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The Crystal Report on Executive Compensation



There's More Pay-for-Performance Than We Think

by Graef Crystal

August 31, 2009

Viewed one way, there's no pay-for-performance at all among major-company CEOs. Viewed another way, there is.

Conventional Method

The conventional way is to look at the present value of a particular year's pay package. This entails, among other things:

- Valuing free share grants at the time of grant, even though vesting is way down the road and the price at vesting may be far different.
- Valuing stock option grants using the Black-Scholes model, which shows the normal outcome but only by sheer chance the real outcome. Moreover, the resulting present values can be influenced by teasing the assumptions – a little or a lot.
- Valuing performance-based long-term incentives at their target level, which, face it friends, is a wild-ass guess, given that, most of the time, the shareholders are kept completely in the dark as to the goals to be achieved for any given payout.

Using this conventional data set, it is hard to discern any serious relationship between total pay and performance, when performance is defined in total return terms.

Taking Account of Stock Option Gains

To get around the admitted deficiencies of this method, some analysts throw the Black-Scholes down the drain. The only thing that counts in their valuation is the amount a CEO receives when he exercises his options.

This approach has the advantage of using real-world numbers, but it, too, has a major deficiency, viz., letting the CEO decide when he will show income.

One CEO exercises an option with a \$100 million gain, and the media go crazy. But another CEO doesn't exercise, and he is seen as underpaid, even though the paper profits in his unexercised options increased by \$100 million in the same year.

Then we have a third CEO who doesn't exercise options until after his retirement, and those gains are lost completely to the pay tabulators because he is no longer on his company's proxy statement.

A Different Approach

I have devised for this article a third way of looking at CEO pay. (By using the phrase "I have devised", I do not wish to suggest that there are not others out there who have also taken the same approach.)

Included in this definition of pay are:

- Base salary for 2008.
- Annual bonus for 2008.
- The present value of pension accruals for 2008.
- Miscellaneous compensation for 2008.
- The value at vesting of free share and performance share awards in 2008.
- Amounts realized in 2008 from the exercise of stock options.
- And the amount by which the paper profits on all unexercised options at the end of 2008 exceed (or are under) the paper profit on all unexercised options at the end of 2007.

Using this definition, I calculated total pay in 2008 for 566 CEOs running companies with market caps of \$2 billion or higher.

You need to know here that this definition of pay can easily produce negative compensation. That happens when, as recently, the stock market tanks and wipes out billions in option paper profits.

Indeed, 254 of the 566 CEOs, or 45 percent, had negative compensation in 2008 – negative compensation of as much as \$298 million in the case Stephen Hemsley of Minneapolis-area

based UnitedHealth Group. It is more than ironic that Mr. Hemsley should find himself in this place at the very time his firm is being savaged and called immoral by key members of Congress.

It is also worth noting that the next four largest health insurers (Wellpoint, Aetna, Humana and Cigna) also reported negative total pay for 2008.

Once I had this database up and running, I wanted to see what might explain why one CEO earned hugely positive pay, while another took it in the neck.

The three variables I tested were:

- The size of the company, as measured by its 2008 sales.
- The excess total return of the company, defined as the amount by which the company's total return in its 2008 fiscal year exceeded (or was under) the return on the Standard & Poor's 500 Index.
- The tenure of the CEO. (Longer-tenured CEOs might be expected to have more outstanding options and hence greater losses during the recent market slump.)

But I had a problem when it came to my dependent variable, namely, pay.

In every study I have undertaken, pay is not normally-distributed. That is to say, the average is always higher – often, much higher – than the median.

To obtain the normal distribution that statisticians require for a valid regression result, one calculates the natural logarithm of pay and uses that series as the dependent variable. If the natural logarithms are plotted on a graph, one almost always gets the standard bell-shaped normal distribution.

But you can't calculate the logarithm of zero, much less the logarithm of a negative number.

And to use actual pay (i.e., non-logged) would produce a travesty.

To handle this problem, I selected as my dependent variable the pay rank number. Hence, the CEO with the highest positive total pay was ranked #1, while the one with the highest negative pay was ranked #566.

My multiple regression analysis showed that there was no significant statistical correlation between the size of the company and the pay rank number. Ditto for the CEO's tenure.

But there was a statistically-significant relationship between the excess return of the company and the CEO's rank number. Excess return accounts for 21 percent of the variation in rank numbers.

In each case, I subtracted the CEO's actual rank number from the rank number that was predicted by my regression analysis. A positive deviation rank meant that the CEO had earned more than what his company's excess return suggested he should have earned. A negative deviation rank showed just the opposite.

Herewith follow three tables:

- The 40 CEOs with the largest positive rank deviations.
- The 40 CEOs with the largest negative rank deviations.
- And the 20 CEOs with rank deviation that are closest to zero.

Each table has three significant columns:

- The excess return in 2008 (called EX_RET1).
- The actual value of the pay package, as defined above (called TDCAINMON). Values shown here are in thousands of dollars.
- The rank deviation (i.e., the predicted rank number less the actual rank number).

THE 40 CASES WITH THE HIGHEST POSITIVE RANK DEVIATIONS:

COMPANY	EXECUTIVE	EX_RET1	TDCAINMON	RANK_DEV
AIG	SULLIVAN, MARTIN J.	-60%	\$13,973	445
XL CAPITAL	O'HARA, BRIAN M.	-55%	\$7,504	381
CBS	MOONVES, LESLIE	-30%	\$26,365	378
CHESAPEAKE ENERGY	MCCLENDON, AUBREY K.	-21%	\$114,287	363
INTERNATIONAL PAPER PLAINS EXPLOR & PROD	FARACI, JOHN V. FLORES, JAMES C.	-25% -20%	\$17,010 \$19,729	346 338
NEWS CORP	MURDOCH, K. RUPERT	-15%	\$26,938	332
BANK OF AMERICA CUMMINS	LEWIS, KENNETH D. SOLSO, THEODORE M.	-26% -20%	\$12,409 \$15,687	325

				323
ALLEGHENY TECH	HASSEY, L. PATRICK	-33%	\$8,548	323
TERRA INDUSTRIES	BENNETT, MICHAEL L.	-28%	\$10,655	321
CNA FINANCIAL	LILIENTHAL, STEPHEN W.	-13%	\$16,038	304
DOW CHEMICAL	LIVERIS, ANDREW N.	-22%	\$9,960	301
INVESCO	FLANAGAN, MARTIN L.	-16%	\$13,791	301
SPX CORP	KEARNEY, CHRISTOPHER J.	-23%	\$9,487	298
WYNN RESORTS	WYNN, STEPHEN A.	-25%	\$8,454	296
GUESS INC	MARCIANO, PAUL	-18%	\$12,151	296
HALLIBURTON	LESAR, DAVID J.	-14%	\$13,195	292
BOEING	MCNERNEY, JR., W. JAMES	-13%	\$13,535	289
JEFFERIES GROUP	HANDLER, RICHARD B.	-1%	\$28,262	288
SMITH INTL	ROCK, DOUGLAS L.	-32%	\$6,197	284
FLOWSERVE	KLING, LEWIS M.	-9%	\$14,126	282
OCEANEERING INTL	COLLINS, T. JAY	-20%	\$7,444	267
ALLEGHENY ENERGY	EVANSON, PAUL J.	-9%	\$10,841	262
AMETEK	HERMANCE, FRANK S.	2%	\$15,916	255
J C PENNEY	ULLMAN, III, MYRON E. (MIKE)	-25%	\$5,718	254
EOG RESOURCES	PAPA, MARK G.	12%	\$27,599	246
EQT	GERBER, MURRY S.	1%	\$13,579	245
HEWLETT PACKARD	HURD, MARK V.	11%	\$24,324	244
OCCIDENTAL PETR	IRANI, RAY R.	16%	\$66,670	241
FLUOR	BOECKMANN, ALAN L.	-1%	\$11,984	240
ICAHN ENTERPRISES	MEISTER, KEITH A.	-42%	\$3,002	236
MICRON TECH	APPLETON, STEVEN R.	-52%	\$2,131	

				236
SYSCO	SCHNIEDERS, RICHARD J.	-1%	\$9,696	232
INTERPUBLIC GROUP	ROTH, MICHAEL I.	-14%	\$6,320	232
PERKINELMER	SUMME, GREGORY L.	-9%	\$7,044	227
FORD MOTOR	MULALLY, ALAN R.	-29%	\$3,938	226
REYNOLDS AMERICAN	IVEY, SUSAN M.	2%	\$10,310	224
WALT DISNEY	IGER, ROBERT A.	12%	\$16,317	224
INTUIT	BENNETT, STEPHEN M.	7%	\$12,870	224
	LOW	-60%	\$2,131	224
	MEDIAN	-17%	\$12,639	286
	AVERAGE	-17%	\$16,850	286
	HIGH	16%	\$114,287	445

THE 40 CASES WITH THE HIGHEST NEGATIVE RANK DEVIATIONS:

COMPANY	EXECUTIVE	EX_RET1	TDCAINMON	RANK_DEV
BLACKROCK	FINK, LAURENCE D.	0%	-\$28,463	(201)
ANSYS	CASHMAN III, JAMES E.	4%	-\$22,532	(202)
IDEXX LABS	AYERS, JONATHAN	-1%	-\$29,950	(204)
SCHLUMBERGER	GOULD, ANDREW	-19%	-\$153,079	(204)
AMPHENOL CORP	LOEFFLER, MARTIN H.	-11%	-\$53,178	(206)
PRAXAIR	ANGEL, STEPHEN F.	5%	-\$23,424	(207)
MURPHY OIL CORP	DEMING, CLAIBORNE P.	-10%	-\$52,653	(209)
PACCAR	PIGOTT, MARK C.	-9%	-\$49,678	(210)
EATON	CUTLER, ALEXANDER M.	-10%	-\$55,641	(211)
CHEVRON	O'REILLY, DAVID J.	19%	-\$12,480	(212)
STAPLES	SARGENT, RONALD L.	6%	-\$24,014	

				(212)
OMNICOM GROUP	WREN, JOHN D.	-5%	-\$39,365	(214)
UNITEDHEALTH GRP	HEMSLEY, STEPHEN J.	-17%	-\$297,708	(214)
DEVON ENERGY	NICHOLS, J. LARRY	11%	-\$18,461	(217)
CISCO SYSTEMS	CHAMBERS, JOHN T.	-13%	-\$105,300	(219)
JUNIPER NETWORKS	KRIENS, SCOTT	-10%	-\$68,858	(221)
AETNA	WILLIAMS, RONALD A.	-14%	-\$152,964	(222)
BLACK & DECKER	ARCHIBALD, NOLAN D.	-1%	-\$37,163	(223)
JOHNSON CONTROLS	BARTH, JOHN M.	0%	-\$35,058	(223)
CATERPILLAR	OWENS, JAMES W.	0%	-\$35,226	(224)
NORTHERN TRUST	OSBORN, WILLIAM A.	6%	-\$29,380	(225)
GENERAL DYNAMICS	CHABRAJA, NICHOLAS D.	3%	-\$33,385	(228)
HONEYWELL INTL	COTE, DAVID M.	-8%	-\$111,474	(234)
MARRIOTT INTL	MARRIOTT, JR., J. WILLARD	-5%	-\$73,105	(237)
TRAVELERS	FISHMAN, JAY S.	23%	-\$15,099	(239)
PROCTER & GAMBLE	LAFLEY, ALAN G.	15%	-\$25,349	(243)
COCA COLA	ISDELL, E. NEVILLE	13%	-\$28,514	(243)
ALLERGAN	PYOTT, DAVID E. I.	0%	-\$58,314	(245)
PEPSICO	NOOYI, INDRA K.	11%	-\$30,471	(245)
CVS CAREMARK	RYAN, THOMAS M.	10%	-\$33,146	(248)
J P MORGAN CHASE	DIMON, JAMES	12%	-\$32,470	(251)
HANSEN NATURAL	SACKS, RODNEY C.	13%	-\$32,861	(256)
CONOCOPHILLIPS	MULVA, JAMES J.	-3%	-\$235,445	(259)
ALTRIA GROUP	CAMILLERI, LOUIS C.	6%	-\$55,532	(260)
YUM BRANDS	NOVAK, DAVID C.	21%	-\$25,564	

				(264)
DANAHER	CULP, JR., H. LAWRENCE	2%	-\$114,482	(267)
GENZYME	TERMEER, HENRI A.	26%	-\$24,322	(276)
ENTERGY	LEONARD, J. WAYNE	9%	-\$59,300	(277)
VORNADO REALTY	ROTH, STEVEN	9%	-\$91,382	(284)
UNITED TECHNOLOGIES	DAVID, GEORGE	9%	-\$145,921	(291)
	LOW	-19%	-\$297,708	-291
	MEDIAN	2%	-\$36,194	-225
	AVERAGE	2%	-\$63,768	-233
	HIGH	26%	-\$12,480	-201

THE 20 CASES WITH THE LOWEST RANK DEVIATIONS:

COMPANY	EXECUTIVE	EX_RET1	TDCAINMON	RANK_DEV
VIACOM	DAUMAN, PHILIPPE P.	-20%	-\$2,636	7
FACTSET RES SYST MAGELLAN MIDSTREAM	HADLEY, PHILIP A.	17%	\$1,831	6
	WELLENDORF, DON R.	12%	\$1,598	6
TIFFANY	KOWALSKI, MICHAEL J.	-8%	-\$272	5
TECO ENERGY	HUDSON, SHERRILL W.	13%	\$1,611	5
MSCI INC.	FERNANDEZ, HENRY A.	-6%	-\$38	3
SONOCO PRODUCTS	DELOACH, JR., HARRIS E.	11%	\$1,402	3
REGENCY CENTERS	STEIN, JR., MARTIN E.	14%	\$1,644	3
TEXTRON	CAMPBELL, LEWIS B.	-43%	-\$9,066	2
KLA TENCOR	WALLACE, RICHARD P.	-12%	-\$1,343	1
TELLABS	PRABHU, KRISH A.	0%	\$370	1
NII HOLDINGS	SHINDLER, STEVEN M.	-25%	-\$4,785	(1)
APPLE	JOBS, STEVEN P.	-4%	\$0	

				(1)
SOUTHWEST AIR	KELLY, GARY C.	8%	\$1,126	(1)
PETROHAWK ENGY	WILSON, FLOYD C.	27%	\$2,611	(1)
VERTEX PHARM	BOGER, JOSHUA S.	68%	\$8,400	(2)
PULTE HOMES	DUGAS, JR, RICHARD J.	42%	\$3,866	(4)
DIAMOND OFFSHORE	TISCH, JAMES S.	-19%	-\$3,543	(5)
HESS	HESS, JOHN B.	-10%	-\$1,267	(5)
ALTERA	DAANE, JOHN P.	24%	\$2,146	(6)
	LOW	-43%	-\$9,066	-6
	MEDIAN	-3%	\$748	1
	AVERAGE	-5%	\$183	1
	HIGH	68%	\$8,400	7

The compensation data used in this article were obtained from Equilar Inc., a leading provider of executive compensation information. Please click here to go to Equilar:

<http://www.equilar.com>

2009 marks Graef Crystal's 50th 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.