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Ways to Counterbalance the Effects of Market Instability on Long-Term Incentives

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The compensation committees of most public companies and many private companies have already established their executives' incentive awards for 2025. However, they may have done so before market volatility intensified as a result of rising uncertainty about tariffs and US trade policy.

As boards struggle to understand the near-term effects on business overall, many compensation committee members are left with additional concerns about the impact of dramatic market swings on recently approved incentive plans. In particular, the motivational and retentive power of long-term incentives (LTI) could be in question, as LTI share awards can be subject to distortions based on volatility around grant date.

LTI Value Impacts

Typically, performance-based LTI awards are established based on a target value instead of a set number of shares. The number of shares awarded is an outcome of the target value and the stock price on the grant date. In other words, if the committee aims to deliver an award valued at $1 million, the number of shares granted will depend on how many shares are required to total $1 million, based on the stock price on the day of the grant.

Therefore, a spike in share price on the grant date will mean fewer shares are awarded; conversely, a drop in share price will result in a higher number of shares awarded. During periods of high stock price volatility, the impact on the number of shares awarded can be significant and can tangibly distort the delivery of targeted LTI value.

While LTIs are typically based on target value divided by share price on the date of grant, there are companies that grant stock options, and market volatility affects those programs as well. In these circumstances, market volatility is reflected in the strike, or exercise, price of the awarded options. In fact, the Black-Scholes model calculations required to determine the fair-value strike price include volatility as a key input. Higher volatility means higher option value, and thus fewer options are awarded.

For companies using an options-based LTI design, a lower award number can have more associated risk in realizing a monetary value commensurate with the expense of the award. Additionally, a lower award number can have lower perceived value to the incentive plan participant and diminished motivational effect.

Stock market volatility impacts a third LTI design element: Incorporating a relative total shareholder return (rTSR) component to the LTI awards, whereby start- or end-price volatility can artificially impact the number of shares earned. In this case, compensation committees measure performance over a three-year period as the norm and compare stock price growth to peer companies. If the starting point is unusually high on a relative basis due to volatility, future payouts could be lower.

Conversely, if the volatility has resulted in lower share prices with a corresponding larger grant of shares, then retention value may be improved. However, there are risks of misalignment with shareholders, delivering more value simply for getting the price back to a "normal" level, or creating undue pressure on dilution.

In each of these scenarios, boards should remember that long-term incentive plans based on stock awards inherently—and purposefully—represent at-risk pay for the executive team. They are meant to incentivize behaviors that drive value creation and to align rewards with the shareholder experience. That said, extreme volatility does introduce complications that can get in the way of spurring performance and aligning outcomes. Therefore, it is worth exploring ways that compensation committees can counterbalance market volatility so that it has less influence on outcomes.

Limiting the Influence of Volatility

For target-value awards, companies may choose to use an historical trading average, such as a trailing 20-day trading average, to calculate the share numbers rather than the closing stock price on the date of grant. This smooths out potential stock price fluctuations compared to using stock price on the grant date. It is required that this method be disclosed in the Compensation Discussion and Analysis section of the proxy statement. Additionally, the accounting value, and thus the proxy-disclosed value, will need to reflect the number of shares awarded multiplied by the stock price on the grant date, so there will likely be differences between the targeted value awarded and what is ultimately expensed and disclosed.

Proxy advisory firms typically do not object to this unless the disclosed value is significantly at odds with their models. A 20-day average usually does not cause issues; it is considered a smoothing practice rather than an attempt to game the system.

With stock option awards, it may be worth revisiting whether the award vehicle is appropriate. In circumstances or industries where it remains the best choice, companies may choose to use more frequent grant periods, such as quarterly instead of annual. Smaller technology companies, early-stage biotechnology firms, and various start-ups often take this approach, where frequent option awards help counterbalance lower cash compensation. This helps mitigate volatility, but it does introduce some complexity into accounting and plan administration. Moving to such a model as the established practice helps with any shareholder or proxy advisor objections.

Finally, companies using rTSR plans can expand the number of metrics that are included. While short-term incentive plans often incorporate revenue, profit, cash flow, and strategic goals, among others, rTSR is used as the sole metric in LTI plans about 40 percent of the time, as it can be difficult to set similar financial goals on a multiyear basis. Pearl Meyer has advised companies to balance the risk of market volatility inherent in rTSR plans by introducing some financial metrics, such as three-year revenue, earnings-per-share growth, or return on invested capital.

Clearly, these potential solutions will not solve issues present this year. However, the intensity of current market conditions and the recent setting of many LTI plans make this an excellent time to think through additional or alternative design decisions and have some mitigation ideas at the ready for 2026 planning.

About the Author

Steve Van Putten is a senior managing director with Pearl Meyer and leads the firm's efforts with respect to thought leadership and intellectual capital development. Steve's primary focus and expertise is on advising compensation committees and senior management on executive and director compensation matters. He has over 30 years of board-level experience consulting to Fortune 500 companies on executive pay.

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