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September 20, 2006

***GUEST COLUMN — The Changing Total Reward Landscape in a Strengthening Labor Market: Challenges and Implications***

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Unemployment rates are at six-year lows, and companies are reporting aggressive hiring plans as they look to next year. Are we back to the turn of the millennium? Hardly! In 1999 and 2000, employee compensation packages looked a lot different than they do today. Before, companies had the benefit of multiple stock options to aid in the attraction and retention of talent. Now, as a result of FAS123(R), companies face significant institutional investor pressure to reduce stock option “burn rates” and to implement stock option expensing. Therefore, firms have dramatically scaled back option participation. Other facets have changed as well. For example, the 6-8% merit increase budgets seen in the boom are now 3-4%. Also, companies are now passing along to employees larger portions of ever-increasing medical insurance rates as they grapple with how to slow the costs of what CFOs have identified as one of their top three biggest concerns — rising medical costs and their impact on company budgets and profitability.

The challenges are huge. How do companies compete for scarce talent and try to retain the key employees they have, while ensuring that the nineties model of profitless growth doesn’t repeat itself?

First, we must look at where the labor market is today to understand the challenges ahead. The current economic landscape is looking quite strong for the first time since 1999-2000. Recent advanced estimates released by the Bureau of Economic Analysis show that for the first quarter of 2006, real Gross Domestic Product increased at an annual rate of 4.8%, jumping far ahead of the fourth quarter of 2005 which showed only a 1.7% increase. The unemployment rate is falling; down to a national average of 4.7% in March 2006. While this is not quite as low as the average was in 2000, the unemployment rate has significantly diminished since 2002-2003 where it reached a high of 6.5% in January 2003 (BLS).

With all of these economic leaps forward, what does this mean for the labor market? The labor market is growing, along with the economy, and jobs are continually being created. However, employees do not necessarily have more leverage over wages and compensation, despite the tight market. Salary increases are lagging, having only risen 0.6% in the first quarter of 2006, the lowest since 1999, according to a recent Dow Jones article. This is good news for employers, but employment costs most likely will begin to rise, meaning companies will have a harder time retaining key talent.

One untested factor that will make retaining key talent more difficult is the addition of stock option expensing. Stock option expensing, implemented in the beginning of 2006, means that companies now must subtract option costs from earnings, whereas in the past, stock option costs were relegated to the footnotes. The

impact of stock option expensing remains to be seen, but we do know that companies have scaled back on option plan participation to reduce their usage, which may mean that companies have less of an ability to both attract and retain employees. With greater turnover and less control, how do companies cope in this new situation?

First, both companies and their employees have to understand that total rewards, which include stock options, aren't the "be all/end all" in the game of attraction and retention. Companies need to be competitive with their total rewards, but rewards also have to be viewed as part of a broader system — what has been termed the "employee value proposition." According to a recent Culpepper and Associates study on recruiting practices, the top five factors rated as most beneficial to recruiting efforts, in order, were:

1. Interesting or challenging work projects
2. Excellent workplace environment
3. Above market base salary
4. Medical benefits
5. Paid time off

Compensation is often viewed as the most critical element, but it's not. It just happens to be the most tangible element, and frequently the easiest to address. Focusing solely on compensation, or viewing it as the most important element of the equation, can and often does backfire — you are able to get the people you want, but you don't end up keeping them.

What are the things that companies and managers should be doing in the compensation arena?

1. Ask employees what they want. When you have a limited pool of dollars that can be spent, it is critical to gain the maximum value that you can from those dollars.
2. If you have reduced option participation, understand the impact and make sure your employees do, too. While perhaps competitive, it has altered the employee/employer value proposition, and smaller companies, which continue to grant more broadly based options, may have a leg up in attracting and retaining key talent.
3. Understand what you have to pay to attract and retain top talent, not just the market median. Ensure your key employees are appropriately paid, as it is a lot easier to keep key talent than to replace it.
4. Provide some form of upside opportunity that allows key employees to share in the success of the organization.
5. Make decisions quickly, particularly relative to offers. Top talent today often has multiple opportunities.
6. Make communication of total rewards, and the value provided, a key priority — value isn't maximized if it isn't understood.

While these suggestions seem easy and straightforward, very few companies do them, or do them well. Implementing them can be a key source of competitive advantage in your quest to attract and retain top talent.

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