A R T I C L E S

Are U.S. CEOs Overpaid? A Response to Bogle and Walsh

by Steven N. Kaplan

I am delighted to have the opportunity to respond to Jack Bogle's and Jim Walsh's comments on my article "Are U.S. CEOs Overpaid?" (*AMP*, May 2008), in which I concluded that the typical U.S. CEO is not overpaid.

The main issue I addressed is whether the high pay of CEOs is largely a market phenomenon (and CEOs are paid appropriately), or, instead, is driven by the power of the CEOs and the weakness of their boards (leading CEOs to be overpaid). I concluded that high CEO pay is largely a market phenomenon, likely driven by technological change and the increased scale technological change allows. An important part of my argument was that many other groups—private equity and hedge fund investors, investment bankers, athletes, and lawyers—have seen their compensation increase substantially and by the same order of magnitude as CEOs, despite the arm's-length nature of their compensation arrangements. In other words, market forces, not weak corporate governance, have bid up the pay of successful individuals in many sectors. For this reason, I argued that the proposed "Say on Pay" Act—requiring an advisory shareholder vote on CEO pay at every company every year—would not improve on or even affect the current market-based outcomes, but would impose additional costs on companies and shareholders.

Editor's Note: In the last issue of *AMP* (May 2008), Steven N. Kaplan wrote the lead article in the Exchange section. In that issue, John Bogle and James Walsh responded to Mr. Kaplan's article. Here we give Mr. Kaplan an opportunity to rebut those responses.

I approached my article and my testimony as a scholar. A scholar's role is not to try to be popular or to present the public mood. Rather, a scholar has a responsibility to understand his or her area of expertise, to gather data carefully, to present accurate empirical results, and to present a logical, thoughtful analysis. Neither Professor Walsh nor Mr. Bogle addressed my key argument, refuted my empirical results, or disproved my basic conclusions.

Professor Walsh never addressed the basic argument that the rise in CEO pay, like the pay of other groups, has been driven largely by market forces. Rather, much of his energy was focused on his view that it is unfair that CEOs and the other groups are paid so much. While the issue of fairness is a serious and complicated one, it is more relevant for taxation and education policy than for the issue of corporate governance regulation that I considered.

Professor Walsh's response had a number of other shortcomings. He began his response with a serious error, important to his argument, that he repeated several times. The error led him to overstate his measure of CEO pay by a factor of 70 times. He continued with an empirical analysis that was methodologically and logically flawed. Finally, Professor Walsh questioned my motives. One wishes that he had delved a little deeper. In doing so, he would have discovered that his suppositions were unfounded.

In responding to my paper, Mr. Bogle largely acknowledged my empirical findings and agreed

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that the U.S. CEO pay system can be improved. We fundamentally disagree, however, on the extent to which CEO pay is determined by market forces rather than managerial power. He simply asserted that CEO pay cannot be explained by market forces. Like Professor Walsh, he did not explain why other groups have seen their compensation rise by the same order of magnitude as CEOs, despite the arm's-length or market nature of their compensation arrangements.

Response to James Walsh

Let me begin with Professor Walsh (2008). He began by pointing out that CEOs are highly paid. This is not in dispute.

Yet Professor Walsh never really addressed the central issue of whether the increase in pay is driven by market forces or managerial power. He ignored the most important point in my paper: that other groups—private equity and hedge fund investors, investment bankers, athletes, and lawyers—all have seen their compensation increase substantially and by the same order of magnitude as CEOs, despite the arm's-length nature of their compensation arrangements.

For better or worse, the large increases in pay of all of those groups suggest that a market phenomenon is at work—particularly the forces of technological change and increased scale—not poor corporate governance. That is why pay has increased for so many different groups, not just CEOs. The related question is whether the CEO pay system is broken and requires additional regulation. I argue that because CEO pay is driven largely by market forces, the additional proposed regulation would have little or no impact other than to impose additional costs on companies and investors.

Rather than addressing the key issues I wrote and testified about, Professor Walsh devoted much of his response to asserting that CEOs and, presumably, the other groups are paid a lot and that that is bad for society. While the issues of income inequality and fairness are serious ones, they are not relevant to the questions I addressed. I addressed the question of why we have seen the increases in income for CEOs and other groups, not whether the increases are fair. In my opinion, more appropriate venues for discussions of income inequality and fairness are in the areas of taxation and education policy, not corporate governance.

Professor Walsh's response had a number of other shortcomings. In particular, in his first paragraph and then at least twice more, Professor Walsh stated that CEOs of the top 1,000 U.S. firms "claimed, on average, 7% of [their] firm's total sales" (p. 26). He repeated the 7% figure twice more to attempt to highlight the fact that CEOs are highly paid. In fact, the correct percentage is less than 0.1%. In other words, Professor Walsh inflated his results by a factor of at least 70 times!

Let me explain why the 7% figure is so obviously wrong. Professor Walsh stated that CEOs of the top 1,000 companies took home $9 billion in pay in 2005. That is approximately correct. It turns out that the 500 Fortune 500 companies together had combined sales of $9 trillion in 2005. If the other 500 companies had no revenues, the correct percentage of CEO pay to sales would be 0.1%, not 7%. And if the top 1,000 CEOs really had earned 7% of sales, they would have earned more than $630 billion.

To see this in another way, Wal-Mart had sales of more than $300 billion in 2005. A simple calculation shows that 7% of $300 billion is $21 billion. Therefore, 7% of sales for just Wal-Mart is more than twice the $9 billion Professor Walsh claimed was paid to all 1,000 CEOs and was 7% of all 1,000 companies' sales.

It is worth adding that he introduced and repeated the incorrect 7% figure in an attempt to establish that CEOs are highly paid rather than to consider the key question of whether the high pay is driven largely by market forces.

In his first paragraph alone, therefore, Professor Walsh presented inaccurate information that was central to his response. More disappointing is that he failed to engage my argument.

Now let's consider what followed. One of the arguments and empirical results presented in my article was that CEOs are paid for performance. (Critics of U.S. corporate governance often claim that this is not the case.) Josh Rauh and I considered the amount of money a CEO actually realizes and compared that to the company's stock perfor-

mance (relative to the industry) over the previous one-, three-, and five-year periods. We were very clear about what we did. We found a strong relationship between realized pay and previous stock performance, whether over one, three, or five years. In finance and economics, this is the standard way to measure performance. It also is the hot button issue for shareholders of public companies. Investors complain when CEOs earn a lot of money despite a company's poor stock performance. And, of course, boards of directors have a fiduciary duty to shareholders.

Professor Walsh did not challenge our results here at all. He implicitly conceded that there is, indeed, a strong relationship of realized CEO pay to stock performance. And, in fact, in his response Mr. Bogle acknowledged that this strong relationship exists.

Instead of challenging our results that CEOs are paid for stock performance, Professor Walsh presented alternative estimates of CEO pay and performance. Unfortunately, his methodology had two problems that made his results impossible to interpret as he would have liked.

First, Professor Walsh measured compensation as the sum of options granted and options realized. This is logically inconsistent and amounts to double counting. The value of options granted in a particular year is the expected value of the options over the 10-year life of the options. The options realized generally represent options granted in the past that are exercised in a particular year. By counting both options granted and options realized, Professor Walsh effectively counted the value of the options twice. He is counting options from the past and options from the present in the same year. You cannot logically choose to count both.

Josh Rauh and I counted options realized and realized pay overall because that is the best measure of what the CEO actually gets to keep. The CEO does not actually get the value of the options granted in the year of the grant. The options are not worth anything unless the stock price goes up in the future. Professor Walsh's analysis was emblematic of exactly how the critics of CEO pay obfuscate the debate.

Second, Professor Walsh used return on assets (ROA) to measure performance. This is a problematic and inappropriate measure. To see how ROA alone is problematic, consider the case in which a CEO goes into a company with a very low ROA. The CEO is successful in increasing ROA from a very low number to simply a low number. The CEO has done well. The company's stock price will probably have gone up. Professor Walsh's measure will consider this CEO not to have done well because the company has a low ROA. Alternatively, take a CEO who starts with a very high ROA and sees it decline to just a high ROA. The CEO has not done well. The stock price will likely decline. Yet Professor Walsh's measure will consider this CEO to have done well because the company has a high ROA. Change in ROA might be a better measure, but it will be better because it is more correlated with the appropriate measure: the stock performance measure that Josh Rauh and I used.

His other criticisms—about time period and whether the CEOs are paid for their own performance rather than that of their predecessors—also turn out to have no effect on the basic result that CEOs are paid for performance. In particular, the results are qualitatively similar for one-, three- or five-year performance intervals.

Professor Walsh also made the point that CEOs of large companies who do not perform well are still paid what appears to be a lot of money. This should come as no surprise. CEOs of S&P 500 companies, almost by definition, have been very successful over their careers and are very talented. CEOs are paid well on average because they have many other opportunities, the CEO job is riskier and less certain than in the past, and the typical S&P 500 company is a large and complicated entity with more than 20,000 employees. And, again, while CEOs who perform poorly are paid, they are paid much less than CEOs who perform well.

A good analogy might be two lawyers in a high-profile corporate trial. The companies will hire the best lawyers they can find. The lawyers will get paid very well. Yet one side will win and one side will lose. Does that mean the lawyers on the losing side have no talent and should not be paid for the trial or for future trials?

Professor Walsh raised the fairness issue (inappropriately in my opinion), citing a *Parade* magazine survey as evidence that CEO pay is unfair and too high. It is worth adding here that serious scholarship undertakes appropriate and accurate analysis to address the appropriate question. While I understand that popular opinion may be relevant to issues of fairness, I worry when scholarly work is evaluated based on whether it conforms to public opinion. Our job as scholars is to offer facts and analysis in order to inform public opinion, and to attempt to change such opinion when we believe it is inconsistent with the facts.

Continuing his response, Professor Walsh questioned the statistics from Kaplan and Minton (2008) on CEO turnover without having any of his own. There is no doubt, statistically, that CEO turnover has increased significantly since 1998. Others have found that forced turnover also has increased over time. One can argue about the economic significance of the change. It does seem significant to me that the average CEO tenure has declined roughly from 10 years to 8 years (using internal turnover) and from 10 years to 6 years (including external turnover as well).

Professor Walsh pointed out that the relationship between turnover and performance, while statistically significant, is not so compellingly economically significant. Again, this is a matter of interpretation. In Kaplan and Minton (2008), we found that a decline of one standard deviation in industry-adjusted stock performance increases the likelihood of turnover in the next year by 3.4 percentage points. From a baseline of 12.8%, this implies an increase to a 16.2% likelihood of turnover. This represents almost a 25% increase in turnover likelihood in one year. We think that is economically as well as statistically meaningful.

To this point, Professor Walsh had not addressed my basic argument that several other groups experienced similar increases in pay to CEOs, he had not refuted my empirical results, he had inappropriately calculated CEO pay by double counting in his empirical analysis, and he had relied on a serious miscalculation to bolster his argument.

Professor Walsh then turned to attacking my motives. He insinuated that I have conflicts and suggested that these might affect my opinions. He noted that I sit on the boards of three companies and that my compensation appears to have been high at one of them. He claimed that I never revealed this and that this hides a bias on my part toward overpaying CEOs.

The first statement—that I have hidden anything—is simply incorrect. After all, Professor Walsh discovered that I sat on these boards by going to my Web site and SEC filings. The board information will come up in any Google search of my name. More important, I submitted biographical information with my Congressional testimony that explicitly cited those board seats.

Second, it is difficult to argue that the proposed legislation would have any impact on CEO and top executive pay at those three companies. In other words, it is difficult to show much of a conflict. The issue in my Congressional testimony and in my paper is whether CEOs and boards are able to overpay the CEO in a way that would not be approved by shareholders. To be conflicted, as Professor Walsh implied, I would have to be on a board in which the CEO and the board could overpay the CEO (and themselves) against the wishes of the majority of shareholders.

This type of conflict is absent on the three boards Professor Walsh mentioned. Accretive Health is privately held and venture capital funded. Board members represent the large majority of shares. When the board makes a compensation decision, a shareholder majority has approved it. The options in Morningstar to which Professor Walsh referred were granted almost entirely when Morningstar was privately held and there were no public shareholders. Furthermore, the CEO and founder still owns a majority of the shares. When a compensation plan is approved, a shareholder majority has effectively approved it.

The third board is different, but also irrelevant. I am a trustee of the Columbia Acorn Funds, a mutual fund group. The trustees hire an asset management firm to manage shareholder money, but do not set the pay of the CEO of any organization. As a result, the proposed legislation has no impact on the board in that way. In other words, it is hard to see how I benefit in the way Professor Walsh implied. It is not hard to imagine, however,

that by being on the board of a money manager, I might have learned something about the costs and benefits of corporate governance regulations.

One wishes Professor Walsh had probed more deeply. In fact, he could have done so easily if he had simply asked me. This is an elementary courtesy even investigative journalists extend to their targets. One would have expected more of a scholar.

This then takes us to a central point in Professor Walsh's response: the role of a scholar. I do not dispute his right to question my analysis, my arguments, or even my motives. But good scholarship requires a deep understanding of the subject, a careful gathering of the data, and clear, thoughtful analysis, followed by conclusions that are clearly expressed, even if they go against the public mood. I leave judgments about who more successfully met these standards of scholarship to the reader.

Response to Jack Bogle

Jack Bogle (2008) also disagreed with my testimony and paper. Unlike Professor Walsh, he did not question my empirical findings. Like Professor Walsh, he did not address the most important point in my testimony: that other groups—private equity and hedge fund investors, investment bankers, athletes, and lawyers—all have seen their compensation increase substantially and by the same order of magnitude as CEOs, despite the arm's-length nature of their compensation arrangements. He simply asserted that CEO pay is high because of managerial power rather than any market forces. In addition, some of the arguments he made to challenge me turn out to be supportive of my position. In the end, Mr. Bogle's disagreements were ones of assertion that ignored the systematic evidence I presented.

In my paper, I mentioned that the U.S. economy has done relatively well during the time U.S. CEO pay has increased substantially. Productivity growth, in particular, has been unexpectedly good since the 1990s. The point here was simply to say that the U.S. corporate sector has done well over this period and does not appear to be poorly managed. I specifically mentioned that this does not prove causality.

Mr. Bogle basically agreed with this. He pointed out that CEO pay has increased. We agree. He pointed out that corporate profitability has increased. We agree. He then predicted that in the future, profits will decrease. Time will tell. I do not see how anything he said here in any way contradicts my arguments.

Unlike Professor Walsh, Mr. Bogle did address my argument that other groups have seen a large increase in pay just like the CEOs. Rather than attempt to explain why this might be the case, he simply asserted that boards of directors are not subject to market forces (while the others are). I think my evidence is more persuasive than his assertions.

His assertions here have at least two particular problems. First, Mr. Bogle claimed that institutional money managers and mutual fund managers are conflicted and will not attack CEOs. This ignores the large increase in hedge fund activism in the last several years. Hedge fund investors are highly motivated to maximize value because of the way they are compensated—with 20% of the profits on their investments. Hedge fund investors such as Carl Icahn have much more money to invest than in the past. They are using that money to buy shares and put much greater pressure on underperforming companies and CEOs. Despite this increased pressure from outside shareholders, CEO pay remains at the levels it reached in 2000. Consistent with my arguments, it is possible that the greater pressures of these market forces have contributed to the fact that CEO pay has remained relatively stable since 2000.

Second, Mr. Bogle did not have any response to the movement of top public company executives to private equity–funded companies and private equity funds themselves. This movement is hard to explain if public company CEOs are so hugely overpaid. Private equity investors are highly motivated to maximize value and not to overpay their executives. Nevertheless, public company executives, like David Calhoun of General Electric, willingly leave public companies to run private equity–funded companies.

Next, Mr. Bogle discussed pay for performance. He concurred that CEOs are paid for stock performance. So again, he did not disagree with any-

thing I said in my testimony or paper. He disagreed with the idea that stock performance is the appropriate measure because of the fact that stock prices fluctuate in the short term, sometimes in ways not associated with performance. He proposed some different measures, such as earnings growth, cash flow, etc.

Here, I both disagree and agree with Mr. Bogle. Again, as with Professor Walsh, I disagree with Mr. Bogle that boards should not pay CEOs for stock performance. As I mentioned earlier, stock performance is the standard way to measure performance in economics and finance. It also is the hot button issue for shareholders of public companies. Investors complain when CEOs earn a lot of money despite a company's poor stock performance. And, as I pointed out in my paper, private equity investors, who are highly motivated to maximize value, pay their CEOs based on the performance of the company's stock. That suggests that stock performance is the right metric. It also is the case that the results in Kaplan and Rauh (forthcoming) on pay for performance are quite strong using five years of stock performance, which is the reasonably long period Mr. Bogle argued for.

On the other hand, Mr. Bogle was correct in saying that boards can do a better job of paying CEOs. In particular, boards should encourage CEOs to hold a large fraction of their shares and realized options as shares as long as they are CEOs. This ties their wealth to the long-term performance of the company and reduces incentives to take advantage of short-term stock price movements. My understanding is that boards have been moving in that direction.

Finally, Mr. Bogle made some arguments about hindsight. He argued that the outcomes for Charles Prince (CEO of Citigroup), Stanley O'Neal (CEO of Merrill Lynch), and James Cayne (CEO of Bear Stearns) show that the CEO pay system is broken. He argued that they made a lot of money despite the fact that the fortunes of their firms have declined substantially. He called for incentive pay to be phased over a long period and for clawback provisions for returning incentive compensation when earnings are restated. Again, in hindsight, the story is not so simple, particularly in the cases of Cayne and O'Neal.

Mr. Bogle wanted to argue that James Cayne was unfairly overpaid. But as Mr. Bogle pointed out, Mr. Cayne left most of his pay in Bear Stearns stock. As a result, Mr. Cayne saw his stock decline in value from $1 billion to $60 million when he sold the shares in 2008. Mr. Cayne paid dearly for Bear Stearns' poor performance. This is precisely the long-term incentive pay that Mr. Bogle called for (and with which I agree).

Stanley O'Neal's story is similar. Mr. Bogle stated that Mr. O'Neal earned $161 million between 2002 and 2007, then received another $160 million when he resigned in October 2007. That is just not true. Mr. O'Neal did not receive $160 million twice. The $160 million reported when he resigned was largely the cumulative pay he had received in prior years. The number is so large because it was apparently a company requirement that O'Neal leave a large percentage of his stock and options as stock in the company. So Mr. Bogle double counted Mr. O'Neal's pay.

Just as with Mr. Cayne, because Mr. O'Neal left so much of his pay in Merrill Lynch stock, the value of Mr. O'Neal's holdings and his wealth declined substantially as Merrill Lynch's stock price dropped. Again, this is precisely the long-term incentive pay proposed by Mr. Bogle. It also is worth adding that Merrill's stock was roughly $40 when Mr. O'Neal took over in 2002 and was roughly $37 when he resigned. His overall performance was not quite as terrible as Mr. Bogle reported and not the disaster that was Cayne's.

So Mr. Bogle and I agree that long-term incentive pay is a good idea. We disagree that the Cayne and O'Neal examples show that the system is broken. The Cayne and O'Neal examples show that at least some boards do take long-term incentive pay seriously. Unfortunately, the incentives were not strong enough to offset the nefarious effects of the credit bubble.

To summarize, Mr. Bogle acknowledged or confirmed many of my empirical results and did not challenge any. While we agree that the U.S. CEO pay system can be improved, we fundamentally disagree on the extent to which CEO pay and the pay of others is determined by market forces

rather than managerial power. He simply asserted that CEO pay cannot be explained by market forces. Yet he did not explain why other groups have seen their compensation rise by the same order of magnitude as CEOs, despite the arm's-length or market nature of their compensation arrangements.

Overall, I argued that the typical U.S. CEO is not overpaid. The main issue I addressed is whether the high pay of CEOs is largely a market phenomenon or, rather, is driven by the power of the CEOs and the weakness of their boards. I argued that high CEO pay is largely a market phenomenon, likely driven by technological change and increasing scale. While Mr. Bogle and Professor Walsh raised the issue of fairness and feel that CEO pay is unfairly high, they did not present any compelling evidence that those pay levels are not driven by market forces.

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