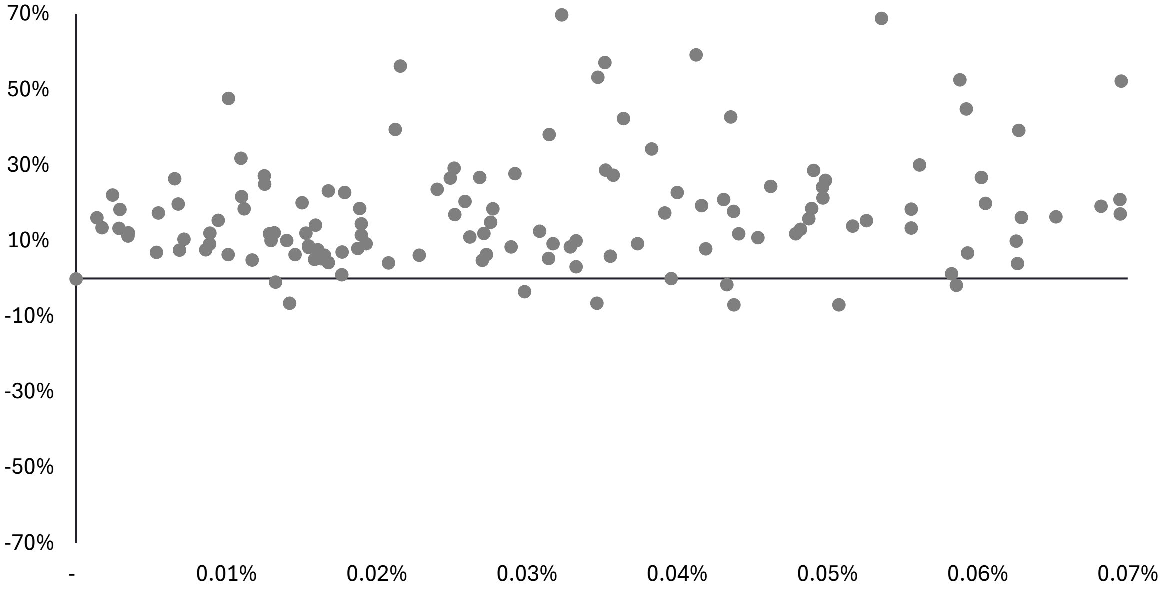
Figure 10: CEO Pay/Market Cap (Horizontal Axis) to Return on Equity (Vertical Axis)



Source: Jefferies, FactSet

So why doesn't performance-based pay correlate to improving returns for shareholders? Arguably there are many issues but most importantly, we believe boards are not truly independent, or procedures for setting CEO pay are conflicted - i.e. too much 'managerial power' lies with the CEO, particularly with long serving CEOs. Additionally, boards may not have the competency to fully understand complex incentive structures, or simply the STI's and LTI's are benchmarked inappropriately to peer groups that may or may not be relevant, or industry/regulatory changes render hurdles for incentive pay obsolete.

Figure 11: CEO Pay/Market Cap (Horizontal Axis) to 3-year TSR (Vertical Axis)



Source: Jefferies, FactSet

THE RIGHT INCENTIVE PROGRAMS

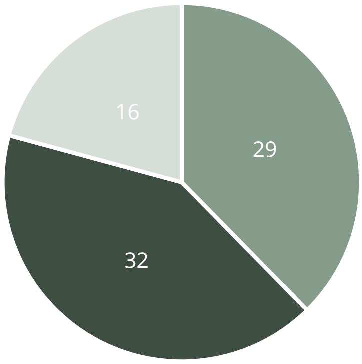
Incentive programs should be unique to the company and almost to the individual, as understanding the risk profile and tolerance, and personal wealth outside the firm, are important variables in setting appropriate incentive schemes. Ideally CEO's have significant personal wealth tied to the outcome of the firm being managed and we find that owners of capital, in general, are acting in the long-term best interests of shareholders, such that the alignment of interests is strong. Stewards of capital tend to have lower tenure and generally poorer TSR's, which we will discuss in further detail.

Analysing the vast range of incentive schemes available and the percentage of executive pay that is allocated between fixed base fee, short term incentives (STI's - normally over a period of 12 months) and long-term incentives (LTI's - which are normally set over a period of 3 years and are based on at least two performance measures). As seen in Figure 12, ISS analysed the trend of executive pay for ASX 100 companies and found in FY23, a total of 77 ASX100 companies used relative TSR in their LTI setting, of which 48 companies applied more than 50% weight to their relative TSR targets (including 16 companies with 100% weight). This is designed to incentivise executives for outperforming their peer group. i.e. if their stock price goes down by 15%, but their 'peer' group falls 20%, then they still generate LTI's. Normally the RTSR is combined with either an earnings-based calculations (eps or NPAT growth) or a capital efficiency measures such as ROE or ROCE (Return on Capital Employed).

Chester broadly feels that these STI's and LTI's are designed to be asymmetric. That is, CEO's benefit more from the upside than they personally suffer from the downside, particularly with such large base salaries - which leads to, particularly in cases of stewardship, the potential for excessive risk taking. This is not dissimilar to the agency problem faced with hedge funds and large short-term incentives paid for short term performance.

We at Chester also have a problem with RTSR as a measure given; 1) companies define their own peer group, which creates biases; 2) LTI's vest even if the company's return to shareholders has been negative; and 3) TSR is heavily influenced by factors outside the CEO's control. The challenge of designing a LTI comes down to the uniqueness or individuality of each CEO.

Figure 12: ASX100 Companies using RTSR in LTI's - FY23



Source: ISS Corporate Governance Insights

The Right Incentive Programs

LTI's and even the share-based components of STI's should vest over 3-5 years, which is arguably against the wishes of managers, who overall, are risk averse and prefer cash in their pocket now. A CEO should always have their hurdles set before commencing their role, there is nothing more frustrating than seeing a new CEO complete significant write-downs with profit warnings, and then re-basing the share price for the setting of performance objectives. Similarly, a CEO should exit the business with a substantial stake of 'at risk' pay left in shares that vest after a suitable period post departure. This hopefully ensures they are always acting in the best interests of the company for the long term, and not just maximising profits during their tenure.

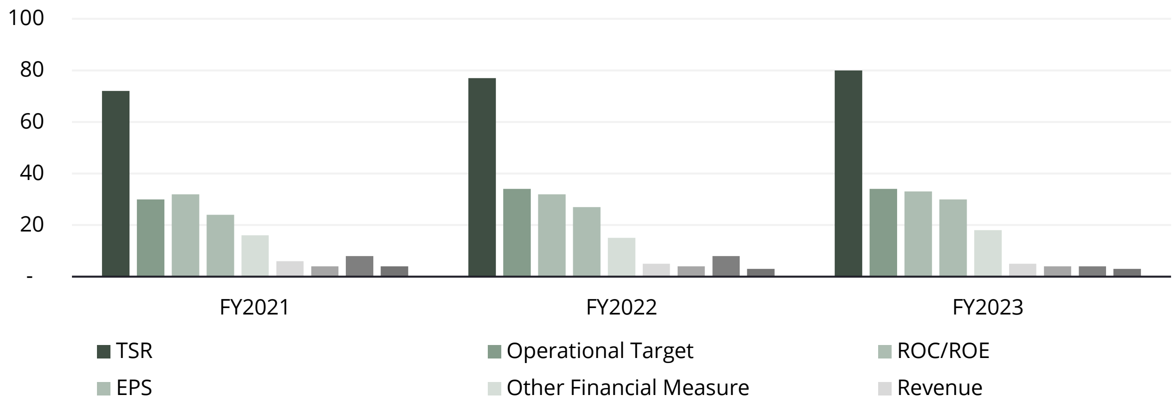
We prefer rolling 3-year earnings growth targets combined with ROCE (Return on Capital Employed) measures (earnings growth must consider the use of capital) to any TSR measures, as TSR can be heavily influenced by macro factors. Generating above nominal GDP growth on a rolling average 3–5-year basis should smooth individual year volatility and reward company's for generating above 7-9% earnings growth. As long as this objective is being met with capital returns above WACC, then these are suitable objectives for sustainable business growth, regardless of what the 'peer' group is doing.

PWC authored a paper in 2024 called 'The Psychology of Incentives' which was a global study into what motivates executives. The key findings were at odds with the fact that LTI's are a key remuneration tool among Australian CEO's. Executives are risk averse in general, thus most executives would prefer a higher fixed salary than the potential to earn higher income, but with a greater percentage of 'at risk' pay. That is, certainty is more highly valued. In the same way, CEO's treat LTI's with scepticism and are likely to demand a premium in excess of 10% for variable pay compared to fixed pay. This means that variable pay may be a relatively expensive method of paying executives and thus, would need to consider whether the benefits are worth the additional cost.

Moreover, across the 157 executives surveyed, 41% actually believe their LTI plan is an effective incentive. The recommendations were clear, in that clean and simple STI and LTI plans were preferred to any TSR based measures or complex designs of incentive plans.

Figure 13 illustrates some of the types of measures used by ASX 100 companies in LTI’s from FY2021 to FY2023. Note these changes usually create more complexity with an increased use of TSR or RTSR, which for reasons stated above, we disagree with.

Figure 13: Measures used by ASX100 Companies in LTI's

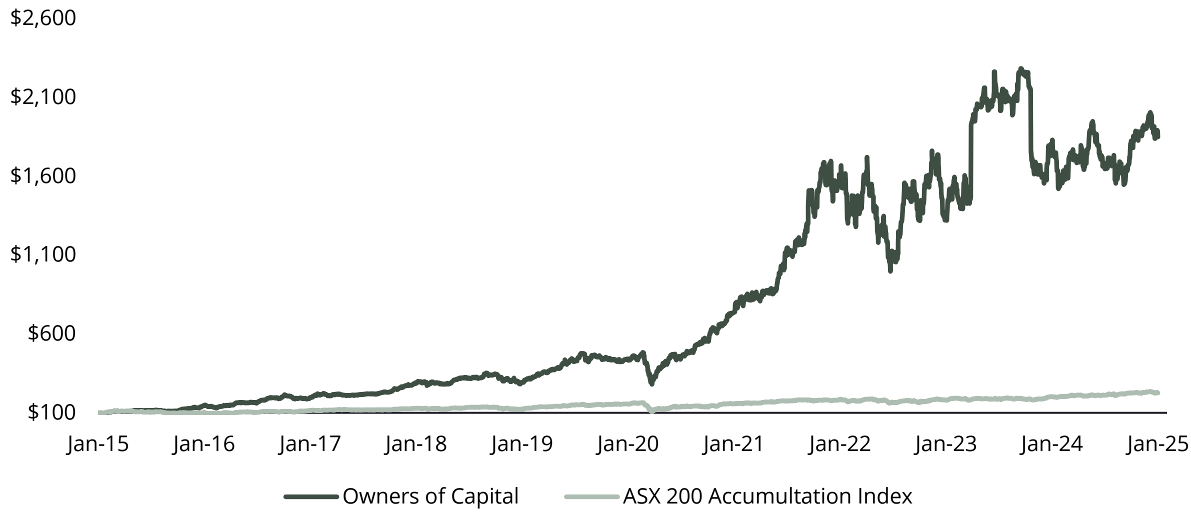


Source: ISS Corporate Governance Insights

Owners vs Stewards of Capital

We have endeavoured to construct an index over a 10-year period that equally weights ASX200 companies that have Chair's or CEO's with significant personal wealth tied up in the company they are running, seen in Figure 14. We find that owners of capital have much stronger alignment of interests with shareholders than stewards of capital (executives without significant stakes or long tenures). We have defined owners of capital as CEO's (or Chairmen) who are founders of the company or with at least 10 years of service with the company and with greater than $25m of personal wealth tied up in company stock. We have kept the index to the ASX200 for simplicity, while providing a large enough data set that creates a sub-index of stocks that we define as 'owners' of capital. For this exercise we have used current ASX200 companies that include (but are not limited to) GMG, HUB, HVN, LOV, MIN, NWS, NXT, PME, PMV, PNI, REH, SDF, SGH, TLX, WTC and WOR. These companies have founders that are still heavily invested in the long-term strategic direction of the firm, or with significant personal wealth still tied to the company's performance. We note that there is 1) a high degree of survivorship bias in the index we have constructed and 2) differences in size and earnings growth between emerging owners of capital led companies and the ASX 200. However, it is no surprise to see this universe of companies significantly outperform the index over a 10-year period.

Figure 14: Owners of Capital vs the ASX200 Relative Return



Source: Bloomberg, Chester Asset Management

Figure 15 illustrates a table of 'value' CEO's in Australia in FY24, based on the total remuneration versus the size and complexity of the organisation they run. All of the CEO's in this list fit the description we use to define "owners" of capital. While interesting, it does penalise market cap companies with CEO's earning $5-10m, thus the list is skewed towards low remuneration structures. We do note however, that many of these CEO's pay themselves a sizeable dividend every year - it pays to be a substantial shareholder.

Figure 15: ASX 'Value' CEO's						
Name	Company	Code	Total Pay (A$B)	Mkt Cap (A$B)	Rev. (A$M)	Ownership
Graham Turner	Flight Centre	FLT	986,611	3.04	2,711	7.5%
Sam Hupert	Pro Medicus	PME	965,221	24.2	166.3	24%
Christian Behrenbruch	Telix Pharmaceuticals	TLX	1,405,518	9.2	783.2	6.5%
Ian Macoun	Pinnacle Investment Management	PNI	1,410,343	4.1	49	9%
Richard White	WiseTech Global	WTC	1,000,000	28.8	1,041	38%
Jamie Pherous	Corporate Travel Management	CTD	1,094,211	2.1	716.9	12%

Source: Company Reports, Bloomberg

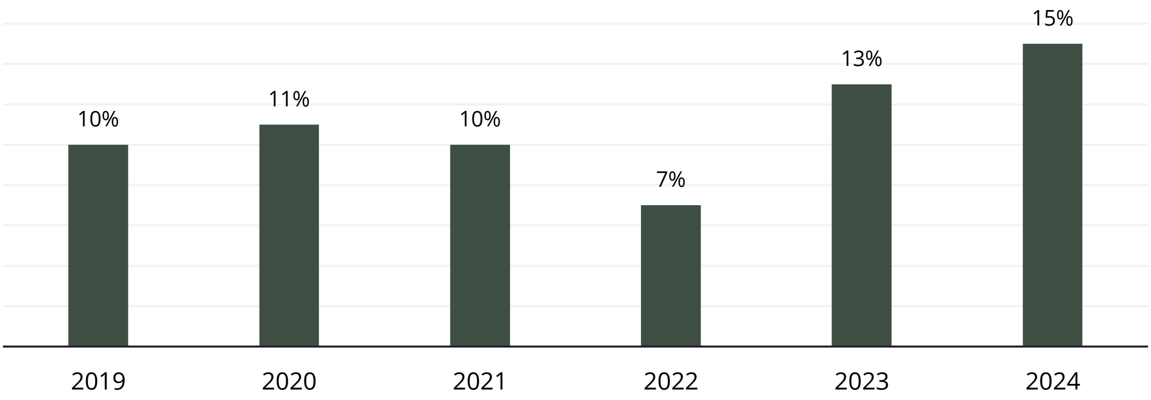
An interesting observation from remuneration reports is that the headline number that the CEO is compensated for the year, is often markedly differently from the take home cash they actually receive in the bank. This is for a wide variety of reasons, but largely around option accounting, which is priced based on the Black-Scholes valuation methodology and valued at 'fair value' based on grant date, where in reality, when the options are exercised, the take home portion or share conversion vary significantly. The take home pay also depends largely on how much of previous STI's and LTI's actually vest in the current year, so it pays to be cautious around some of the large numbers that create headlines in remuneration reports.

Shareholder Engagement

In 2011, the Australian government introduced a 'two strikes' rule to the Corporations Act, which has since had a significant on the way that companies are governed in Australia. Under this rule, if a remuneration report receives 25% or more "no" votes (of shares that are present and voting) at two successive AGM's, then shareholders can remove the board with a board spill motion at the second AGM. The entire board can be voted out if more than 50% of shares are voted against the board.

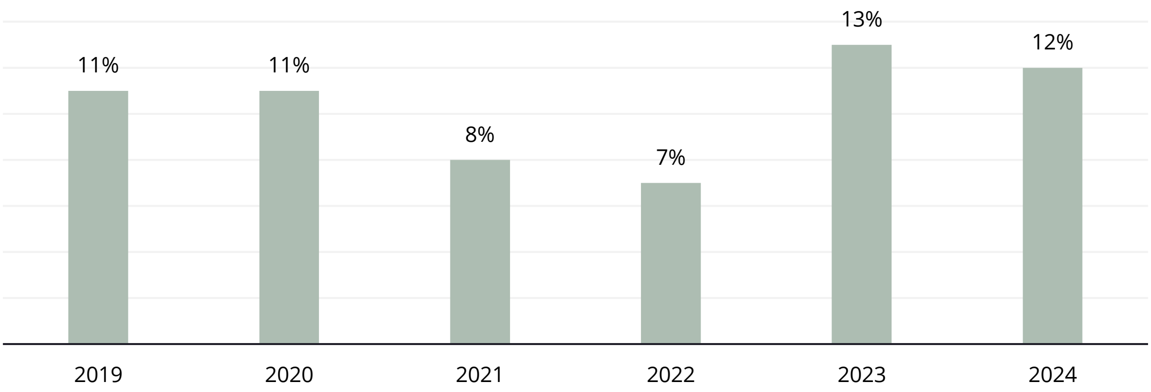
There is no doubt that this has led to an increased level of shareholder activism, as through voting against remuneration reports, shareholders can convey their displeasure at the current board. In the first year of adoption (2011) more than 100 companies received a first strike against their remuneration report. Fast forward to 2024 and the 'strike' mechanism is widely used a tool to express shareholder dissent. As seen in Figures 16 and 17, during the 2024 AGM season, 15% of ASX 300 companies received strikes on their remuneration reports - a historic record. An additional 12% of companies narrowly avoided strikes, reflecting more widespread dissatisfaction.

Figure 16: Percentage of 'Strikes' (>25% no vote)



Source: The Reward Practice

Figure 17: Percentage of 'Near Misses' (15-25% no vote)

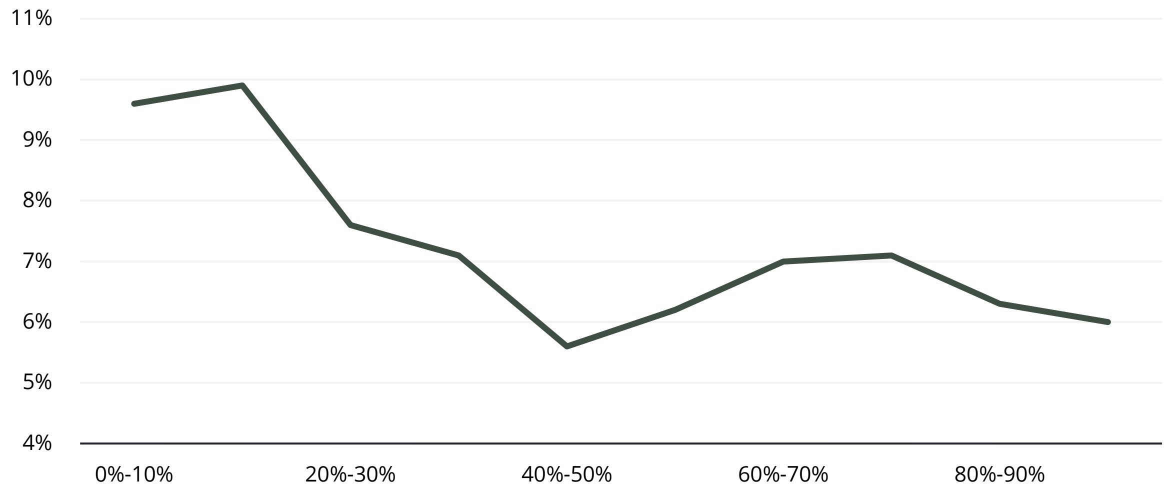


Source: The Reward Practice

The recent rise in shareholder dissent has largely focussed on the size and structure of CEO pay, particularly variable incentives that were seen as excessive or poorly aligned with performance. Long-term incentives (LTIs) have drawn criticism for lenient metrics or timelines, while governance lapses in determining pay outcomes have added to frustrations. Notable companies with high shareholder dissatisfaction included 1) Mineral Resources (MIN) (75% 'no vote'; citing governance issues – first strike; 2) Lovisa Holdings (LOV) (74% 'no vote'; citing excessive CEO pay – second strike) and 3) Elders (ELD) (68% 'no vote' – second strike; citing pay practices and mishandling of CEO succession plan).

One criticism of this current structure is that it is often being used by shareholders as a popularity contest, as opposed to actually voting on whether the remuneration report is appropriate or not. Guerdon Associates analysed TSR for the year leading up to the AGM and found that it is negatively related to votes against the remuneration report, or said another way, the higher the TSR, the lower the 'no vote' (as seen in Figure 18). While the 'strike' policy is widely used a genuine tool to express dissatisfaction with the executive remuneration, there is obviously other influences that dictate voting outcomes, given the correlation between TSR and the high percentage of 'no' votes a company receives.

Figure 18: 12 Month TSR compared to Average Votes Against - ASX 300



Source: Guerdon Associates

Corporate Governance – The Setting of Objectives

A direct result of the 'two strikes' policy has been more caution from boards and remuneration committees. The advent of the 'two strikes' rule in 2011 appears to have increased scrutiny and transparency regarding remuneration practices, with proxy voters reining in excess pay quantum and supporting rigorous performance indicators. However, there has been a strong trend towards more complex incentive programs. We find it a curious trend that so many consultants have emerged in creating an industry around corporate governance issues. In effect, asset managers (stewards of capital - i.e. managing money on behalf of their client base), have outsourced the decision making on important issues to independent advisors. This has occurred largely as a result of the increasing complexity of executive incentive schemes, thus an industry of experts has emerged to untangle the web of STI's and LTI's to determine if a particular company's compensation plan is effective or not.

While we agree that incentive schemes have been made far more complex in recent times, we endeavour to understand how CEO's are incentivised and more importantly, remain motivated to continue to deploy our shareholder capital as effectively as possible. We believe then, that a myriad of factors, rather than just the compensation report, are needed to assess whether the CEO and management team remain engaged. This often boils down to an understanding of individuals, rather than any group think around trends - particularly towards relative total shareholder return (RTSR), which we feel create inappropriate benchmarks.

We actually believe the trend should be in the opposite direction. More simplicity and more individual tailoring of incentive plans. As discussed previously, understanding the motivation of the individual is vital in setting appropriate incentive plans, otherwise the incentive schemes can create the wrong outcome of excessive risk taking. i.e. What does the increase in salary do for marginal effort? Will a CEO work harder for the prospect of $10m p.a. in 3 years' time after performance hurdles are met, versus taking $5m p.a. today, without making any company transforming strategic decisions? Incentive plans are not uniform, they should be very specific to the company's internal ambitions and industry life cycle. Hence, we strongly believe that incentive schemes should be heavily weighted to internal issues, rather than macro influences and market sentiment that drives TSR outcomes. We favour a skew towards encompassing qualitative issues such as safety records and employee engagement, which dictates longer term thinking surrounding corporate culture, vitally important to running sustainable businesses.

Perhaps, corporate governance rules in Australia should cover off some broad-brush rules, rather than leave executive compensation and corporate governance in the hands of each company's board. ASIC could show more leadership in this regard in simplifying the range of outcomes available for executive compensation.

India, albeit a relatively socialist country, has had some interesting compensation plans in place since the Indian Companies Act was legislated in 1956.

For certain listed companies 'the total remuneration payable by a public company to its directors and its managers in respect of any financial year shall not exceed 11% of the net profits of that company for that financial year'.

Indian legislation also states that 'in any financial year, if a company has no profits or its profits are inadequate, the company shall not pay its directors, including any managing or whole-time director or manager any sum except with the approval of the Central Government'.

These rules, while something any junior mining company would shiver at the prospect of, show just how long the issue of compensation has been thought about. Not that Australia would ever propose such punitive restrictions (and have few listed innovative companies to speak of).

CEO Tenure and Longevity Risk

Figure 18: Relationship Between CEO Tenure and TSR

CEO Tenure	2 Year TSR			5 Year TSR		
Percentile	25th	50th	75th	25th	50th	75th
Short Tenure	16%	31%	43%	12%	23%	77%
Medium Tenure	37%	44%	53%	10%	55%	82%
Long Tenure	33%	50%	69%	44%	105%	135%
Overall	23%	42%	59%	20%	58%	123%

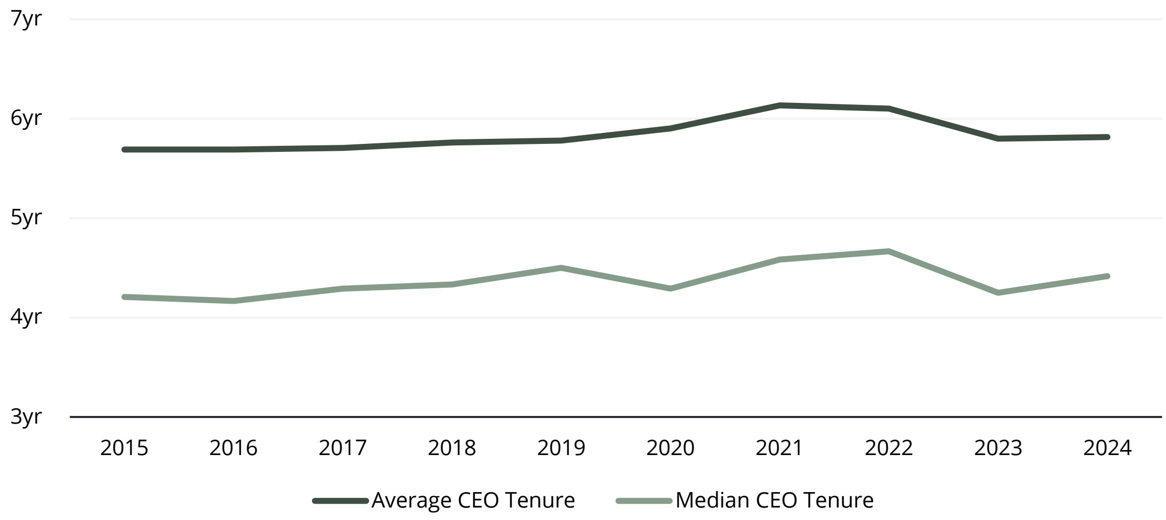
Source: Guerdon Associates

Figure 18 illustrates what we intuitively know, that the longer a CEO stays with a company, the higher total shareholder return. It measures TSR and tenure for ASX50 companies with CEOs categorised into groups of short, medium and long tenure. Short tenure is defined as less than 2 years, medium ranges from 2 to 5 years and long tenure is 5 years and more.

The positive relationship between tenure and TSR remains true for several reasons, largely survivorship bias, which indicates a combination of stability, execution capability and track record, thus shareholders remain happy. Companies performing well are very unlikely to willingly turnover their CEO. The opposite is also true, that lower performance may precipitate CEO turnover. CEO's unable to execute or meet strategic targets, ultimately fall on their sword, and subsequently the share price suffers.

CEO tenure has stabilised over the past five years (see Figure 20), which comes after a multi-year period (post GFC to 2012) where CEO tenure fell rapidly, following a period where business models (and CEO execution) were challenged. While median CEO tenure has stabilised, we consider it to be low, driving outcomes that are not in the best interests of shareholders.

Figure 20: ASX 200 CEO Tenure

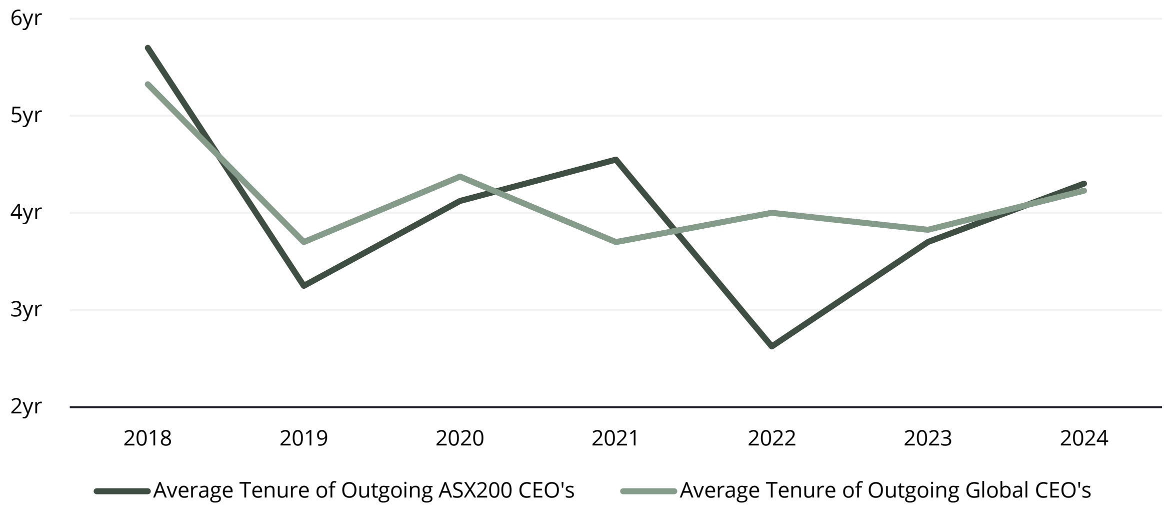


Source: Jefferies, FactSet

Outgoing CEO tenure has fallen since 2018 (see Figure 21); thus, CEO's have less time deliver positive shareholder outcomes, either being at risk of termination by boards or leaving of their own accord. It is likely that if a CEO delivers negative returns after three years, their overall tenure is at risk.

Turnover has been rising for several reasons, but implicitly, it is the speed of information that is driving this change. Technology and regulatory changes make navigating strategic changes more challenging and with increased communication comes increased awareness and hence increased pressure from shareholders. This leads to increasing focus on seeking short term wins which sharpens the focus of CEO performance over short term goals. Engaging all stakeholders, from shareholders to employees to customers has seen the CEO role become higher profile and increases the perception of the CEO on the premium or discount applied to the company valuation.

Figure 21: Average Tenure of Outgoing CEO's



Source: Russell Reynolds

Much of this short termism is led by the structure of the funds management industry which itself faces quarterly and yearly reporting pressures. This narrows the focus to a disproportionate time spent on short term issues, rather than longer term strategic issues.

One interesting fact, is the tendency for corporate governance scores to be higher for boards and CEO's over shorter time periods. Companies with longer surviving CEO's (tenure greater than seven years) on average, have lower board and remuneration scores than companies with shorter CEO tenure.

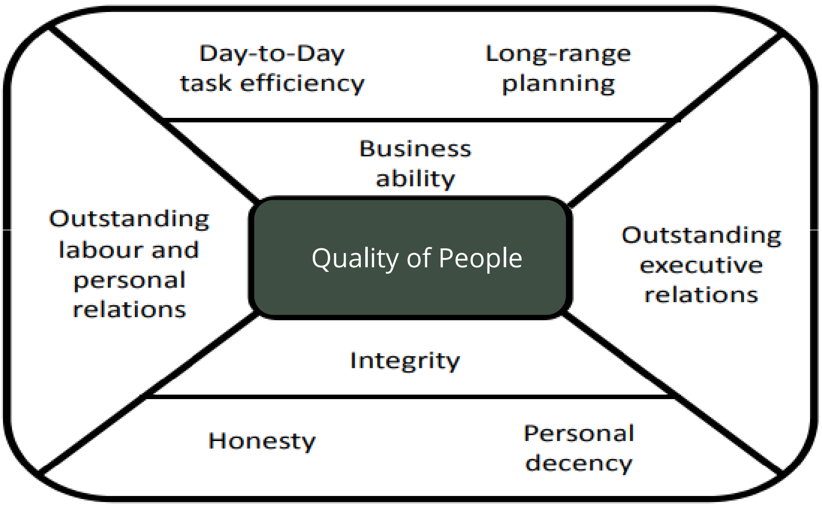
This doesn't reconcile with the fact that companies with longer CEO tenure consistently show better TSR's than companies with shorter CEO tenure.

The inference of this data is clearly that incumbents can lead to CEO power, which leads to perceived key man risk, weaker governance structures, lack of succession planning and poor or excessive remuneration practices.

The idea that a majority of the board remain independent is very noble, however in reality, stronger boards are those with in depth understanding of the company and the industry its operating in. Knowledge and understanding of a company are often seen as jeopardising independence, thus boards with stronger knowledge of the company, are often seen as less independent from a corporate governance standpoint. For example, the appointment to the board of a long-term auditor is seen as not necessarily independent, but is most likely, a sensible addition to the board given the prior history of the company. We prefer boards to have longer terms, as 6–9 year revolving appointments give a stronger appearance of company and industry expertise.

We really look for high quality people to run our capital, while this is a subjective view, we spend a lot of time thinking and assessing senior managers. The first rule of investing really is - if you don't understand it, don't buy it. If we don't understand the CEO's incentive structure, motivation or strategy, or are uncomfortable with it, then we don't own the company.

Figure 22: What We Look for in Management Teams



Source: Phillip Fisher, The Great Investors

Figure 22 is an illustration of what we are looking for in management teams. The difference between outstanding companies and mediocre ones is the quality of the people.

It is common for executives to have one strength from Figure 22 but not all, i.e., it is uncommon to find an executive with brilliant long range planning skills, and excellent day to day operational skills. For example, Professor Graeme Clark, the founder of Cochlear (COH), springs to mind as a pioneering entrepreneur, handing over the reins to Chris Roberts in 2004 who's operational skills were needed to steer the company through its next phase of growth. But it would be wrong to discredit Graeme Clark with COH's commercial success. Two very different skill sets. For real success, both skills are necessary.

We also find integrity as a key trait of highly successful executives. CEO's and management that possess honesty and personal decency in their business dealings. We find that owners of capital are more likely to act in the best interests of shareholders over the long term, and less likely to act in their own best interests in maximising profits over the short term. Understanding the integrity of CEO's can only come from witnessing them in different environments and also relies on industry contacts to understand how CEO's interact with all stakeholders. We are often wary of great salesmen. Great salesmen can sell anything and present beautifully but often lack the substance of intimately understanding the operations and are likely to gloss over any bad news. We respect CEO's who present results, both good and bad, with full accountability.

A successful CEO also needs very strong labour and personal relationship skills. We think there is a strong case to have employee engagement scores rank equally with quantitative financial outcomes for measuring CEO incentive plans. Clearly employees who are engaged and 'buy' into the company strategy and philosophy is the key to creating sustainable businesses. We have all seen examples whereby employees actually create the success or demise of a company image. Any customer facing role in retail, transport, tourism, healthcare, banking and finance has the ability to create perceptions around that brand based on everyday interactions. A successful CEO will harness this power with leadership that directly shapes the thought process and workplace enjoyment of every single employee.

What We Look for in Management Teams

Strong cultural ties also bind employees to companies as they enjoy working for the company. This can ultimately lead to lower salary costs and greater productivity as employees feel worthy and are recognised for their contribution. Again, very hard to quantify but vitally important to the ongoing success of a business.

Finally, the CEO must also demonstrate outstanding executive relations. The best run companies always hire from within because the value system of succession planning candidates is well known and ensures continuity of the culture. It also ensures that senior managers can aspire to further their career at the organisation, thus retain the idiosyncratic knowledge that comes with a deep understanding of the company internal workings.

A vital role for senior management is to identify and train motivated and talented juniors for succession. Assigning each senior manager autonomy to carry out designated responsibilities enables possible CEO candidates to develop the appropriate skills for succession. Thus, a successful company doesn't just rely on the CEO, but the CEO is happy to let other executives take responsibility for important company operations. An interesting statistic is the difference between CEO salary and the level of pay of senior managers. If the difference is too wide, it is more likely that the CEO wields too much power, and not enough responsibility is passed down to potential replacement candidates.

We believe the longer the CEO tenure the better, outside removal for obvious flaws in the company strategy, while being cognisant that different managers will perform better during different stages of the company's life cycle. For example, some CEO's are entrepreneurial that build businesses, while other are brilliant operators of existing assets.

The median CEO tenure in Australia is approximately 4 years. This creates the powerful incentive to focus on short term results. Management stability is vital through changes in strategy and the execution of important projects. Alarm bells ring if changes of management teams occur in the middle of bedding down acquisitions or executing new projects.

We also find that CEO's ultimately have very little visibility of how their business will perform beyond the next quarter. They are receiving information from divisional managers who are also under pressure to perform. The inherent difficulty in forecasting consumer behaviour, currency, reserve bank decisions, commodity prices and macro events mean any guidance beyond this is only subjective.

We are wary of CEO's that spend too much time worrying about the share price. The focus should solely be on the process of driving a successful culture and reaching internal targets. The share price will be an outcome of these processes and be heavily influenced by macro forces.

We also watch for insider selling. Monetising value or "rebalancing" their private portfolio often means a CEO believes the best performance is behind the stock, while being mindful that there are often legitimate reasons for directors or management to sell small parcels of shares from time to time (taxes or divorce).

Chester Asset Management Summary

For various reasons, executive pay has risen disproportionately to average wages over the past 40 years. Looking at the ratio of executive wages to average wages and executive housing to average housing, we believe executives should receive a base pay no greater than $3.0m. More than this is deemed excessive, regardless of the size of the organisation. This should grow broadly in line with average wages, with a detailed explanation as to why any CEO is paid above this in their fixed component of salary.

Incentive programs should be unique to the company and in many cases to the individual, as well as understanding the risk profile and tolerance, and personal wealth outside the firm, are important variables in setting appropriate incentive schemes. Ideally CEO's have significant personal wealth tied to the outcome of the firm being managed, we find that owners of capital, in general, are acting in the long-term best interests of shareholders, such that the alignment of interests is strong. Conversely, stewards of capital tend to have lower tenure and generally poorer TSR's. The more an individual's wealth is tied to an organisation, the better. In these circumstances, we also find that the executive incentive plans are less complex, something we are in favour of, which is very much against recent trends.

LTI's and even STI's granted should vest over 3-5 years, which is arguably against the wishes of managers, who overall, are risk averse and prefer cash in their pocket now. A CEO should always have their hurdles set before commencing their role, there is nothing more frustrating than seeing a CEO complete huge write-downs with profit warnings, and then re-basing the share price for the setting of performance objectives. Similarly, a CEO should exit the business with a substantial stake of "at risk" pay left in shares that vest after a suitable period post departure. This hopefully ensures they are always acting in the best interests of the company for the long term, and not just maximising profits during their tenure.

We prefer rolling 3-year earnings growth targets combined with a capital employed measure to any TSR (or RTSR) measures, as TSR can be heavily influenced by macro factors. CEO's should focus on the process of internal targets within their control, not share prices which have a myriad of external influences. Generating above nominal GDP growth on a rolling average 3–5 year basis should smooth year to year volatility and reward company's for generating above 7-9% earnings growth.

The ideal split between fixed, STI's and LTI's is approximately 40-50/30-40/10-20, while cognisant that many firms operate in deeply cyclical industries, where TSR and earnings growth is as much a function of the macro cycle as it is manager skill. In these cases, a strong argument can be made for higher percentage of fixed salary.

We believe the longer the CEO tenure the better, outside removal for obvious flaws in the company strategy, while being cognisant that different managers will perform better during different stages of the company's life cycle – i.e., some CEO's are entrepreneurs that build businesses, while other are brilliant operators of existing assets.

CEO's with integrity and highly specialised skills in managing labour relationships with both operational and long range strategic abilities are both very hard to find, and managers who we are happy to invest our capital with.

Conclusion

This paper has assessed the trend of rising executive compensation and determined that there is a finite level of acceptance before compensation becomes excessive. It then reviews the debate of owners of capital and stewards of capital and finds that owners of capital generate better total shareholder returns as they are better aligned to shareholders through founding the business, or having a significant portion of their wealth tied up as stock. Owners of capital tend to have CEO's with longer tenure and lower salary's on average, compared to stewards of capital. It finds that incentive schemes have become more complex over time and that the use of TSR or RTSR's as a benchmark for incentive schemes are unsuccessful. Incentive schemes should be more closely linked to internal targets and include a component of employee engagement as a measure of sustainability. Finally, it looks at traits that are admired in CEO's and what is sought when allocating capital towards companies.

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