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CEO compensation and future shareholder returns: Evidence from the London Stock Exchange ☆

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ABSTRACT

This study examines the ex-post consequences of CEO compensation for shareholder value. The main objective is to explore whether companies that pay their CEO excessive fees (in comparison to those of peer firms in the same industry and size group) generate superior future returns and better operating performance. Our analysis, which separately considers the cash-based and incentive/equity-based components of CEO compensation, is based on a large sample of UK-listed companies over the period 1998–2010. We find that CEO incentive pay is negatively associated with short-term subsequent returns. Interestingly, firms that pay their CEOs at the bottom of the incentive-pay distribution earn positive abnormal returns and, also, significantly outperform those at the top of the incentive-pay distribution. Further analysis reveals that such outperformance can be largely explained by the excessive exposure of low-incentive-pay firms to idiosyncratic risk. Finally, evidence from panel regressions suggests that, in addition to its negative relationship with returns, incentive pay is also inversely associated with future operating performance.

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1. Introduction

Chief executive officer (CEO) pay has long attracted a large amount of scrutiny and public controversy. Following the recent financial crisis, which revealed severe flaws in corporate compensation practices, a subject of intense debate is whether cross-sectional variations in CEO pay can be fully justified by economic fundamentals (Bizjak et al., 2011; Faulkender and Yang, 2010). Prior empirical research that attempts to address this issue provides contradictory results. On the one hand, a large strand of literature documents evidence consistent with the view that compensation serves as a broadly effective means of aligning the interests of managers with those of shareholders (Bizjak et al., 2008; Gabaix and Landier, 2008; Hall and Liebman, 1998; Himmelberg and Hubbard, 2000; Kaplan, 2008; Kaplan and Rauh, 2010). Accordingly, it is argued that any increase in CEO pay reflects significant changes in the market for CEOs (e.g. shortage of skills and talent) and can be explained by the nature of the CEO job itself (e.g. tight corporate governance) (see Murphy and Zábojník, 2004). On the other hand, another line of research, which draws upon the managerial power approach, treats CEO pay as a complicating factor rather than a solution to the agency problem (Bebchuk and Fried, 2003, 2004; Bebchuk and Grinstein, 2005; Bertrand and Mullainathan, 2001; Yermack, 1997). The proponents of this so-called "skimming view" of CEO compensation emphasize the ability of managers to expropriate wealth from shareholders.[1]

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[1] Goergen and Renneboog (2011) provide a comprehensive review of the literature on managerial compensation.

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A common feature of much of the prior literature is that it examines CEO pay from an *ex-ante* perspective, based on the view that current pay arrangements should be linked to past performance. This perspective assumes that a positive association between CEO pay and past performance is attributed to the fact that past performance signals a CEO's ability to successfully manage the firm (Danker et al., forthcoming). However, another perspective is that boards of directors use non-observable (to outsiders) information to reward CEOs for actions that may benefit the firm in the long run. Importantly, such actions are not always reflected in currently observable performance (Hayes and Schaefer, 2000).[2] This implies that effective compensation policies, particularly incentive-based pay, may induce managers to exert costly effort to increase their firms' future growth opportunities (see Grout and Zalewska, 2010), which helps eliminate agency conflicts between top managers and shareholders and creates shareholder value in the long term. According to this view, CEO compensation should be linked to future shareholder returns.

This study adopts the latter perspective and examines the *ex-post* consequences of different CEO pay arrangements for shareholder value in the UK. Drawing upon and extending a growing body of literature on the consequences of CEO compensation,[3] our objective is to explore whether companies that pay their CEOs higher fees generate superior subsequent stock returns and better operating performance. Using a sample of 1787 companies listed on the London Stock Exchange (LSE) over the period from 1998 to 2010, we firstly sort firms on the basis of their raw as well as industry- and size-adjusted measures of CEO compensation and assign them to the corresponding decile, quintile and percentile portfolios. Post-ranking equally-weighted portfolio returns are then calculated. To classify firms, we use total CEO pay as well as measures of the cash-based and equity-based (or incentive) components of compensation. This allows testing the conjecture that different components of compensation are associated with different outcomes for future shareholder returns. Abnormal portfolio returns are estimated on the basis of both commonly used asset-pricing models (the CAPM, Fama–French and Carhart models) and asset-pricing models that account for higher co-moment factors and idiosyncratic volatility. Additionally, we use panel regressions to investigate how CEO pay affects future operating performance.

Our results reveal the existence of a strong negative relationship between (excess) CEO incentive pay and future shareholder returns. More specifically, firms in the lowest incentive-pay decile earn significant abnormal returns of between 6.58% and 10.37% p.a., depending on the asset-pricing model used. Conversely, firms in the highest incentive-pay decile yield considerably lower and statistically insignificant risk-adjusted returns. Moreover, our panel-data results suggest that, in addition to its negative relationship with returns, CEO incentive pay is also negatively associated with future operating performance. We subject these results to a series of robustness tests (e.g. considering different portfolio-formation criteria, using alternative measures of excess pay, excluding firm-years characterized by CEO turnover, excluding firms with high ownership concentration, allowing for different lags between the period that elapses from the end of the financial year until the actual publication of the annual report, and using various asset-pricing models and alternative panel-data estimators).

We then perform several tests to understand the drivers of the outperformance of low-incentive-pay firms. First, we check whether performance differences between low-incentive-pay and high-incentive-pay portfolios are driven by differences in exposure to higher co-moment factors, such as negative coskewness and positive cokurtosis, or “tail risk”. Our empirical tests rule out this possibility. Our results are also inconsistent with the overconfidence hypothesis, which suggests that overconfident CEOs accept large amounts of incentive pay and subsequently engage in firm-value-destroying activities that are associated with lower future returns (see Cooper et al., 2013). Finally, we check whether low-incentive-pay and high-incentive-pay firms are exposed to different levels of idiosyncratic risk. We provide evidence supporting the view that the outperformance of low-incentive-pay firms can, to a large extent, be explained by their excessive exposure to idiosyncratic risk.

This study contributes to a growing body of research on the *ex-post* shareholder value consequences of CEO pay in several ways. To the best of our knowledge, this is the first study to examine the relationship between CEO pay and future shareholder returns for firms listed on the LSE. The UK market is often used as a model for sound governance when it comes to CEO pay. This is due to the perception that UK CEOs' pay is relatively low, and also to the existence of legislation that mandates an advisory shareholder vote (“say on pay”) on the executive compensation report (see Ferri and Maber, 2013). However, a recent study by Conyon et al. (2011) shows that risk-adjusted pay for US CEOs is not consistently higher than that for UK CEOs. In particular, Conyon et al. (2011, p. 433) find that “while US CEOs have higher risk-adjusted pay in 1997, UK CEOs have higher risk-adjusted pay in 2003”. Likewise, Fernandes et al. (2013) show that after controlling for firm, ownership, and board characteristics, 2006 CEO pay in the UK is the highest among 14 countries with mandated pay disclosures. Moreover, following poor performance relative to their peers during the recent financial crisis, several leading UK companies have suffered the embarrassment of losing (or coming close to losing) a shareholder vote on executive pay (e.g. Aviva, Barclays, Xstrata, Premier Foods).[4] To this end, the UK market provides an interesting setting to study the relationship between CEO compensation and shareholder value.[5] So far, only one study has addressed the link between CEO compensation and future (long-term) stock price performance, and it focused on the US market (see Cooper et al., 2013).

A notable difference between the present study and that of Cooper et al. (2013) stems from the methodology used. In addition to panel regressions that help establish the link between CEO pay and operating performance, we also put forward a flexible multi-factor asset-pricing framework to examine the link between CEO pay and stock returns. We employ both standard asset-pricing models, which account for the market, size, value and momentum factors, and also models that control for higher

[2] For instance, the costs of certain actions, such as acquisitions or R&D expenditures, are usually incurred immediately while the benefits are unlikely to be observed for several years (see Lerner et al., 2011).

[3] See, for example, Abowd (1990), DeFusco et al. (1991), Yermack (1997), Hayes and Schaefer (2000), Hanlon et al. (2003), Conyon and Freeman (2004), Bebchuk et al. (2011), Minnick et al. (2011), Grout and Zalewska (2010, 2012) and Cooper et al. (2013).

[4] See BBC News—Business: “Aviva boss Andrew Moss to step down”, 8th May 2012.

[5] See Zalewska (2013), Ferri and Maber (2013) and Voulgaris et al. (2010) for a detailed discussion on the key features of the UK corporate governance system, and its differences from the US one.

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