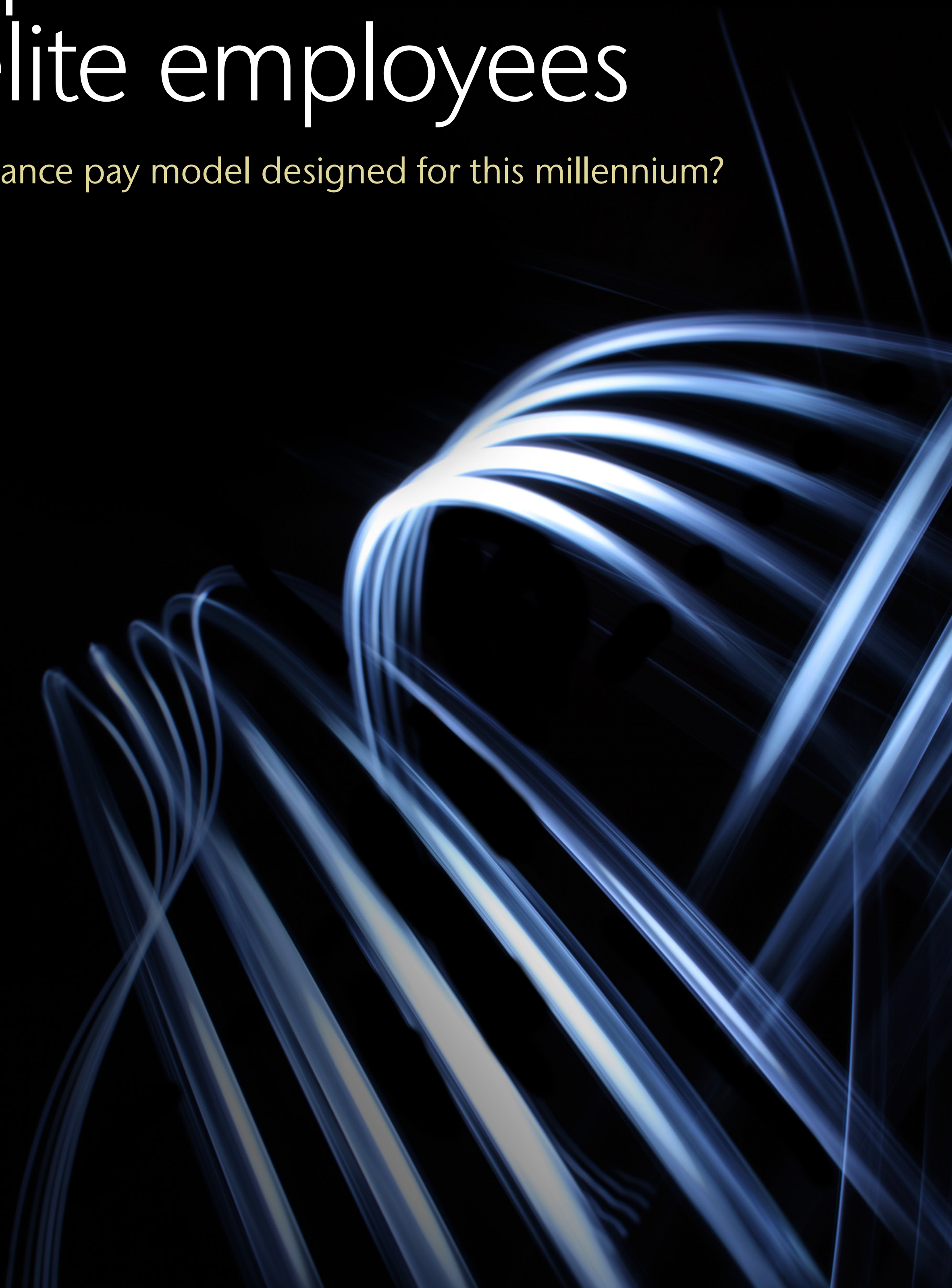
High performers and elite employees

Is your performance pay model designed for this millennium?



Empower Results

#1

Aon Hewitt‘s remuneration database is the largest and most comprehensive in Australia.

Is your performance pay model designed for this millennium?

A lynchpin of talent strategies in today's leading companies, and Aon Hewitt Best Employers, is to differentiate based on individual performance. We advocate it, our clients embrace it and the research[1] shows it works. But do we truly understand high performance? How prevalent, impactful and sustainable is it in today's environment?

Existing approaches to linking pay and performance are based on long-held assumptions about performance that it is now time to challenge. Research suggests that a small number of exceptional performers may be delivering outcomes far superior to those predicted or measured by traditional workplace models and, thereby, dominating productivity in modern workplaces. If we believe that increasingly, "Superstars make or break an organization, and the ability to identify these elite performers will become even more of a necessity as the nature of work changes in the 21st century"[2], then the rules of engagement around measuring and rewarding individual performance must change. Engaging and retaining our elite employees is a must.

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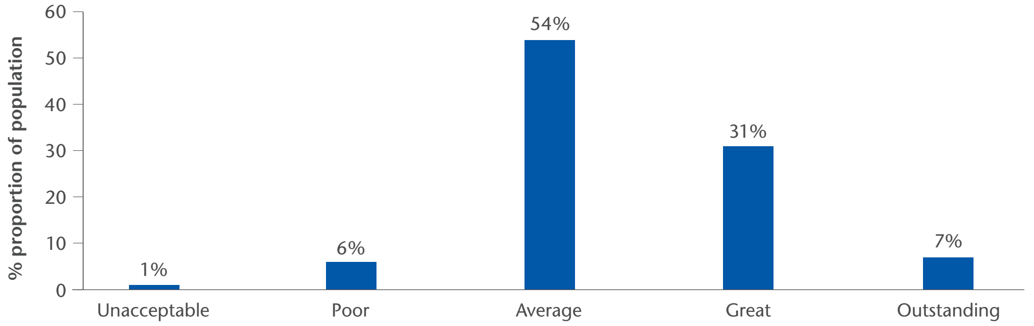
Is the performance bell-curve a myth?

It is a long-held assumption that the incidence of performance within an organisation will be normally distributed, with a clustering of results around average, and outliers spread equally around that mid-point. Indeed, existing performance rating scales with their consistent performance increments (performance steps from 3 at Average to 4 at Great and 5 at Outstanding) support this premise. While most organisations struggle to fully realise a bell curve distribution in practice – with results skewed to high performance (Figure 1) – it is clear that this is the market's underlying intent.

Figure 1: Australian market performance rating distribution



Source: Aon Hewitt General Industry Remuneration database, June 2014.

But does the bell curve approach truly account for the full range of performance outcomes achieved? A recent study[3] suggests not; finding that performance in the fields of research, entertainment, politics, and amateur and professional sports more closely resembled a Pareto distribution[4] (Figure 2) than a bell curve in 93% of cases. The Pareto distribution is sometimes referred to in conjunction with the '80-20 rule', where 20% of the population explains 80% of the outcome. In other words, the majority of performance was delivered by a small number of 'Superstars', with a sharp drop off in performance to the majority.

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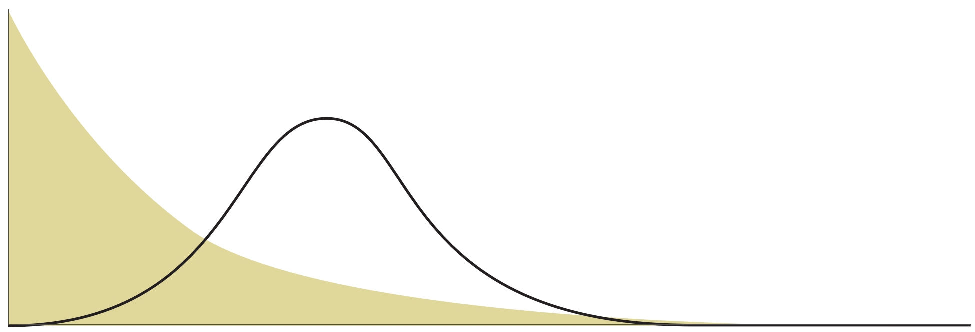
1 Studies on the Aon Hewitt Best Employer database (2013) show that 70% of employees in Best Employers gain a clear benefit from being a high performer, compared with 41% in other organisations.

2 Cascio, W. F., and Aguinis, H. "Staffing Twenty-first-century Organizations." *The Academy of Management Annals* 2.1 (2008): 133-165.

3 O'Boyle Jr., E. and Aguinis, H. (2012), "The Best and the Rest: Revisiting the Norm of Normality of Individual Performance", *Personnel Psychology, 65: 79–119.*

4 A skewed, heavy-tailed, power law distribution that is sometimes used to model the distribution of incomes and other financial variables.

Figure 2: A Normal distribution *(Black)* overlaying a Paretian distribution *(Cream)*



Source: O'Boyle and Aguinis[3].

While there are clearly factors among the fields tested (eg publicity) that aren't typically at play in corporate roles, there is some intuitive appeal to the overall finding in the context of contemporary knowledge-based workplaces. As we move away from manufacturing and hierarchical environments which were the dominant workplaces in the mid-20th century when the performance bell curve was first popularised, it makes sense that "instead of a massive group of average performers dominating production through sheer numbers, a small group of elite performers seem to dominate production through massive performance"[5].

As work becomes more individualised and less process-oriented, there is greater capacity for individuals to differentiate themselves through performance. Consider that when Steve Jobs was named Harvard Business Review's Top Performing CEO in 2010, he was responsible for total shareholder return double the average of the next four ranked CEOs[6]. However, if performance really does follow an 80-20 pattern in the modern workplace, it would have dramatic implications for employee performance and pay strategies. Our traditional performance assessment approaches could be said to inadvertently elevate the performance of the average worker relative to their high performing counterparts, and underplay the degree of superior performance that is observed in reality. Aon Hewitt has interrogated its extensive remuneration and performance databases to test for additional insight.

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Consistently outstanding performance is rare – sales performance follows a '40-20' rule

In the 2013 performance year, just 7% of the workforce was rated as having displayed Outstanding performance[7]. Of this group, only 46% (or just over 3% of the total workforce) had been rated as Outstanding performers one year prior[8]. We estimate this falls to 1.6% of the workforce when three successive performance years are considered, and just 0.4% after five years[9].

The good news is that we are clearly 'zero-basing' our performance decisions – assessing contribution annually and not just rating performance based on prior reputation. But does this instability in the highest performance ranks debunk the notion of superstars or, in fact, differentiate the elite from the merely very good?

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5 Aguinis, H. and O'Boyle, E. (2014), "Star Performers in Twenty-First Century Organizations." *Personnel Psychology, 67: 313–350.*

6 Hansen, M.T., Ibarra, H., Peyer, U. , "The Best-Performing CEOs in the World", *http://hbr.org/2010/01/the-best-performing/ceos-in-the-world/ar/1*, January 2010.

7 Aon Hewitt General Industry Remuneration Report, June 2014.

8 Same incumbent analysis – 2013/2014 Aon Hewitt General Industry database.

9 Predictive model assuming same year-on-year performance patterns as 2013/14.

Here's what we found:

- Around 2.3% of the workforce in any given year[10] is moving each way between Great and Outstanding performance. So 1 in 3 of our top performers are consistently very good but not necessarily elite – their performance is not dominant versus their peers.
- The path to and from Outstanding performance is mostly incremental (that is, to and from Great performance), but around 1.4% of the workforce (or 1 in 5 of our top performers) makes the leap directly from Average to Outstanding (or vice versa). The each way nature of this movement shows a significant volatility in performance outcomes that is inconsistent with truly elite performance.
- The probability of remaining an Outstanding performer year-on-year differs by job family – Senior Executives and those working in Administration are more likely to remain consistently high performers, with performance for IT and Project Management professionals showing the greatest year-on-year variation. Roles with more objective and time-based performance criteria appear to show greater volatility in performance.

Our results suggest that the majority of the workforce is well-served by the current performance-against-objective model. Employees are being assessed against a range of criteria and targets that presumably become more difficult as skills are mastered and thresholds reached, resulting in variability in year-on-year performance. The majority of employees' performance can be comfortably placed on a 5-point scale relative to their peers in any year.

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But the results do not provide sufficient insight on the top 1% of the workforce (or around 1 in 10 of our best performers) who achieve outstanding performance levels on a highly consistent basis. They clearly outperform their peers – but by how much? Are their outcomes only incrementally ahead of their peers, as suggested by the 5-point rating scale, or are these individuals, in fact, our 'Superstars'? Are they really '6's' or even '8's' on a 5-point scale?

Without collecting raw performance data, this is a difficult question for Aon Hewitt to answer. However, we have considered sales compensation as a proxy for hard performance outcomes, with interesting results. As can be seen in Figure 3, while we do not see the majority of performance outcomes below average (as would characterise a Pareto distribution) we do see a clear trend towards a long-tailed distribution for high performance. In this instance, the top 20% of population accounts for around 40% of all sales performance – not as extreme as the Pareto distribution, but significantly more skewed than we'd expect from our traditional bell curve assumptions. We can see that, at least for sales staff, the performance (and pay) of our top half to 1% of the population is materially different from the remainder.

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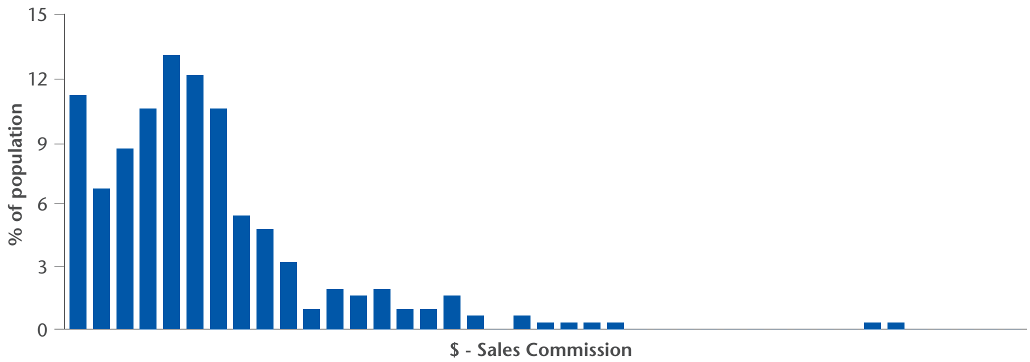
Figure 3: Distribution of sales commission data as a proxy for underlying performance



Source: Aon Hewitt AIIA Remuneration database, August 2014.

[10] Based on 2013/14 performance movements.

Worth consideration

While our insight is far from definitive, and it is noted that sales forces are one of the employee groups more commonly thought to have non-normal individual performance distributions, the possibility of a non-bell curve individual performance distribution is worth considering as technology prompts rapid change in formerly traditional workplaces. The research and data suggest three key implications for performance pay models.

Implication #1: Fixed remuneration linked to potential

The instability of high performance for the majority of our best performers places a question mark over the long-standing practice of the 'merit matrix'. While 91%[11] of organisations currently link fixed remuneration to performance ratings in some fashion, ratings are a somewhat blunt instrument in this context. Performance ratings reflect past performance and, as we've seen, are not necessarily a strong indication of future contribution. In addition, ratings determined in a performance-against-objective model are measuring a narrow facet of talent (the execution of this year's objectives) and have typically already been rewarded through incentive payments. Finally, due to the constraints of the standard 5-point scale when assessing elite performance, our data suggests that the difference between fixed remuneration for an Average performer and a 'Superstar' over a 3-year period is only 9%[12] – not really reflecting the difference in impact between the groups. Surely there is a better way to determine an employee's relative worth reflective of the skills they have acquired, the work-related behaviours they display and the track record they have consistently demonstrated? That is, can we differentiate fixed pay using something more predictive of future impact?

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One option to better align pay with value-add might be to link fixed pay to potential – not our traditional succession planning 'ready now/ready later' model of high-potential, but a series of key characteristics that are found to be truly predictive of success within the organisation. This is very hard to do at current levels of talent calibration sophistication, and perhaps less necessary while promotion is helping the fixed remuneration of our highest potential employees keep pace, but it may become critical as workplaces are increasingly fluid and less hierarchical. The oft-cited maxim that you promote on potential but pay only for performance may no longer hold true in the contemporary workforce.

Implication #2: Differentiate between Outstanding and Elite when it comes to pay

There has been much recent discussion about the shortcomings of current performance management approaches. Some have gone so far as suggesting that performance ratings should be disbanded altogether. Aon Hewitt's view is that surrender is not a strategy[13] – and performance ratings should remain firmly in place. However, we do recommend that organisations are clear about the purpose of performance calibration and tailor their approaches accordingly.

Research suggests that incentive level has no bearing on whether or not below average employees ultimately improve performance.

While there are some good developmental reasons to calibrate categories of below-average performance, *for the purposes of pay differentiation* we would propose that it is a low value exercise. Knowledge-based organisations would be better off spending time and resources identifying elite performers from their outstanding peers and remunerating accordingly. Take Figure 4 for example. Current market practice is to reward high performers around 50% more than average performers and below-average employees around 50% less. However, our research suggests that incentive level has no bearing on whether or not below average employees ultimately improve performance[14].

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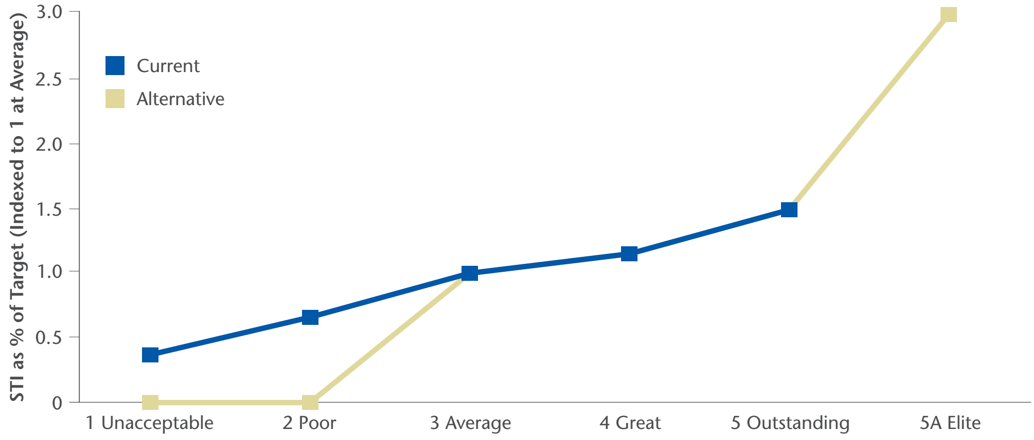
11 Aon Hewitt HR Policy and Practice Report, October 2013.

12 Based on a 2012 General Industry merit matrix and assuming performance based on 2013/14 performance movements.

13 Aon Hewitt July 2014, "Surrender Is Not a Strategy – Win the War for Talent through Performance Management that Delivers on Its Promise", Whitepaper.

14 Incidentally, around 50% will improve and 50% will remain in the categories below average.

Figure 4: Alternative STI payouts across individual performance levels



Source (current): Aon Hewitt General Industry Remuneration database, June 2014.

At the same time, we know that:

- high performers self-select to organisations that offer higher pay to top performers[15]; and
- organisations with highly engaged workforces strongly differentiate pay according to performance (Figure 5).[16]

Figure 5: Distribution of Shot-Term Incentive outcomes, by organisation engagement level

Source: Research from Aon Hewitt Best Employer database 2012, correlated with remuneration databases.

Why would we direct funds to our below average performers at the expense of our elite?

Why then would we direct funds to our below average performers at the expense of our elite? An alternative approach (Figure 4) delivers the same overall spend but leads to significantly better retention of critical staff for the organisation. Clearly, super-normal payouts would need to be accompanied by super-normal achievements as measured by 'super' stretch targets. It is not necessary to add performance rating categories to reward elite performance – organisations could simply identify in the implementation of pay structures that performance ratings are only the 'first pass' of performance differentiation. There may be need for greater pay differentiation within high performance rating bands. That is, one pay packet doesn't fit all.

One pay packet doesn't fit all.

[15] Aon Hewitt Best Employer research 2012.

[16] Aon Hewitt General Industry database, June 2014.

Implication #3: Less collectivism in pay models

If performance is truly long-tailed at the high end, it makes sense for pay to be also. But this has significant implications for our traditionally egalitarian pay models. Even in this era of pay for performance, pay is delivered with only minimal skew towards the highest performers. Currently, the top 7% of performers account for 9% and 12% of fixed remuneration increases and bonus payments respectively[17]. If elite employees are "compensated in ways reflective of their contribution, then it is possible that top performers may not earn just a bit more than their peers; rather, the pay disparity between elite and nonelite could rise to 5-, 10-fold, or even higher"[5]. While there are some industries – such as finance sectors – showing comfort with this recognition of 'Superstars', it is clear that general industry in Australia is still paying in a way that suggests competitive advantage will be achieved by strong average performance rather than through a vital few employees (see Figure 6). This may or may not be appropriate depending on where value is created within the organisation.

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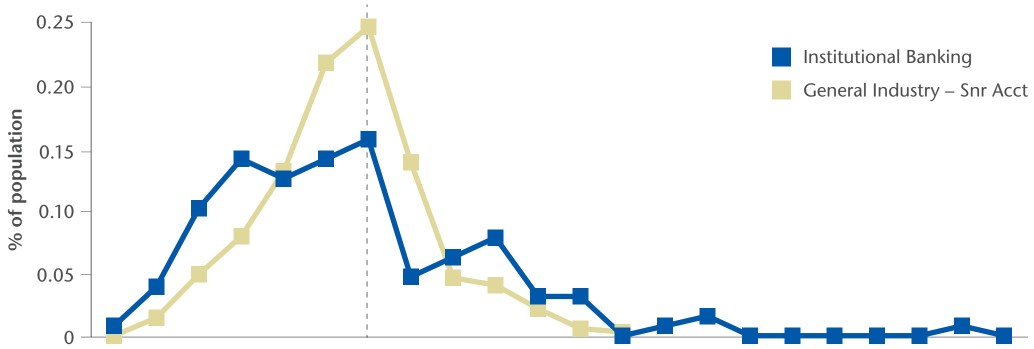
Figure 6: Distribution of Total Remuneration Outcomes around median – Investment Banking and General Industry (Accountant)



Source: Aon Hewitt proprietary surveys.

Final thoughts

The existence of elite employees will be determined by the nature of an organisation's business and the scope for individual impact. To identify elites, we will need to be open to the possibility that they exist – and not force their outcomes into models built for the average performer. To retain and engage elite employees will demand individualised pay structures that truly reflect contribution. Priority should be given to elite employees in critical business units – while superstars may exist in all areas, their outsize value to the organisation is in bottom-line productivity. As Australian business recognises the need to push for productivity gain through innovation rather than cost savings, how well will your organisation's pay structures keep pace?

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[17] Aon Hewitt General Industry database, June 2014.

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