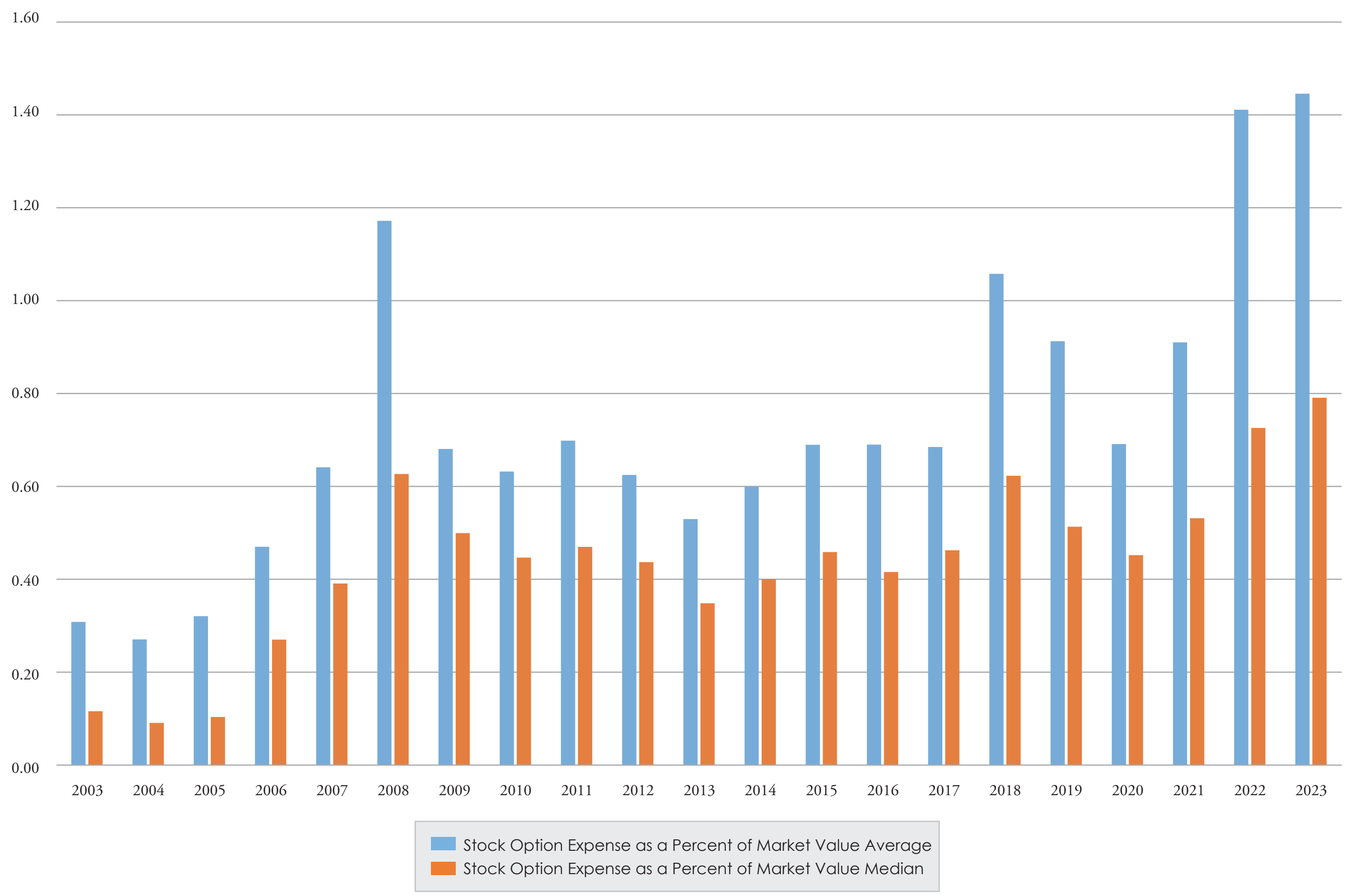
Stock Option Expense Has Become a Problem

The power of incentives has been well-appreciated in business for a long time. Charlie Munger, in a speech to an audience at Harvard University in 1995, has been frequently quoted as saying "Show me the incentives, and I'll show you the outcome."

Mr. Munger likely would have agreed that incentive plans ought to be structured properly to reward the outcome sought, and that they should also be appropriately proportionate to that goal.

Over the last 20 years, annual stock option expense for profitable companies in the Russell 2000 Growth Index has been growing both in absolute terms and as a percentage of the market capitalization of those companies. Chart 1, below, shows the average and median stock option expense as a percentage of market capitalization for the profitable companies in the index each year for the last 20 years.

Chart 1: Annual Stock Option Expense as a Percent of Market Cap
Profitable Companies in the Russell 2000 Growth Index



Source: Renaissance Research, FactSet

By calculating stock option expense (SOE) as a percentage of market capitalization, we can normalize the expense over time to offset the effects of inflation and, more generally, the appreciation in value of the companies analyzed. The average SOE rose from 0.31% in 2003 to 1.45% in 2023, representing a 369% increase in the relative stock option expense over the past two decades. This equals an 8% annualized rate of inflation.

The average stock option expense in absolute terms has grown much faster. In 2003, the average stock option expense for profitable companies in the Russell 2000 Growth Index was $2.6 million. In 2023, that figure was $23.0 million, representing a 784% increase.

Stock option expense has not become a problem for all stocks in the Russell 2000 Growth Index. However, it is a phenomenon that warrants more attention in stock analysis. To the top right, in Table 1, we have summarized data from 643 companies in our Small Cap Growth universe, organized by deciles. The top decile represents the 64 companies with the lowest stock option expense as a percentage of market capitalization and the tenth decile represents the 64 companies with the highest. As can be seen from the last column, stock performance year-to-date has been highly correlated to SOE divided by market value. In fact, the correlation is -80%.

Another way to think about stock option expense is the level of dilution relative to the top line growth rate of the company. In fact, management teams of rapidly growing companies often have richer incentive plans in recognition of growth. If a company is growing at a 30% rate on the top line, a compensation plan that expands the shares outstanding 3% annually does not seem egregious relative to another with a similar comp plan while only growing at a 10% rate. To see if the market is reacting to this relationship in 2024, we ranked the companies in our Small Cap Growth universe based upon their fiscal year two expected revenue growth (higher is better) and their annual stock option expense as a percentage of market capitalization (lower is better). To the right, in Table 2, we combined these two metrics for an overall decile rank.

The 91% correlation suggests that this may in fact be a more insightful way to think about stock option expense.

One problem for many companies with rich incentive plans is that the structure of the plans is not always providing appropriate incentives. For example, I'm supportive of issuing stock options to management when those options have a strike price that is at or close to the market price on the grant date, as the executive makes money when the stock price moves above the strike price. However, in many of today's incentive plans, we often find the use of restricted stock units or "RSUs". RSUs are an outright grant of stock to an executive in exchange for work over a set period. There may be some goals to achieve during the vesting period, but those goals are often set at a low bar. The executive pays nothing for the stock and makes money even if the stock price is down during the period. How does this align the interests of shareholders with those of management?

We've recognized the potential dilutive effect of stock option plans for several decades. Therefore, as part of

Table 1

	Stock Option Expense as a Percent of Market Value	2024 Year-to-Date Total Return
1st Decile	0.11%	19.44%
2nd Decile	0.24%	28.77%
3rd Decile	0.35%	16.44%
4th Decile	0.45%	18.42%
5th Decile	0.61%	9.71%
6th Decile	0.84%	5.69%
7th Decile	1.09%	11.87%
8th Decile	1.55%	3.87%
9th Decile	2.38%	1.85%
10th Decile	5.49%	-5.52%
	Correlation	-80%

Data from 12/31/2003–12/31/2023
Source: Renaissance Research, FactSet

Table 2

	FY2 Expected Revenue Growth Adjusted for SOE Stock Dilution	2024 Year-to-Date Total Return
1st Decile	25.70%	27.80%
2nd Decile	16.50%	20.80%
3rd Decile	14.60%	20.10%
4th Decile	12.40%	18.80%
5th Decile	10.40%	7.40%
6th Decile	15.30%	8.50%
7th Decile	9.40%	3.70%
8th Decile	6.40%	5.50%
9th Decile	4.80%	1.60%
10th Decile	1.20%	-3.80%
	Correlation	91%

Data from 12/31/2003–12/31/2023
Source: Renaissance Research, FactSet

our quantitative framework, we measure growth on a per-share basis across all major income statement line items. This tilts our stock picks toward companies that are reducing outstanding shares and away from those with expanding share counts. Beyond this, understanding the scope and structure of stock option plans helps to identify companies with management teams whose interests are well-aligned with shareholders and those whose are not.

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REFERENCED INDEX

(Indices are unmanaged and are not available for direct investment.)

Russell 2000 Growth Index—The Russell 2000 Growth Index is composed of the smallest 2,000 of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecast growth values.

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