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The Executive Compensation System is Broken

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This paper is based on the author's comments at the Columbia University Symposium on Bebchuk and Fried's "Pay without Performance: The Unfulfilled Promise of Executive Compensation." The paper offers the author's perspective on the book and the problems of executive compensation it discusses.

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[*] Founder, The Vanguard Group. This paper builds on comments delivered at the Oct. 15, 2004 Columbia University symposium on Bebchuk and Fried's *Pay without Performance: The Unfulfilled Promise of Executive Compensation*. The opinions expressed here do not necessarily represent the view of Vanguard's present management.

Like everyone here, I think my position is probably unique, but I have a variety of credentials, for want of a better word, to address the issues presented today. It's hard for me to put them in order, but let me start off by saying that I am a concerned American citizen. I'm a businessman with fifty-five years of experience. I've been a CEO for thirty-one of those years. I'm the founder of a company, and in a certain funny way, in what I consider a peculiar use of the word, I suppose I'm an entrepreneur. I happen to be a Republican, but one who's been a critic of corporate governance in the recent era, which seems to be an all-too-rare combination. I have been a student and a teacher, and I have something of an academic bent. Over the past twenty-five years I have been an independent director for four different corporations. I've been an audit committee chairman. I've been a compensation committee member; clearly, when you hear my remarks today, you will know that I have never been a compensation committee chairman. I realize how tough these issues are.

I said I was a critic of corporate America. I have been called a hell-raiser, but I'd take issue with that, for I do not believe that I have ever been a hell-raiser in my entire career. I subscribe to the story about Harry Truman, who was on that whistle-stop express in the 1948 election, and everybody yelled, "Give 'em hell, Harry! Give 'em hell, Harry!" to which he said, "I'm not giving 'em hell, I'm just telling 'em the truth and they think it's hell." So I'm here to give you, I hope, a little bit of truth.

The first truth I would like to give you is that, as I read *Pay without Performance*, I did

not find a single point with which I disagreed.[1] (Well, maybe a single one, but I can't remember it.) At most, I might take issue with the phrase "pay without performance," because I disagree with how most people define "performance." This point is a very important part of what I have to say today: *performance is not measured by the price of a stock.* The price of a stock is a terrible basis for any kind of a compensation scheme, yet it serves as the basis for most of the compensation plans we're talking about here today.

For those who don't understand, let me explain. What is the price of a stock? The price of a stock is a perception with momentary precision. The stock price is undoubtedly precise, but it's above all momentary. We have entered into a system where we're giving much more attention to the momentary precision of the price of a stock than the eternal, if elusive and vague, intrinsic value of a corporation.

As I hope we all know, the value of a corporation is nothing more, nor anything less, than the discounted value of its future cash flow. Do we see compensation schemes based on future cash flow? I had not seen one until three years after the Enron scandal broke, and Jeffrey Immelt was rewarded on that enlightened basis. Instead, we see compensation schemes based entirely on the price of the stock.

It is said that stock option plans align the interests of managers with the interests of the owners. Seldom has a more untoward lie been foisted on the American public. Options do no such thing. They have a lottery-like benefit. Executives do not hold their stock. Academic studies have shown that as soon as their options vest, executives

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1. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

exercise the options and proceed to sell the shares almost immediately. Executives are not stockholders; they're gamblers in the stock market lottery.

Indeed, I will tell you a story out of my own experience. In a particular company, we were trying to minimize the use of stock options—which is very difficult to do in the real world because the executives want them—and replace them with restricted stock options in which the shares would have to be held for a certain period of time. As a director, I asked the chief executive of this company, "What length of holding period do you have after executives exercise their stock options?" He replied, "Holding period? Why on earth would anyone do that?" The idea is to get in and get out as fast as you can and, from the standpoint of someone who's trying to maximize his gain, that's the right strategy. But that philosophy has nothing to do with the long-term interests of the shareholders of the corporation. As an aside, I heard the remarks of Mr. Prince of Citicorp in a seminar earlier in the day. Citicorp is setting a great example by requiring its senior executives to hold 75% of their stock during their entire career with the company.

So we're now able to see the results of these option plans. Professor Bebchuk estimates that they generated roughly $260 billion of economic value for corporate America's executives over the last decade, and I think that number sounds about right, maybe even a bit low. So, if we've paid them such a princely sum, these CEOs must be very valuable. Well, let's think about that for a minute—let's think about what they have created.

We know how much value CEOs have added, because people keep track of

everything in this day and age. Over the last twenty years CEOs have provided earnings guidance in which they've called for five-year earnings growth for their companies, averaging 11.5% per year. That is, as everybody knows, a fairly ambitious target. What have they delivered? They have delivered earnings growth of 6% per year. That is, CEOs have fallen about 50% short of their own expressed long-term objectives. Does that performance seem like it's worth a lot to you? Well, maybe they were too optimistic. Maybe they were too ambitious.

So how does that performance compare to the growth of our economy? Well, while the executives were delivering 6% earnings growth, our economy grew at 6.5% per year. In other words, the executives failed to even grow their earnings at the same pace as our economy.

That brings me to the subject of earnings. There are so many games played today in the reporting of earnings. Corporate America has become a giant financial engineering scheme. There's an old management-consultant saying that says, "If you can measure it, you can manage it." Never has that been more true than in the reporting of corporate earnings. Consultants initially used it to say essentially, "If you can measure what somebody is doing, you can manage it." But corporate America has now taken that a step further, and they're managing and measuring every blessed thing in their firms, including their earnings. Why? Because we are compensating them based on their ability to "make their numbers." We've gotten exactly what we asked for. And it is, in a word, outrageous.

I don't know how to characterize these underperforming, but often arrogant, lions

of modern capitalism. Are they irreplaceable? Based on the data, it wouldn't seem so to me. They aren't very good projectors of their future growth and they haven't even been able to increase their earnings above the rate of our GDP. So any compensation system relying on the price of a stock and, by proxy, relying on manufactured earnings is a system that is ripe for abuse. We've seen far too many instances of just that.

We all should know that stock returns come from two simple sources. One is called *investment return*. (Lord Keynes called it *enterprise*.) Investment return, the way I calculate it, would be the initial dividend yield plus the future earnings growth. If the dividend yield is 2% (it's a little less than that now) and the company's earnings grow at 5%, the investment return is 7%. The second source is *speculative return*, which is nothing more than the annualized change in the amount investors are willing to pay for one dollar of earnings. We've just gone through an era where speculative return was the dominant part of this equation.

Let me give you an example. It's a couple of years old, but it makes a good point because it was done at the market high. The S&P 500 index rose from a level of 130 in March 1981 to 1527 in March 2000, the market high, a return on capital equal to 13.8% per year, without even factoring in dividends. The rise in the price-earnings ratio from eight times to thirty-two times accounted for 1100 points of that 1400-point gain, or 7.6% per year, meaning earnings growth was 6.2% per year.

If we take out, as we should, the speculative impact on the rise in the market, and apply a reasonable 5% cost of capital as a benchmark, then corporate management could claim responsibility for a 1.2% annual achievement. Yet when the index reached

1527, a stock option for 10,000 shares at $130, the initial price of the S&P would have placed a nice, cool $14 million on an executive's plate as a reward for that meager 1.2% annual return above the company's cost of capital. That, as they might say, is nice work if you can get it.

Option-based compensation is not a good system because it's so greatly impacted by speculative return. Sometimes it helps and sometimes it hurts. But far too often it results in huge payments unrelated to corporate accomplishment. I heard earlier this morning that General Electric's long-time CEO Jack Welch created $600 billion of value and was fairly entitled to, well, the moon. It should not be ignored, however, that the $600 billion market cap is now approximately $390 billion. Mr. Welch is gone from GE now, and we don't know if poor Mr. Immelt is going to get penalized for that $210 billion loss of capital. But that's just one example of how wild this overcompensation system has become.

One of the problems in awarding boxcar compensation to CEOs, obviously, is that it's easy to spend other people's money. That's what directors are doing. They're spending the stockholders' money, and when the stock price goes way up, the executive comes in and sells his or her stock. Think about this one for a minute: who buys the stock when the executive sells it? Well, I've never seen a thorough economic study of this question, but I would expect that at least a third of that stock is bought by the very corporations those executives run, often at inflated prices. The corporations buy the stock back to avoid share dilution that the option exercise would otherwise create. So the executives not only decide when they're going to sell their stock, they also decide, in

essence, when the corporation is going to buy it back. In this great bull market, right at the high, corporations were buying back their own stocks in massive amounts, certainly at hundreds and hundreds of billions of dollars.

Part of the problem is that when the CEO becomes not only the boss of the business, but also the boss of the board, there's no one to second-guess him or her, despite the fact that the board of directors should be doing just that. We've talked here this morning about the entrenched power of the CEO, and that's one of the core elements in how our system of executive compensation went awry. So you would think that if the directors won't do the job, certainly the stockholders would. Or, more precisely, the stock *owners* will do the job. Well, we have a problem there. There are hardly any stock *owners* left in America. There are plenty of *stockholders*. Every stock is held by somebody. But very few investors own stocks directly. We own our shares through mutual funds, through thrift plans, and through pension plans, where the voting is done by our money managers and trustees, acting (we assume) as our faithful agents. In the institutional investment field, furthermore, we turn our shares over at a rate of 110% per year, meaning the average institutional investor owns the average stock for an average of just eleven months. We're not even holding the stock when the next proxy meeting comes around. Too often, we don't care how we vote, for our focus is only on the short-term, and governance is a long-term issue.

So what began two centuries ago as owners' capitalism—in which our corporations were run for the benefit of their owners—has transmogrified into managers' capitalism, in which our corporations are being run for the benefit of their managers. This

transformation is a big part of the problem, and it's the most difficult part of the problem. How do we return to owners' capitalism when there are so few direct owners of stocks? This is a really awkward, difficult question. Although I do not have an answer for it, I like every single remedy that has been discussed here today that's designed to give corporate directors more strength.

Shareholders need to put some pressure on directors, but alas, except for the wonderful index funds, which probably hold around 15 or 16% of all corporate stock, the attitude of most institutional investors is essentially, "If we don't like the management, we sell the stock." That attitude is an abandonment of not only our rights of corporate citizenship but our responsibilities of corporate citizenship. Until we can solve that problem, we're not going to get very far. We have to move away from being a rent-a-stock industry, and back toward being an own-a-stock industry.

There's a peculiar twist to this notion of stockholders and stock owners: in many ways corporate America owns itself, and that's a big part of the problem. Think about it. Who, ultimately, owns all of this stock? It's owned by corporate pension plans, and it's held in corporate 401(k) plans, and it's run by managers who are paid money to run those plans by the corporations themselves. So we have a system that's kind of interlocked and gravely conflicted.

Now, it's time to wrap this up. Because I built a firm based upon full disclosure, I thought I ought to make a clean breast about my own compensation. As a CEO for thirty-one years, how did I do? What arrangements did I have? How many apartments, how many perks, how many jet planes, how many consultants helped me negotiate my

contract in all these years? So I would have a little credibility, I thought I owed it to you to tell you about my personal situation.

First, my average annual compensation as CEO over this long period has been in the six-figure range, but, truth be told, in the very high six-figure range. Second, I have no pension plan, and never have had a pension plan, and don't want a pension plan. My future retirement benefits are zero. I have no club dues paid; I have no apartment in New York. At Vanguard, we don't have a jet plane, but I don't think I'd be allowed to use it if we did. The one perk I do get, due to some health issues that I won't bore you with, is that a man from our mail room comes down to my home and picks me up in the morning, takes me to work, and when the day ends eleven hours later, drives me home. It's the only perk that I can remember.

While I am no longer a participant in the Vanguard Partnership Plan, which is what I created shortly after starting Vanguard to provide some extra incentives for our crew members (employees), it was a major factor in the generous compensation I described earlier. And when my compensation got out of hand on the high side because we did so well at Vanguard, I gave back to the company, without any commensurate benefit, 40% of the shares I owned in that Partnership Plan.

Now, I have made a lot of money, and I make no apologies for that. But spending money was never one of my strong points. I have been criticized for not being a picture of sartorial elegance, but so has Warren Buffett; it's not because of money, we just dress the way we dress. But I have always tried to walk the walk that matches the talk I've given you today.

The bottom line is that our system of executive compensation is broken. It must be fixed. I salute the authors of *Pay without Performance* for giving us a marvelous, indeed almost timeless, platform in which we can at last begin to develop long overdue corporate reforms.