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The Crystal Report on Executive Compensation

Goldman Could Trigger U.S. Pay Controls

by Graef Crystal

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By all indications, Goldman Sachs is about to hand out bonuses to its top executives that, in the context of the current economic malaise, will likely invite some severe repercussions from Congress – repercussions that could touch not just Wall Street but top executives at all U.S. companies.

Goldman's defense is apt to be : "We earned the money, so why shouldn't we pay it out?"

Ultimately, though, the test of whether Goldman's senior executives earned their bonuses lies in the level of returns the company's shareholders are receiving. That's my view.

And therein lies the problem.

Split Between Executives and Shareholders

In an earlier article, I recounted a conversation I had in the mid-1980s with Alan Greenberg, the longtime CEO of Bear Stearns. He told me that a rule of thumb he used about bonuses went like this: "We determine the amount of our pre-tax, pre-bonus compensation. Then we take half of that amount for bonuses and leave the other half for our shareholders".

Salaries were not a part of Mr. Greenberg's formulation. But back in those days, no one, including Mr. Greenberg himself, earned a base salary of more than $200,000.

Whether or not that was the right formula, at least it was heartening to hear Mr. Greenberg including his shareholders in a discussion of executive pay.

Not long ago, I read in a piece by *New York Times* columnist Joe Nocera that Goldman was planning to pay out 50 percent of its net revenues.

My first thought was: Joe got it wrong. It's not 50 percent of net revenues. It must be 50 percent of pre-tax, pre-bonus profits.

But after exchanging emails with Joe, I looked at some projected figures for Goldman's bonuses and for its net revenues. And though I came up a bit short of the 50 percent level, the difference was trifling.

Recently, I received a copy of a report released by Johnson Associates, a leading New York-based compensation consulting firm that specializes in Wall Street pay.

And there it was:

- On Page 7 of the Johnson report, I learned that, for a sample of investment banks and commercial banks, 2009 compensation was likely to be about 46 percent of net revenues.

- But on Page 8, I learned that compensation for the same companies was likely to be just under 70 percent of "pre-tax, pre-comp income".

So somewhere along the line, Mr. Greenberg's formulation underwent a rather severe metamorphosis. Now, much more than half the pre-tax, pre-bonus profits were being diverted to employees.

Put it this way. At a publicly-owned investment bank, there are two groups of partners: The shareholders and the executives.

Like good partners, each splits the net revenues of the company.

But when it comes to expenses, there's a slight difference. The shareholders pay all of the company's expenses out of their half of net revenues. But the executives pay nothing out of their half of net revenues. They take it all as bonuses.

(Shareholders do get some relief in that they are able to deduct all the expenses from the company's taxable income, including all the bonuses.)

That shift from 50 percent of pre-tax, pre-bonus profits to 50 percent of net revenues thus makes it impossible for shareholders to earn returns that match the levels of pay being delivered.

Goldman itself provides a vivid example here.

Goldman's Performance

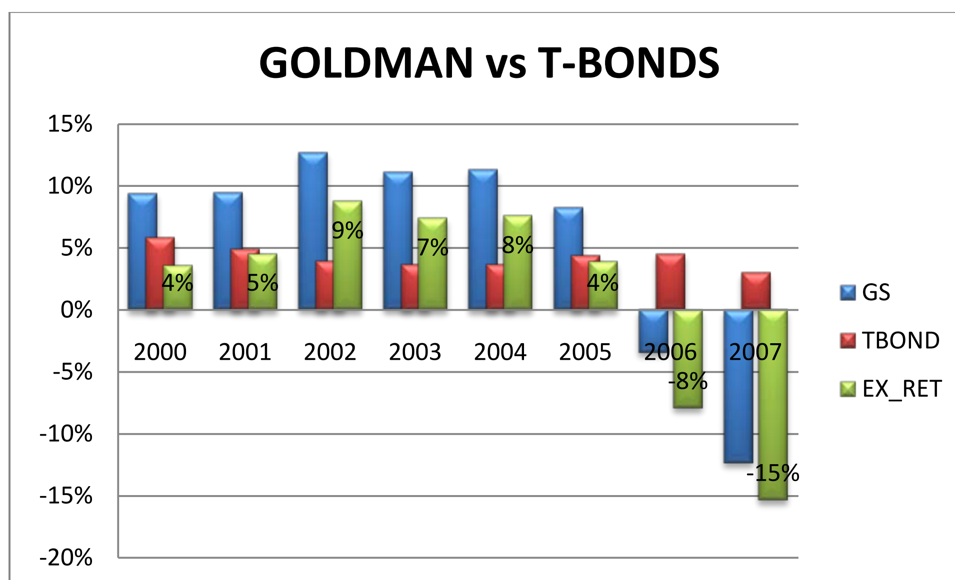
In an earlier article on Warren Buffett's pending acquisition of Burlington Northern, I ran a chart showing that, not just Burlington, but all the four major U.S. railroads had delivered mightily for their shareholders. Then I included a fifth line showing how Goldman had performed.

That fifth line wasn't pretty at all. Goldman's total return was only half that of Burlington Northern and CSX, the two top performers among the four railroads.

That prompted me to take a further look at Goldman's returns. I decided to use the same eight time windows of total return as in my Burlington Northern article. The first time window began Nov. 30, 2000, and each succeeding time window began one year later. The last time window began Nov. 30, 2007. All eight time windows ended Nov. 24, 2009.

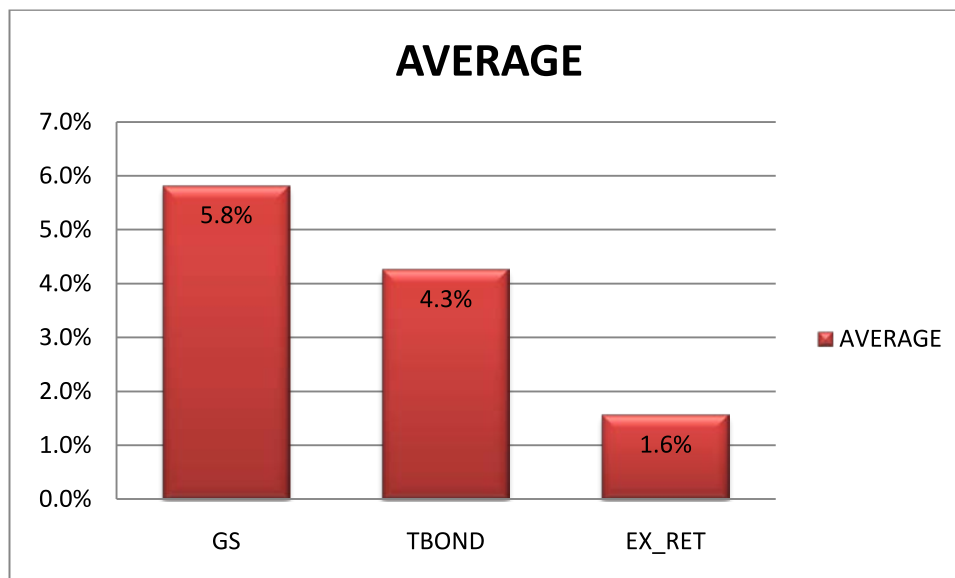
I then compared Goldman's total return in each time window to the yield on a Treasury strip bond, purchased at the beginning of the time window and with a maturity equal to the width of the time window.

The results can be seen in the following chart, which shows for each time window Goldman's total return, the Treasury strip return and the excess return, defined as Goldman's return less the Treasury strip return:



A second chart shows:

- The average return for Goldman for all eight time windows.
- The average yield on the Treasury strips.
- And the average excess return.



To be sure, Goldman delivered a higher return than an investor could have received by putting his money in ultra-safe Treasury strips.

But the difference wasn't all that much, when you consider that the Top Five executives at Goldman, in their best year, pulled down pay approximating $250 million.

Maybe it's time to take a fresh look at the way Ace Greenberg used to handle things. At least the shareholders would be accorded a seat at the banquet table and wouldn't be cast in the role of servants.

Graef Crystal's is now in his 51st year 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 still contributes

occasional columns to Bloomberg News.) He has written six books and more than 1,600 articles on executive pay.