RESEARCH BRIEF

Center for Executive Succession

CEO PAY AND SHAREHOLDER INTEREST ALIGNMENT

Research that appeared in the *Academy of Management Journal* shows that CEO pay is closely aligned with shareholder interests. Contrary to the rhetoric often put forward in the popular press, CEO and shareholder interest alignment (the degree that shareholder wealth increases as CEO wealth increases) is tightly coupled and has remained quite consistent over time.

Key Takeaways:

- Contrary to popular press reports, CEO pay and shareholder interests are closely aligned.
- CEO pay should be considered in terms of CEO return or the CEO's total firm related wealth, not in one-year snapshots.
- As the financial alignment between CEOs and shareholders increases, CEO wealth increases along with firm performance.

Using data across S&P 1500 companies between 1992 and 2004, researchers found that CEO firm-specific wealth was closely tied to shareholder performance. CEOs were found to do better financially when shareholders also had higher financial returns. Specifically, for each $1,000 increase in total shareholder return, CEOs received $31.13. Similarly, firms with higher financial alignment between CEOs and shareholders performed better over time. Additionally, this relationship remained relatively stable between 1992 and 2004.

The research team also posited that traditional CEO compensation measures (e.g., those that primarily examine single year pay allocations, such as stock options awarded within one year), are inappropriate comparisons to make when thinking about shareholder interests that are cumulative. Thus, the research team advocated considering the total change in CEO firm specific wealth or the total change in the CEO's firm relevant portfolio. This would entail changes in the value of the CEO's equity holdings, including changes in stock option value, restricted stock, etc. The researchers state that this would be a more appropriate basis for comparing CEO financial performance with shareholder financial performance than traditional pay comparisons that erroneously compare a single snapshot of the CEO's pay (e.g., stock option values realized) with changes to shareholder wealth (i.e., shareholder return). The authors termed such a value *CEO return* and explain that to understand the relationship between CEO financial performance and shareholder financial performance, it is necessary to think of both similarly.

Their analysis statistically controlled for aspects of the environment (like year, industry trends), the firm (like size, ROE, and volatility), and the CEO (like tenure).

Source: Nyberg, A.J., Fulmer, I.S., Gerhart, B., Carpenter, M.A., (2010). Agency theory revisited: CEO return and shareholder interest alignment. *Academy of Management Journal* (53) 5: 1029-1049.

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