These CEOs Are Bleeding Your Investments

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We all love great, profitable companies, but the managers to whom we entrust our investments could be robbing our companies blind in a completely legal way. Research now suggests that high executive compensation is one of the clearest signs of a company's long-term *underperformance*. That means that if you're looking for great stock market gains, then you have to dig much deeper than the traditional financial metrics. As time goes by, these overpaid managers will kill your returns if you don't spot them.

You're paying for CEO over-compensation. Yes, you.

Executive compensation forms the basis for one of the fiercest debates on corporate governance. While one side argues that the government must rein in lavish pay, another side contests that the free market has to be left to decide. Proponents of the status quo suggest that if companies were unable to pay high salaries then they simply wouldn't be able to attract top talent. Their opponents argue that bidding for executive talent pushes compensation well beyond reason, hurting all companies and their shareholders.

New research on compensation suggests that highly paid CEOs are taking money out of your pocket. Finance professor Raghavendra Rau of Purdue University and two co-researchers examined the relationship between executive pay and stock returns for around 1,500 businesses per year over the 12-year period ending in 2006.

"They found that the 10% of firms with the highest-paid CEOs produce stock returns that lag their industry peers by more than 12 percentage points, cumulatively, over the next five years," according to Jason Zweig in *The Wall Street Journal*.

The issue of management compensation was absolutely central to the decision of megabanks such as Bank of America, Citigroup, and Wells Fargo to repay their government-funded TARP loans. Managers at these companies wanted out of any government restriction on their pay. As my Foolish colleagues Morgan Housel and Ilan Moscovitz have argued, pay is the key reason that executives are trying to worm a way out of having their big banks broken up, since such Bankensteins pay lavish bonuses but are *not* more efficient than their smaller peers. Our experience with banks over the last two years certainly suggests there might be something to this over-compensation thing.

Even more stunning is the effect that the CEO compensation has on ordinary shareholders. Zweig explains:

> Companies at the top of the pay pile, Prof. Rau concluded, award their CEOs an annual average of $23 million -- but leave their shareholders poorer (relative to other companies in the same industry) by an average of $2.4 billion per year. Each dollar that goes into the CEO's pocket takes $100 out of shareholders' pockets.

That's the kind of action that will quickly kill your long-term returns.

This trend seems to be confirmed by another study on compensation by Lucian Bebchuk at Harvard Law School. Bebchuk examined CEO pay at more than 2,000 companies. He concluded that the higher the chief exec's proportion of pay, the less the company was likely to earn in the future.

Even worse

Perhaps what's most shameful about this compensation debacle is that the shareholders' representative -- the board of directors -- often abdicates its duty to represent and defend shareholders against management. After all, pay is set by the board, which is often cowed into surrendering shareholders' profits in exchange for lavish compensation packages. Consider the case of Chesapeake Energy, whose board acts as if the company were run for the benefit of CEO Aubrey McClendon.

In the run-up to the commodities peak of mid-2008, McClendon owned a ton of Chesapeake stock, and had borrowed against it. As the price of natural gas flamed out faster than New Coke, Chesapeake's shares plunged, leaving the CEO with a massive margin call. Ultimately, the board covered the tab of his ill-advised borrowing, and provided him with more Chesapeake stock to make up for his losses.

As if that sweetheart deal weren't enough, the board also had the company purchase McClendon's antique map collection for the "low, low price" of $12 million. That's shareholders' money (your money, if you own Chesapeake) going to bail out the CEO.

The litany of highly paid CEOs and mediocre company performance is astounding, but one of the most extraordinary is the case of Home Depot and its ex-CEO Robert Nardelli. When Nardelli walked away after six years on the job, he was handed a severance package that was valued at some $210 million. Home Depot's stock finished basically flat over his tenure. While annual net income doubled during Nardelli's time as CEO, it is now about 10% lower than when he took office in December 2000.

High pay might *maybe* be excusable if a board of directors were able to scientifically distinguish genuine managerial skill from dumb luck. But they simply aren't able, according to many experts, because there are too many factors that affect a company's fortunes. For this reason, a board's efforts to incentivize high performance with only high pay can be nothing other than ham-fisted.

The extra dangerous part for you is that these executives move on to other companies, earning another fat paycheck and accomplishing precious little. Nardelli went on to private equity firm Cerberus Capital, which appointed him to head up Chrysler, a company the firm had acquired.

Management matters

Because management has so many ways to take advantage of shareholders, it's absolutely vital that you examine how well they act as stewards of your capital. That's one of the key criteria that Motley Fool co-founders Tom and David Gardner use when evaluating companies to recommend for their monthly investing newsletter *Motley Fool Stock Advisor*.

The passion and shareholder-friendliness of Costco founder and CEO Jim Sinegal led Tom to recommend its shares to members. Similarly, management values espoused by Whole Foods Market founder and CEO John Mackey were a key reason that led to its recommendation in the newsletter.

If you'd like Tom and David to help you find shareholder-friendly companies that they believe are likely to outperform, you can check out all of our *Stock Advisor* research, including all past issues, free for the next 30 days.

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