Chesapeake and the Executive Pay Sell Signal

Reuters
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As Chesapeake Energy Corp shows, fat executive compensation all too often comes twinned with lousy investor returns.

Shares of Chesapeake have tumbled in the last two weeks after revelations by Reuters of unusual and disturbing pay and other arrangements between the company and its CEO and founder Aubrey McClendon. McClendon borrowed up to $1.1 billion to fund private investments he was allowed to make in company oil and gas wells under its "Founder Well Participation Program," a hilarious euphemism if ever there was one.

He also was, at least from 2004 to 2008, actively helping to manage a $200 million hedge fund that speculated in commodities his company produced.

McClendon is to relinquish his role as chairman, the SEC has launched in informal investigation and rating agency S&P has downgraded the company on corporate governance concerns. Meanwhile, since 2008 - the year McClendon was America's top paid executive - Chesapeake shares are down more than 50 percent and have underperformed the S&P 500 by about 5,000 basis points.

Don't say you weren't warned. In 2008 the company awarded McClendon a one-time $75 million "Well Cost Incentive Award" (which I guess raised his already high incentive to be Aubrey McClendon) and agreed to buy his map collection - yes, his map collection - for $12 million. McClendon has since agreed to buy back the maps, with interest.

You could argue that McClendon isn't at fault for the plunge in natural gas prices, which rocked his company. But by that logic you'd have been rewarding him in the first place for a natural gas price driven higher by Middle East instability and loose monetary policy, neither of which can be credited to the founder, whatever incentives he may enjoy.

Or consider Herbalife, a direct marketer, whose chief executive, Michael Johnson, was the top-paid U.S. executive in 2011, with total pay of $89.4 million. Its shares fell more more than 30 percent since famed short-seller David Einhorn asked pointed questions on its conference calls, queries that cast doubt on the sustainability of its growth and business model.

A LOOK AT THE DATA

Of course Herbalife and Chesapeake are just examples, so rather than argue from anecdote, let's take a look at the data.

A comprehensive 2009 study by Michael Cooper of the University of Utah and Huseyin Gulen and Raghavendra Rau of Purdue found that CEO pay is actually negatively related to future shareholder gains for periods of up to five years. To read the study, please click

Companies whose CEO pay is in the top 10 percent actually underperform peers by about 13 percent over five years, according to the study.

The absolute worst indicator is the value of options granted and long-term incentive payouts, upending the idea that fixing executive pay can be done simply by trying to tie executives' long-term fortunes to those of the company.

"Our results seem most consistent with the hypothesis that over-confident managers accept large amounts of incentive pay and with the hypothesis that investors over-react to these pay grants and are subsequently disappointed," the authors wrote.

I'd argue that high pay often comes to executives in industries and in companies that enjoy outsized success, most often due to factors beyond the CEO's control.

They are then duly over-paid and, the law of reversion to mean being what it is, often go on to lead their companies into periods of value destruction.

Another 2009 study by Lucian Bebchuk of Harvard, Martijn Cremers of Yale and Urs Peyer of French business school Insead, found lower stock market returns tend to go hand-in-hand with periods when companies are reporting an increase in the share of overall compensation going to top executives.

The authors also found an association between higher pay and lower accounting profitability, less-upbeat market reaction to company acquisitions, more "opportunistic timing" of CEO option grants and lower CEO turnover even if you control for performance and length of tenure.

The bottom line is that there is a market-failure in executive pay and shareholder relations that allows for abuse by insiders.

While this abuse is made possible by lax regulations and laws, how often it happens is as much a social as a legal phenomenon, which is why it doesn't happen in every company within a sector.

At the same time, executives who are bent on unfair self-enrichment will be more likely to make foolish or self-serving decisions about how to manage the business.

That explains Bebchuk's high pay companies where takeovers are badly received by the market; they are often perceived as empire building or nest-feathering rather than value creating.

Other than exercising their inadequate rights of control, shareholders ought simply to vote with their feet. It pays and it will ultimately lead to reform.