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## **At Goldman, Shareholders Don't Seem to Count**

**by Graef Crystal**

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The way I see it, here's the priority order if Goldman Sachs comes up with an extra buck to spend:

- Give it to executives.
- Give it to charity.

Funny, shareholders, far from being in third place on the priority list, don't seem to be on it at all, at least according to many articles I have recently read.

I suppose there's a danger to Goldman of paying something extra to shareholders: They just might get used to the more nutritious meal, and instead of expressing their gratitude, might demand the same every year – or even more.

Goldman's current dividend yield is just 0.78 percent, substantially lower than the median 1.3 percent yield for the companies comprising the Standard & Poor's 500 Index.

More than that, the 10 largest insider shareholders at Goldman own collectively a trifling 2.06 percent of the shares outstanding.

So any bond between Goldman's top executives and its shareholders borders on the coincidental, thereby making it understandable why the former would think of charity before shareholders.

The monstrous amounts that Goldman spends on bonuses seem to derive from the following logic train:

- We used to be a partnership. In those days, we kept all the profit for ourselves.

- Then we went public.
- We recognized that we had to do something for our new “partners” – the ones who gave us the bulk of our capital.
- So we came up with a fair compromise: We take 50 percent of net revenues, and we give the remainder to the shareholders.
- Actually, being the beneficent folks we are, we usually take a bit less than 50 percent (for the years 2005 through 2007, the ratios of total compensation and benefits for all Goldman Sachs employees to net revenues was, respectively, 47.2 percent, 43.7 percent and 43.9 percent; the year 2008 doesn’t count, because Goldman was under TARP restrictions.)
- (In fairness to Goldman, the bonuses of the top partners are regulated by a shareholder-approved formula that establishes a maximum bonus that may be paid to any single individual. For 2007 (the year before TARP), the maximum was 0.69 percent of, effectively, net income before taxes and bonus payments. The maximum percentage had been as high as 1 percent in earlier years, but it was lowered in 2006. However, a subsequent amendment to the plan provides for an inexorable rise back to 1 percent. For 2009, the maximum will be 0.91 percent. And for 2010 and later years, it will be 1 percent.)

Now let’s contrast that logic train with that of most other major companies:

- We have no desired ratio of pay to net revenues. In fact, we almost never think of bonuses in net revenue terms.
- We identify some comparators and determine what they pay. (Goldman, apparently, doesn’t think it has any comparators. And given what it pays, it doesn’t.)
- We aim for some percentile positioning vis a vis our comparator group.
- We accept philosophically that in good years, our percentile positioning ought to rise compared to other companies, and in bad years it ought to drop. But at many companies, that little nicety is observed more in the breach.

Finally, let’s go back in time, namely, the 17<sup>th</sup> Century, when I first became a comp consultant:

- Companies developed a formula to produce a bonus pool.
- The formula had a so-called “threshold” and a so-called “multiplier”.
- The threshold was usually stated as some level of return on equity or return on capital (which added together shareholders’ equity and long-term debt but which then reversed the interest on the same debt out of the income statement).

- For below-threshold performance, the bonus pool was zip.
- For each dollar of net income above the threshold, the multiplier came into play, diverting, typically, some 5 percent to 10 percent of all excess net income to the bonus pool, with the remainder – the vast majority – going to shareholders.
- The bonus formula was frequently submitted to shareholders for their approval.

There were problems with this approach, for example, funding a bonus for a successful business unit manager in a year when the overall corporate performance was so poor that the company bonus pool had shrunk to zero. (Some companies carried forward unused funds from this year's formula for use in a future year. But doing so often ended up undermining the main purpose of the formula, i.e., to tie bonuses to results.)

But both shareholders and executives understood the limits and accepted them.

Note two not-so-subtle differences between the formula I just described and Goldman's formula:

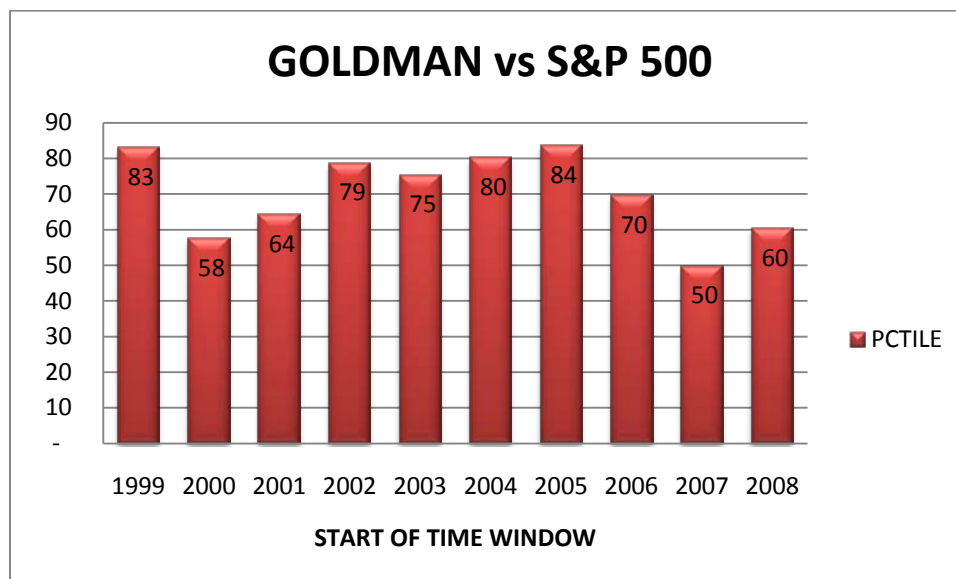
- The formula just described has a threshold, while Goldman's does not. At Goldman, you get paid from the very first dollar of profitability.
- The formula just described produces a pool that covers all executives. Goldman's formula is really a cap on an individual executive's bonus. Perhaps 1 percent sounds like an innocent figure. But there does not seem to be any binding limit on how many executives can each have 1 percent. Oh sure, the plan says the 1 percenters are restricted to "executive officers and members of the management committee". But if one needs more bonus money, one could decide that maybe there's a need for a larger management committee.

One also has to ask: What did Goldman's shareholders get for all the outrageous compensation its top executives were paid?

Goldman went public on May 3, 1999. I examined its total return performance in 10 different time windows. The widest time window began May 3, 1999. Thereafter, each succeeding time window began one year after the start of the preceding window, i.e., May 3, 2000, May 3, 2001, etc. All 10 time windows ended on Nov. 6, 2009, when I performed this analysis.

In each case, I determined how Goldman ranked vis a vis all the current companies in the S&P 500 Index that had a stock price history for the particular time window.

The following chart tells the story:



The median percentile rank for all 10 time windows was 72, meaning that Goldman surpassed all but 28 percent of its fellow S&P 500 companies.

But a 72<sup>nd</sup> percentile ranking, while quite good, is totally out-of-synch with the massive amounts of pay that Goldman offloaded on its top executives to achieve those results.

Who knows, if money really motivates, a pay package of, say, \$1 billion for Goldman's CEO might have caused that company's total return performance to creep into the top decile of the distribution.

I simply cannot understand the arrogance of Goldman Sachs, the arrogance that says this is the way we do it; we don't care how you do it; we don't care how big executive bonuses are; we're entitled to about 50 percent of net revenues and that's that.

When I was a consultant to Salomon Brothers and Bear Stearns in the 1980s, I got into a spirited discussion with one of the top executives of the former firm over "how high is high"?

He said: "You simply don't understand. In Wall Street, the shareholders are bondholders. And the executives are the shareholders." We offer the shareholders a return, but it's not all that luscious. Then we take everything else for ourselves."

What worries me here is that if Goldman doesn't restrain itself in paying yearend bonuses, it will, in Samson-like fashion, bring the temple down on the heads of all companies.

There are people in Congress who are just itching to impose pay controls on executive compensation. If they succeed, the name Goldman Sachs, in fairness, ought to be part of the title of the pay control act.

A word to Goldman shareholders: If you want more in the way of a return, incorporate yourself as a charity. That way, you can make Goldman's priority list.

2009 marks Graef Crystal's 50<sup>th</sup> anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.