CEO compensation study examines factors in excess returns

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Of many issues associated with CEO compensation, excess returns are likely among the most controversial. UT Dallas researchers examined how boards face pressures when trying to control this problem.

Excess CEO returns are the financial returns from a CEO's firm-related wealth and compensation that exceed the shareholders' financial returns, said Dr. Mike Peng, O.P. Jindal Distinguished Chair of Global Strategy in the Naveen Jindal School of Management.

"CEOs deserve to enjoy the returns that shareholders are getting. The problem is that a lot of CEOs seem to be getting returns disproportionate to what shareholders are getting," Peng said. "You want them to own some shares. You want them to do well, as long as the shareholders are doing well."

The paper, recently published online in *Strategic Management Journal* and awaiting print publication, was a joint effort between Peng, professor of organizations, strategy and international management (OSIM), Dr. Zhiang "John" Lin and Dr. Steve Sauerwald MBA'08, PhD'14.

Sauerwald, the lead author, spearheaded the study as part of his doctoral dissertation research, supervised by Lin and Peng, in the Jindal School. He is now an assistant professor of management at the University of Illinois at Chicago.

Using data from a sample of U.S. corporations listed on the Standard and Poor's 1500 index from 1999 to 2010, the researchers found that boards face two competing normative pressures: corporate elite norms and monitoring norms. They also determined that social capital affects how boards conform to those pressures.

Social capital refers to social network resources that benefit board directors, said Peng, area coordinator for OSIM.

When deciding a CEO's compensation, boards consider how other boards compensate their CEOs, especially in competitive industries, he said.

"If a board enjoys a lot of external capital—good relationships with the corporate elites outside the company—then the board is more willing to let CEOs enjoy higher returns," Peng said. "On the other hand, if a board enjoys a higher degree of internal social capital—the board members themselves have worked together for a long time—then they're more comfortable putting the CEO on a shorter leash so that the CEO compensation does not go out of whack too much."

The researchers argued that powerful CEOs and institutional investors might facilitate or constrain the normative pressures in the social network and alter the effects of board social capital on excess CEO returns.

According to the study, powerful CEOs will enhance the positive relationship between external social capital and excess CEO returns. If powerful institutional investors are monitoring, they will reduce the positive relationship, reducing the excess returns.

"As a society, if we care about excess CEO returns, we will have to introduce mechanisms to let institutional investors play a bigger role so

they can positively influence directors," Peng said.

Instead of CEOs serving on one another's boards, creating full-time positions for professional directors may be another solution. Today, a majority of directors serve part time, Peng said.

"How do we enhance director quality so that we have a group of people who have internal social capital as directors serving together?" Peng said. "Why don't we have full-time directors as a profession? If these people can work together for a long time, enjoying a greater deal of board social capital, then perhaps excess CEO returns can be curtailed."

A Case of Excess CEO Returns

To better understand excess CEO returns, here's an example:

During the period 2001-10, the average annual CEO returns from firm-related wealth for John H. Hammergren, CEO of pharmaceutical company McKesson, amounted to 114 percent, but average annual shareholder returns were only 17 percent. In this case, the average annual excess CEO returns would be 97 percent.

More information: *Strategic Management Journal*, onlinelibrary.wiley.com/doi/10 … 02/smj.2339/abstract

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