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High CEO Pay May Correlate With Lower Long-Term Stock Value, According To Two Studies

Huffington Post | Grace Kiser

The defenders of Wall Street pay usually rely on a rather familiar argument. It goes something like this: CEOs demand millions because they deliver profits, which are passed along to their shareholders. And, the argument goes, corporate executives who aren't paid well will simply pack up and take their vaunted leadership skills somewhere else.

(The argument has been a favorite of executives at near-failed companies like AIG.)

But two recent studies suggest that lavish CEO compensation may in fact *undermine* shareholder wealth.

In a study released last week, Raghavendra Rau and Huseyin Gulen of Purdue University and Michael J. Cooper of the University of Utah surveyed 1,500 companies that extended incentive compensation to their CEOs between 1994 and 2006, and examined whether pay correlated to stock performance.

The researchers compared CEO pay across their data set and found that the 10 percent of companies with the most highly paid CEOs earned unusually *low* returns in both the near- and long-term. And the effects worsened over time:

> "The results are striking. In the year after the firms are classified into the lowest and highest compensation deciles respectively (column titled "(+1,+12)"), firms in the lowest total compensation decile earn insignificant industry- and momentum adjusted returns of -0.76%. In contrast, the firms in the highest compensation decile earn a highly significant -4.38%. The performance worsens significantly over time. In the five years after the classification period, firms in the high compensation decile earn a significant negative excess return of -12.27% while firms in the lowest compensation decile earn an insignificant 0.29%. The pattern is similar when we sort on either cash or incentive compensation separately."

For the companies whose CEOs earn the most in *incentive* compensation -- defined as restricted stock and stock options -- the returns were especially low. (This may not bode well for those Wall Street firms, like Goldman Sachs, who have taken to cutting down cash bonuses and boosting stock awards for execs.)

As for an explanation of the findings, the authors speculated that when "over-confident managers" take oversize pay packages, "investors over-react to these pay grants and are subsequently disappointed."

A separate study led by Harvard Law's Lucian Bebchuk investigated the relationship between future company performance and "CEO pay slice" (CPS) -- the percentage of the total compensation for the top five executives that is allocated to the CEO alone. Bebchuk and his colleagues found a negative relationship between a higher CEO share of the executive compensation pot and firm value. Which is another way of saying that high CEO pay may actually hurt certain aspects of corporate performance:

> "CPS also has a rich set of relations with firms' behavior and performance: in particular, CPS is correlated with (i) lower (industry-adjusted) accounting profitability, (ii) lower stock returns accompanying acquisitions announced by the firm and higher likelihood of a negative stock return accompanying such announcements, (iii) higher odds of the CEO's receiving a "lucky" option grant at the lowest price of the month, (iv) greater tendency to reward the CEO for luck due to positive industry-wide shocks, (v) lower performance sensitivity of CEO turnover, (vi) lower firm-specific variability of stock returns over time, and (vii) lower stock market returns accompanying the filing of proxy statements for periods where CPS increases."

Read Professor Bebchuk's study here.