Executive pay gets boost from common owners

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Credit: University of Michigan

The better the company performs compared to its peers, the more top executives should receive in pay, bonuses and stock awards. Right?

But that isn't always how it works in practice. Executive pay packages that don't include a comparison of company performance and that of its competitors are regularly approved by boards of directors, and many have wondered why.

New research by University of Michigan professor Martin Schmalz and co-authors Miguel Anton and Mireia Gine of the IESE Business School and Florian Ederer of the Yale School of Management helps explain why—and why benchmarking happens more in some industries than in others.

They found that when companies in an industry are owned by the same shareholders, the executives tend to be rewarded relatively more for industry performance and less for their own company's performance.

"Many people have been puzzled why shareholders approve pay packages that lead to high pay without much benchmarking," said Schmalz, the NBD Bancorp Assistant Professor of Business Administration and an assistant professor of finance. "But it's actually not that puzzling once you analyze these shareholders' economic incentives."

Mutual funds like Fidelity, BlackRock and Vanguard are often the largest shareholders of companies in the same industry. Previous research by Schmalz has looked at anti-competitive outcomes of such ownership structures in the banking and airline industries. The present paper crystallizes one reason why managers act in their common owners' interest—because they are paid to do so.

Schmalz, Anton, Ederer and Gine examined 20 years' worth of data from ExecuComp, which measures the compensation of top executives of the largest 2,000 U.S. companies.

The more a company's institutional shareholders own big stakes in rival companies, the less pay managers receive for company performance and the more pay they receive in response to rivals' performance.

The logic is easy to understand.

"If you benchmark performance against rival companies, that gives managers an incentive to compete aggressively. If you own a number of companies in the same industry, you don't want that to happen," Schmalz said. "If anything, you want them to cooperate more, because you want to improve the value of your entire portfolio, not just one company. Our findings suggest managerial contracts give managers economic reasons to act in their shareholders' interests—it's as simple as that."

The reason that large institutions own shares of firms in the same industry is similarly plain. When ordinary savers pool their retirement money in the same small set of widely diversified mutual funds (in the form of index funds or otherwise), the result is that these mutual fund families become increasingly powerful shareholders in the ownership structure of all portfolio firms.

The study, "Common Ownership, Competition, and Top Management Incentives," also suggests that mutual funds are keenly aware of their effect on executive compensation. In fact, they engage with portfolio firms about the topic hundreds of times per year, and are in open opposition to other shareholder groups that demand more relative performance evaluation in setting executive pay.

"We don't know what precisely is said in these meetings, but the mere fact that they happen, combined with the effects they have, is indication enough that regulators may want to pay attention to executive compensation as an element of antitrust policy," Schmalz said.

More information: Miguel Anton et al. Common Ownership, Competition, and Top Management Incentives, *SSRN Electronic Journal* (2016). DOI: 10.2139/ssrn.2802332

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