How CEOs steal from your 401(k)
The fat cats now keep almost 10% of profits for themselves, siphoning off money that could've boosted the share prices of the stocks you hold. And the worst of them may take much more.

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Did a gang of greedy CEOs make off with your 401(k)?

A surprising number of seasoned experts maintain they did -- or at least could be held responsible for a substantial amount of your losses.

Now, as the Obama administration attempts to rein in executive pay for companies that take tax dollars in bailouts, it's worth considering how that pay affects everyday investors trying to save for retirement.

Pay's impact on profits

"CEOs look at public companies like personal ATMs," said Daniel Pedrotty, the director of the office of investment at the AFL-CIO, which represents members managing $300 billion in pension assets. "They (the companies) are machines from which they extract as much personal wealth as possible."

Pedrotty's comments may come off as union rhetoric, but Harvard law professor Lucian Bebchuk puts real dollars behind the claim. The top five officers at major U.S. public companies extracted roughly a half-trillion dollars in pay, stock and perks over the past 10 years, pocketing about 9% of average corporate profits.

That's up from about 5% of profits a decade earlier, Bebchuk said. And it doesn't include severance or retirement pay so rich that it can make a shareholder's eyes bleed. The problems:

- Executive largesse siphons off profits that could have raised share prices. Americans invest roughly two-thirds of their 401(k) savings in stocks, which trade at a multiple of profits. A company that earns $2.20 a share might sell for $22 -- or 10 times annual profits, a fairly average multiple.
  If executives took a smaller slice, profits would be higher, and it's fair to assume share prices and 401(k) totals would be higher as well, said Paul Hodgson, a senior analyst with The Corporate Library, a research firm in Maine. How much higher is impossible to say, but "it's significant," Hodgson said.

- Pay isn't tied to performance. Investors might forgive this if CEOs were being rewarded for raising profits. But that's often not how it works. Some of the most spectacular rewards of recent years went to CEOs of companies now near collapse. (See "As banks broke down, CEOs cashed in.")

With performance falling through the floor, Bebchuk is scrambling to update his pay-versus-profit figures to see just how badly shareholders are being savaged. He suspects
that the percentage of profits going to CEO paychecks has soared as the bear market and recession have shredded bottom lines.

- Wild pay encourages bad behavior. Many watchdogs contend the lure of big paydays is part of what led bank and brokerage CEOs to encourage excessive risk taking, one of the causes of today's mortgage market meltdown. The resulting bear market has cost retirement savers $2 trillion and counting, The Wall Street Journal reports.

How do hefty paydays hit your 401(k)? Let's consider one shareholder horror story: KB Home (KBH, news, msgs).

A tale of 2 CEOs

In 2006, the Los Angeles home-building company's chief executive, Bruce Karatz, resigned after it and the Securities and Exchange Commission accused him of manipulating stock grants for executives.

But he'd done very well in 2005. Karatz's employment agreement promised he'd get between 1% and 2% of the company's pretax, pre-incentive-pay earnings.

In fact, his pay and perks amounted to a whopping $37.9 million. On an after-tax, after-paying-Karatz basis, he nipped 4.4% of the company's 2005 profits of $842 million. Add $118 million from the sale of stock options, and Karatz took home about 18% of what the company had earned.

At KB Home these days, Karatz's replacement, Jeffrey Mezger, presides over a mess. The real-estate market has collapsed, as has the company's stock price. A KB Home shareholder who bought $1,000 worth of shares five years ago has seen their value slip to around $290.

Mezger, like his predecessor, is also entitled to a portion of KB's pretax, pre-incentive-pay profits. But the company posted a $929 million loss in fiscal 2007, so this bonus amounted to nothing.

The CEO is still OK, though. His board awarded him a "discretionary" bonus of $6 million, and he ended up with total compensation of $16.4 million for the year.

In 2008, KB's board created a new standard for Mezger's performance awards, promising he'd get as much as $10 million if he just kept the company's losses below $300 million, according to documents filed with the SEC on Friday. KB's loss widened to $976 million in 2008. Mezger walked away with $9.6 million, including a $2.7 million bonus and $4.6 million in stock.

Can't walk away easily

So how does KB Home affect your 401(k)? Well, you probably own a piece of it.
If you have part of your retirement savings in a fund that mirrors the Standard & Poor's 500 Index (SINX) -- the most common type of index fund -- you've got shares in KB Home whether you like it or not. KB is among the 500 companies in that index.

Company 401(k) plans are increasingly dominated by index-based funds, which promise low overhead and returns that at least match the market. But they're tied to the stocks in an index; they can't pick and choose. As an S&P 500 member, it's probably in an array of other funds as well.

And there's the rub. Experts on both sides of the executive pay debate advise shareholders to "vote with their feet" and sell stock in companies where executive pay looks extreme. But if you invest through a 401(k), with a limited choice of funds, walking away isn't easy, said Amy Borrus, the deputy director of the Council of Institutional Investors.

Continued: The wrong rewards

You could move your money all into managed mutual funds, which have more discretion, but they may hold the same stocks, and they carry more overhead costs. You can move to bond or money market options, but returns over time tend to be lower.

And few retirement savers have the option or the time to manage individual stocks from their 401(k) and avoid these kinds of excesses entirely.

The wrong rewards

Just grabbing 9% of the bottom line is bad enough. But their pay has caused far more systemic ills, said Sarah Anderson, the director of the Global Economy Program at the Institute for Policy Studies, a liberal-leaning think tank.

CEO bonuses have been boosted in recent years for outsourcing jobs, firing U.S. workers and slashing worker pensions. Those actions pay off for CEOs (and sometimes their companies) in the short term; in the long term, they hurt workers and the economy, Anderson said.

Consider the subprime-mortgage meltdown. Many CEOs earned bonuses for short-term success like boosting the volume of new loans, not loan quality. That fed down to brokers, who earned commissions for making more loans rather than for making solid loans. Often, the riskier the loan, the higher the commission.

"The way CEOs were paid was based on revenue growth, so they threw their companies toward riskier and riskier business," the AFL-CIO's Pedrotty said. "Then they cashed out before the bubble burst and left all of us holding the bag."

Again, how does this hit your 401(k)? Well, you probably own a piece of Citigroup (C, news, msgs), one of the 30 companies that make up the select Dow Jones Industrial Average (SINDU). Then-CEO Charles Prince took in a total of $41.5 million from 2005 through 2007 as the bank
delved deep into the credit mess. From around $50 at the start of 2005, shares have fallen to around $2.50 today.

Reining in pay

So what can be done?
President Obama drew a line in the sand Feb. 4, announcing strict caps on CEO pay for bailout companies that take taxpayer money through the Troubled Asset Relief Program.

But all executive pay is partly subsidized by taxpayers, Anderson said. That's because most pay is tax-deductible. She maintained that direct taxpayer subsidies of runaway CEO pay amounted to $20 billion annually before the current crisis.

She said the government should demand pay caps -- or at least take away tax subsidies -- at all U.S. companies.

Other solutions

That call may sound extreme, but it reflects a growing shareholder rebellion. As anger has soared, an increasing number of companies are acceding to "say on pay" proposals that give shareholders an advisory vote on CEO pay packages. The huge problem: Company boards are not legally compelled to listen. (Read "How to fight greedy CEOs" for more.)
A more effective idea may be revived, however. The Obama administration has appointed a team of experts to look at something called proxy access. This would give shareholders the right to fire a member of a board of directors and propose a replacement.

Directors, who are supposed to represent shareholder interests, approve CEO pay. So if they're giving away the store, shareholder advocates have long argued that shareholders should be able to fire them. But under current rules, they can only "withhold" a vote for a director. Company managers also select the nominees, so a bad CEO can continue to stock the board with his cronies.

Meanwhile, Congress is talking about ways to fix a looming retirement-saving crisis. Many investors have seen savings of a decade or longer cut by 30% or 40% or more.

So far, the politicians haven't put high executive compensation and the 401(k) problem together. They should. With about $2.7 trillion invested in 401(k) plans (at the end of September 2008, according to the Investment Company Institute), we've got a lot riding on it.

"In terms of contributing to the market downturn, we are very confident that bad executive compensation has had a very significant impact," said The Corporate Library's Hodgson.

At the time of publication, Kathy Kristof did not own or control shares of any company mentioned in this column.