Ethical Capital Opportunity ECO Advisors

RESEARCH SPOTLIGHT

Q3 2022 INCOME INEQUALITY AND EXECUTIVE PAY

In previous newsletters, we highlighted how the COVID-19 pandemic has acted as an important driver for a number of important ESG themes, including labour and employment practices, HR policies, and supply chain robustness.

We noted that some of the most severe economic impacts of COVID-19 fell on the parts of the economy which were least able to afford them, such as those in precarious work and the gig economy[1]. COVID-19 exacerbated socioeconomic inequalities in several ways, especially for manual workers and those who aren't able to work from home. As a result, a new spotlight has been shone on company governance practices to do with income inequality and excessive pay packages of company executives. Executive pay has become more relevant than ever as investors have begun to examine this G pillar ESG issue with a more critical eye[2].

In 2022, record numbers of investors are rebelling against excessive CEO pay and have targeted individual board directors to try to force action. In the last year, only 61 percent of S&P 500 companies that held annual meetings received more than 90 percent support for executive pay, down from 71 percent last year and 76 percent in 2020, according to pay consultancy Farient Advisors[3]. Despite this, US CEOs are on track to reap record rewards this year, raising the prospect of fresh clashes with investors and employees as the gap between their earnings and those of their staff widens to a historic multiple. For the 280 S&P 500 companies that have reported figures as of April 2022, the median CEO's pay has jumped to a record $14.2m for 2021, up from $13.5m in 2020, according to ISS Corporate Solutions[4].

Among the largest executive pay packages to have been announced were David Zaslav's $247m at Discovery, Pat Gelsinger's $178.6m at Intel and Andy Jassy's $212.7m at Amazon[5]. Chief executive pay ratios, which compare a chief executive's total annual pay with that of the median company employee, are also on track to hit a record after a stock market rally delivered far larger windfalls to bosses than to their employees.

According to Equilar, a data company that tracks chief executive rewards at the biggest companies by revenue, the median ratio has shot up to 245 for 2021 from 192 for 2020. If the trend holds, "it would be the largest year-over-year increase since the ratio became a required Securities and Exchange Commission disclosure during the 2018 proxy season"[6].

Bonus payouts were a big driver of last year's increase in executive compensation, according to ISS, with many companies rewriting bonus plans to ensure that losses due to the pandemic did not negatively impact CEO pay. For example, cruise operator Carnival (a position in our short book) did not pay its chief, Donald Arnold, an annual bonus in 2020, but the $6m bonus it gave him for "incentive pay" in 2021 lifted his total pay from $13.3m to $15m. This is despite the fact that the company suffered financial losses of $9.5bn for 2021 and $10.2bn for 2020, when the pandemic saw a complete cruise sector shutdown that lasted 18 months[7].

Executive Pay and Links to Performance

The justification for large compensation packages has centred around the assumed correlation between pay and company performance. Over the past several decades, the academic literature on agency theory and executive compensation has argued that CEO compensation should be aligned to firm performance (see for example, Holmstrom, 1979, Grossman and Hart, 1983, and Jensen and Murphy, 1990). The idea is simple — you want management to act like a long term owner, rather than a highly paid employee.

Are leaders paid like owners in reality? Common wisdom is that they are not. A 2016 report by Chris Philp, a UK Member of Parliament, argued that "there is clear evidence that high CEO pay is no longer strongly associated with performance"[8].

[1] https://www.nytimes.com/2020/03/15/world/europe/coronavirus-inequality.html?action=click&module=RelatedLinks&pgtype=Article

[2] https://www.ft.com/content/a7674cca-1cfb-419f-af5f-b05bbb5b2644

[3] https://www.ft.com/content/a7674cca-1cfb-419f-af5f-b05bbb5b2644

[4] https://www.ft.com/content/f02787c1-35a8-41c4-8099-395109e49b4f

[5] https://www.ft.com/content/f02787c1-35a8-41c4-8099-395109e49b4f

[6] https://corpgov.law.harvard.edu/2022/03/29/proxy-season-2022-early-trends-in-executive-compensation/

[7] https://www.tradewindsnews.com/cruise-and-ferry/carnival-chief-executive-pay-grows-to-15-1m-despite-9-5bn-covid-19-losses/2-1-1169667

[8] Chris Philp, 'Restoring Responsible Ownership: Ending the Ownerless Corporation and Controlling Executive Pay' (2016).

The Harvard Business Review has argued that in most publicly held companies, “the compensation of top executives is virtually independent of performance” and that “on average, corporate America pays its most important leaders like bureaucrats”[9].

As Jensen and Murphy put it, “Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?”[10]

ECO Advisors put this relationship to the test. We started with the hypothesis that higher executive pay should positively correlate with superior share performance. Controlling for other factors, we examined total realised CEO pay, total annual CEO pay, severance pay packages, and evaluated companies by pay percentile in their home market and the global market. Our analysis covered several thousand companies globally. However, we did not find evidence for a positive correlation between these variables and company performance. In fact, we found evidence that excessive pay perks (which includes overly generous pensions and personal use of company jets) had a negative relationship with share performance. We also found that golden parachutes (defined as a large payment or other financial compensation guaranteed to a company executive should they be dismissed as a result of a merger or takeover) had a negative relationship with long term shareholder value creation. It is certainly not obvious to us that the hypothesis that more generous executive pay and perks are linked to superior company performance holds true.

These findings may be due to the significance short-term incentives and bonuses have had on overall CEO compensation, and which, as we discussed, seem to be increasing post-pandemic. Cooper et al. states that “politicians and the media have argued that current executive compensation practices push employees to take short-term risks with little regard for the long-term effect on their companies.”[11] Research suggests that the best way to make a leader accountable to the long-term stock return is to offer lower fixed compensation, such as salary, which they receive irrespective of performance, and in lieu of greater deferred compensation, such as restricted shares[12]. The value of these shares is automatically sensitive to performance. In contrast, performance targets and metrics can often inadvertently encourage short-term decision making. Because short-term targets can be subject to “gaming”, (for example through cutting R&D), they can lead to distortions in appropriate long term executive decision making[13].

[9] https://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how

[10] https://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how

[11] Cooper, Michael, Gulen, Huseyin, Rau, P. Raghavendra. “Performance for pay? The relationship between CEO incentive compensation and future stock price performance.” Wall Street Journal Resources, Dec 2009. p. 1

[12] See: Jensen, Michael, and Kevin Murphy. “CEO Incentives—It’s Not How Much You Pay, But How.” Harvard Business Review, 1990.; Milgrom, Paul, and John Roberts. Economics, Organization and Management. Prentice-Hall International, 1992.

[13] Edmans, Alex. Grow the Pie: How Great Companies Deliver Both Purpose and Profit. Cambridge University Press, 2020.

It is much harder to improve the long-term stock return through "gaming" targets. Edmans argues that "removing targets frees the leader from trying to hit them and instead frees her to create value. She does so with the reassurance that she'll be rewarded after the fact, since value creation typically improves long-run stock returns." [14] With long term restricted stock, he says, executives are rewarded for "delivering a performance flow, rather than meeting performance goals"[15].

Research results indicate that stock markets respond positively to the adoption of long-term incentives programs for senior executives. One study by von Lilienfeld-Toal and Stefan Ruenzi studied the relationship between CEO voluntary stock ownership and long-term stock returns over a twenty-three-year period. Firms with large CEO stakes "beat those with small stakes by 4% to 10% per year". They also enjoyed higher return on assets, labour productivity, cost efficiency and investment[16]. In another study, from 1970 through 1988, the average annual compound stock return on the 25 companies with the 'best' CEO incentives, defined as "controlling a meaningful percentage of total corporate equity", was 14.5%, more than one-third higher than the average return on the 25 companies with the 'worst' CEO incentives[17].

While we have focused on corporate value creation in the discussion so far, we note that executive compensation – both size and structure – may also have serious implications beyond the company, its employees and its shareholders. Some research suggests that unreasonably high pay packages for executives can have a negative effect on society and social wellbeing[18]. Most of the literature on executive pay is written by economists, and focuses only on the effects of executive pay alignment on shareholder value, and neglects the arguments that high absolute pay can be socially detrimental and generate negative social externalities. Social research on the 'economics of happiness' fills this gap. One study concluded that income disparity causes levels of happiness and satisfaction to drop in 60% of Americans, and leads to a degraded sense of general well-being.

Specifically, the growing gap has been found to lead to the destruction of employee morale, and the trust that is needed to make businesses run efficiently[19]. Other research suggests that as income inequality increases, in a practical sense, even if one is middle class, some things start getting priced beyond ones reach. Similarly, there is a psychological effect, in that increased inequality, even if one's own income also rises, can make one feel like their chances of "moving up the ladder" become more and more slim[20]. These outcomes can have a ripple effect, as other research has shown that unhappy workers tend to be less productive and are more likely to take longer sick leaves, as well as to quit their jobs[21] [22].

On August 25, 2022, the US SEC adopted final rules requiring public companies to disclose the relationship between the executive compensation actually paid to the company's named executive officers and the company's financial performance. The final rules implement the "pay versus performance" disclosure requirements mandated by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in 2010. The SEC issued proposed pay-versus-performance rules in 2015 and reopened the comment period on the proposed rules in January 2022[23].

ECO Advisors: Stewardship, Engagement and Executive Pay

Utilising our research and in consultation with labour economics experts, we created a bespoke in-house stewardship and voting policy. We have voted at 100% of eligible AGMs, and in 2021 we abstained or voted against 14% of executive pay proposals due to concerns around pay levels, structures, or insufficient ties to sustainability. Furthermore, we always communicate our concerns around executive pay to our investee companies.

We look to encourage executive pay that emphasises long-termism, such as restricted shares, over large fixed payouts and performance targets that encourage short-term decision-making.

[14] Edmans, Alex. Grow the Pie: How Great Companies Deliver Both Purpose and Profit. Cambridge University Press, 2020. pp.119

[15] Edmans, Alex. Grow the Pie: How Great Companies Deliver Both Purpose and Profit. Cambridge University Press, 2020. pp.116

[16] Ulf Von Lilienfeld-Toal and Stefan Ruenzi, 'CEO Ownership, Stock Market Performance, and Managerial Discretion' (2014) 69 Journal of Finance 1013–50.

[17] Jensen, Michael, and Kevin Murphy. "CEO Incentives—It's Not How Much You Pay, But How." Harvard Business Review, 1990.

[18] Yu, Zonghuo, and Fei Wang. "Income Inequality and Happiness: An Inverted U-Shaped Curve." Frontiers in Psychology, vol. 8, 2017, doi:10.3389/fpsyg.2017.02052.

[19] Oishi, Shigehiro, et al. "Income Inequality and Happiness." Psychological Science, 2011.

[20] https://hbr.org/2016/01/income-inequality-makes-whole-countries-less-happy

[21] Oswald, Andrew J., et al. "Happiness and Productivity." Journal of Labor Economics, vol. 33, no. 4, 2015, pp. 789–822. JSTOR, www.jstor.org/stable/10.1086/681096. Accessed 20 Nov. 2020.

[22] Clark, Andrew E. "What Really Matters in a Job? Hedonic Measurement Using Quit Data." Labour Economics, vol. 8, no. 2, 2001.

[23] https://www.sec.gov/news/statement/gensler-statement-pay-vs-performance-082522

We believe each case must be considered individually and on a discretionary basis, and we carefully document our rationale based on the guidance set out in our Stewardship Policy document as part of our voting process. We directly engage with companies through our voting process by communicating our rationale to all companies where we vote against a proposal.

Some pay assessment criteria we evaluate in our voting decision making process before deciding to vote in favour, to abstain, or to vote against a proposal include:

- Deferred compensation & vesting period: 1 year minimum vesting period, we prefer 3-5 years target vesting period
- Golden hellos and parachutes: The company provides a golden hello/golden parachute to its CEO or other senior executives
- Significant shifts away from performance-based compensation to discretionary or fixed pay elements without justification

Full detail on our policies and assessment criteria are available in our Stewardship Policy document.

Governance, Executive Pay, and our ESG Security Selection Process

Our ESG security selection process penalises companies where executive pay issues, such as those listed above, have been flagged. For each company in the universe our proprietary ESG scoring process uses material ESG factors to determine candidate pools of securities eligible for our long book and short book. Factors such as excessive pay relative to peers, severance vesting, golden parachutes, long term pay performance links, and other executive pay factors make up a significant component of our G pillar input into the final ECO score of a company. We have also added penalties to scores where we have found a negative relationship between factors and performance, such as golden parachutes and excessive pay perks, as discussed earlier.

Executive Pay Engagement Case Study: *Pros Holdings*

One example of our direct engagement with a company on executive compensation is in the case of the 2021 Pros Holdings AGM. We saw Pros Holdings as an ESG improver and overall it showed strong governance practices relative to peers.

In terms of executive compensation, however, we communicated the following to the company ahead of the AGM:

“While ECO Advisors encourages remuneration composition shifts away from fixed compensation heavy schemes towards long-term incentives, we expect that these long-term incentives will be performance-based or have a strong tie to performance. In the case of Pros Holdings we note that only 50 percent of the overall compensation is explicitly linked to performance… We do not view the current executive compensation structure to be in line with the spirit of long-term incentives as outlined in our voting policy, and as such, we have chosen to abstain on the relevant proposal.”

The company responded requesting a meeting and we met with the Chief People Officer and Senior Manager of Investor Relations. During a fruitful conversation we communicated our expectations around executive pay and ultimately stood by our voting decision at the AGM.