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Is the Problem Stock Options—or Stock Prices?

If the stock market is nervous these days, half the reason is distrust of the information it's getting and the other half is fear of what government may do about it.

An important context for these concerns, we're here to tell you, is that a great deal of elite and expert opinion has been irked by the behavior of stock prices since the early 1990s. Alan Greenspan spent a recent speech assailing Wall Street's consensus earnings forecasts as systematically too optimistic. Joseph Stiglitz, a Clinton White House economist and Nobel laureate, lamented before Congress that companies have been putting out "misleading information," producing "overinflated stock prices" and an economy-wide "misallocation of resources."

The most visible and persistent promoter of this view, though, has been the Economist magazine, based in London. It flatly called on the Federal Reserve to "correct" stock prices by raising interest rates during most of the 1990s.

All of the above, interestingly, have linked their ideas lately with a proposal to require companies to deduct from reported earnings an estimated future cost for the stock options granted to management. Nobody quite claims that options are responsible for unacceptably high stock prices—there's too much economic data to suggest markets recognize these costs and adjust share prices accordingly. Rather, the anxiety seems to revolve around the unsightliness of large CEO rewards (especially in a climate of Enron) coupled with an intuition that stock-motivated managements are somehow behind "optimistic" earnings expectations.

Of course stock options are a business tool like any other, with costs as well as benefits, which the market is probably capable of sorting out. For that matter, companies are already free to deduct a present cost for the options they offer, and some shareholder groups are pushing for more to apply the rule.

It would be weird, though, if the markets did not already reflect this information in stock prices. We've been debating the rule change for a decade now and companies already report an estimate of what the impact would be on earnings per share. That's why we're led to the suspicion that the stock options debate is actually a poor and ill-fitting proxy for a bigger question on the minds of critics.

The real mystery is why stock prices grew so fast during the long bull market *despite* the relative lagging of earnings. From 1982 to 1998, earnings of the S&P 500 grew threefold but stock prices increased 11-fold. Investors went from paying $7.50 for every dollar of a company's current earnings to paying $33. Today investors are paying an astringent $45.

It's hard to see how arguing that current earnings are "overstated" does anything but deepen the mystery. Critics of options may hope that throwing the cost into earnings, even if it's already recognized in stock prices, will somehow shock investors into valuing shares differently. But the real action here is the "risk premium"—that is, the apparent willingness of investors to accept returns on stocks that are closer and closer to the returns on a supposedly riskless Treasury bill.

This declining risk premium, according to some analysts, is merely a function of investors finally figuring out that stocks are a safe bet in the long run despite alarming moments along the way. Another plausible answer, though, is that the risk premium has declined because the risks have.

After all, economic policy has improved with government committed to price stability and tax policies that don't squash incentives. Likewise, the growth of popular shareholding has confronted politicians with a voting constituency concerned about the value of its portfolios. If recessions are destined to become shallower and less frequent, that alone justifies a big decline in the risk premium.

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Corporate governance has improved too, thanks to hostile takeovers, activist shareholders and a new cultural emphasis on shareholder value (of which compensation policy may or may not be a relevant part). Many of these gains, though, are subject to political reverse. The big worry has to be whether Washington's war on "misleading information" and "overinflated stock prices" might cross the line into policies that are bad for markets because they're bad for the economy.

Getting back to CEO stock options, some dwell on the paucity of data showing a systematic connection between stock-based compensation and company performance. This is the "appeal to ignorance" fallacy, which holds that if we don't know something is true, it must be false. The trouble here may be as simple as finding some apples to compare with apples. Investors in dot-coms wouldn't have been better off if they couldn't have used options to attract employees on the cheap and share the risks with them, but in the end most dot-com business models failed anyway.

More to the point, if options have a genuine incentive effect but management is capturing too much of the gains, the mystery is easily solved: options grants are too big. Now if academic economists want to do something useful, they would explore whether CEOs have gained outsized bargaining power in relation to shareholders and boards. Our guess is yes because so much of a company's stock-market value these days depends on the image and reputation of the CEO.

But even without the aid of learned economists, change is bound to come thanks to Enron and thanks to the eternal pressure on companies to improve returns. A safe prediction is that the next round of innovation in corporate governance will focus on giving boards and chief financial officers more incentive to rein in CEOs whose interests diverge from those of shareholders.