Memo to Activists: Mind CEO Pay

Hedge Funds Should Start Caring About the High Cost of Executives And Its Impact on the Bottom Line

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By Jesse Eisinger
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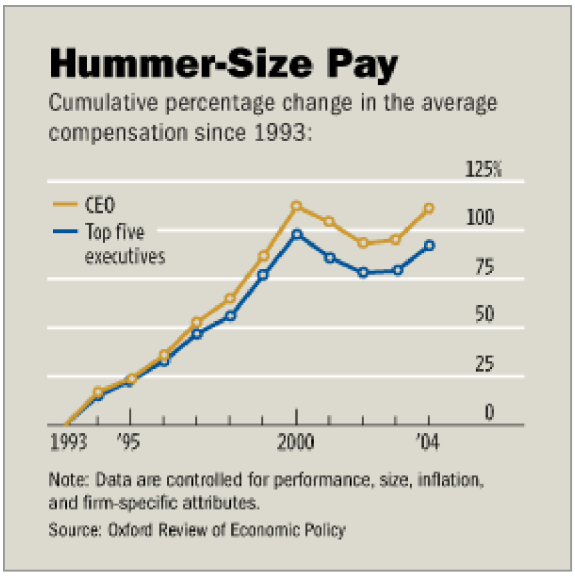
Now that the Securities and Exchange Commission is finally getting around to improving the disclosure of executive pay, it will be up to investors to do something about it.

The shareholder activists with the most clout these days are hedge-fund managers, but given how much they pay themselves, they don't make great poster children for the outrageous compensation issue. And many think there isn't enough value being destroyed by top-executive compensation to really make a difference.



They need to wake up. There hasn't been much good research measuring just how much executive pay affects shareholders, but there's enough to conclude that pay does matter.

Lucian Bebchuk, a Harvard Law scholar of executive-pay practices, published a study in the fall with Cornell's Yaniv Grinstein that attempts to measure pay as a portion of earnings. The results are eye-opening: From 1999 to 2003, the five top dogs at each of the 1,500 largest publicly traded firms cumulatively took down $122 billion in salary, bonus and stock, compared with $68 billion from 1993 through 1997.

That's real money by any measure, but as a percentage of earnings, it's downright astonishing: In the period from 2001 to 2003, top-executive compensation amounted to 9.8% of the companies' net income, almost double the 5% in 1993 to 1995. That's money that otherwise would end up in shareholders' pockets.

Prof. Bebchuk, a critic of the disconnect between pay and performance, says executive compensation might not by itself send activist shareholders storming into boardrooms. But, he says, "This is a big deal economically, one shareholders should care about."

The study isn't perfect, because it compares pretax executive compensation to post-tax net income, an apples-to-oranges comparison. Prof. Bebchuk concedes as much. "With this being the first study trying to look at this, I feel very comfortable that this is a good, rough number. It is a good demonstration that we are talking about very large numbers."

He also argues that the pay figures are understated; for one thing, they don't include retirement benefits.

PAY CHECK

• They Say Jump: SEC Plans Tougher Pay Rules[1]

• SEC to Propose Overhaul of Executive Pay[2]

LONG & SHORT MAILBOX

Will shareholders start objecting to CEO pay? Email me comments and questions at longandshort@wsj.com[3]. Selected letters may appear in an online column[4].

Another way to gauge the impact of executive pay on shareholder value is simply to measure how much stock has been given to employees.

In 2004, the employees of the median company in the top 200 corporations held 14% of the companies' shares, up from 9.9% in 1994, according to executive-compensation consultant Pearl Meyer.

David Yermack, who studies executive compensation at New York University's Stern School, is troubled by the trend. "I think the issue evolved from a moral principle 10 or 15 years ago to a real issue of dollars and cents," he says. "It's not just that managers shouldn't grab so much of the pie for themselves, but that they will grab so much that shareholders might start to feel hungry."

The share of equity going to employees has edged down since 2003. But that doesn't mean CEOs and other select top executives are getting less money from their stock plans. Some companies are giving their executives shares instead of options to buy shares. Stock grants are having little effect on the overall amount of pay, but at least they don't dilute the value of everybody's else's stock as much. In addition, some companies are reducing the number of employees eligible for stock and option grants. So top executives' share of equity could actually be going up even though companies are giving out less overall.

To me, it's irrefragable that CEOs are overpaid. Top-executive pay is rising faster than inflation and faster than the average worker's salary. It's been rising faster than earnings and faster than stock-market returns. And growth in pay has been accelerating.

I should acknowledge that some smart academics disagree. Steve Kaplan, a finance professor at the University of Chicago, argues that the "median CEO is probably underpaid these days" given the demands of the job. Prof. Kaplan points out that private-equity firms -- sophisticated, informed investors -- tend to make big stock grants to the top managers they hire to run the companies they buy. The deal makers who bought software maker SunGard gave 18% of the

company's stock to management. The difference, of course, is that those executives can't sell before they turn the company around.

The key question is this: Are executives being paid what the market will bear or is the market broken? The answer lies in whether rich compensation leads to good performance.

Donald Hambrick, a professor of management at Smeal College of Business at Penn State, says that if the lower rank and file "feel that top executives are essentially looting the firm, that corrodes the whole system." The firm then must incur sizable costs to police malcontented employees. He points to a 1992 study in Administrative Science Quarterly that found that the greater the gap between the pay of top executives and the lower-ranking workers in the company, the worse the product quality was.

Activists target laggards, not top performers. Hedge funds should think about executive pay in this context. Those big checks may be the reason the company is underperforming.

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