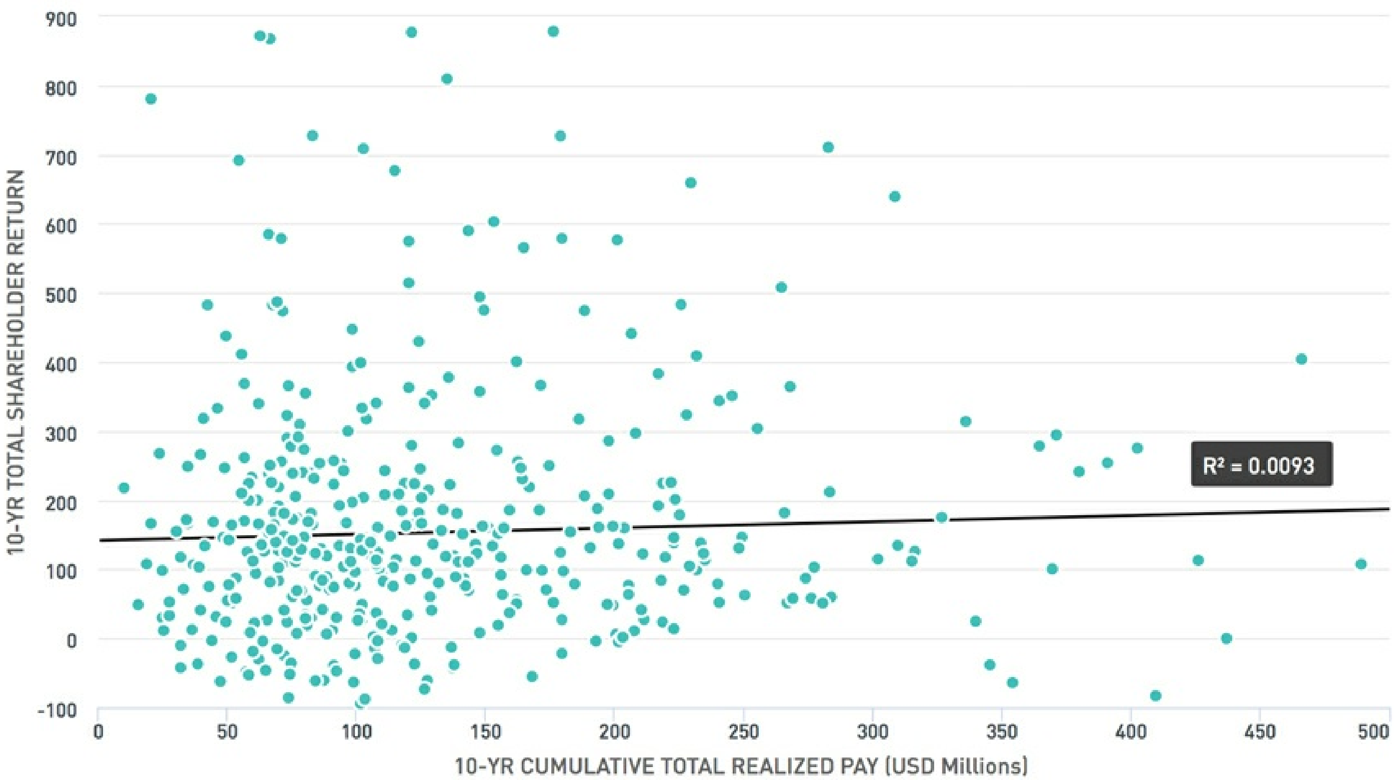
Out of Whack: US CEO Pay and Long-Term Investment Returns

Last year, we asked whether pay awards to U.S. chief executive officers reflected long-term shareholder returns, and found they did not. The bottom fifth of companies by equity incentive award outperformed the top fifth by nearly 39% on average on a 10-year cumulative basis.

That study looked at awarded pay — of which 60%-70% reflected incentive stock awards. Awarded pay figures, which are based on the value of the company's stock at grant date, lay out the range of potential CEO earnings, and are intended to align CEO and shareholder interests. We now extend that study to examine realized pay – how much compensation CEOs actually took home after exercising their equity grants.

But realized pay was just as poorly aligned with long-term performance as awarded pay. More than 61% of the companies we studied exhibited poor alignment relative to their peers. We found little correlation overall between realized pay and long-term investment returns, as indicated by the very low R-squared value of 0.0093 shown in the exhibit below.[1]

Realized CEO pay was not aligned with long-term shareholder returns



10-year Total Shareholder Return as of Dec. 31, 2015 vs. 10-year cumulative total realized CEO pay as reported in 2007-2016 proxy statements. Source: MSCI ESG Research

KEY FINDINGS

- More than three-fifths of 423 MSCI USA Index constituents had cumulative 10-year realized CEO pay totals that were poorly aligned with the company's 10-year total shareholder return performance, based on the 2006-15 period.
- Among the most poorly aligned companies, 23 underpaid their CEOs for superior stock performance and 18 *overpaid* for below-average stock returns, relative to their sector peers.
- The 18 companies that overpaid for underperformance (just 4.3% of our sample) accounted for nearly 10% of the total sample market cap, which could magnify the impact on investors of their pay-for-performance misalignment.
- Short-term performance assessments, an over-reliance on share price-related performance measures, poor succession planning and SEC-mandated annual reporting standards were the main factors exacerbating this misalignment.
- None of the companies in the poorly aligned group experienced consistent disapproval on CEO pay, suggesting that shareholders were more focused on payouts in individual years than over longer time horizons.

These findings suggest that the 40-year-old approach of using equity compensation to align the interests of CEOs with shareholders may be broken

[1] The R-squared value (R^2) indicates what percentage of the variance is explained by the model. A very low figure indicates that the model provides little explanation.

Further reading:

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Are CEOs Paid for Performance?

ESG Governance Metrics