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On Leadership

Why we can't seem to cure CEO pay

By Roger Martin April 17, 2012

This piece is part of an On Leadership round table exploring the reasons behind the persistence and prevalence of outsized executive pay.

The ridiculous but persistent system that companies use to compensate CEOs is a lot like the medical establishment's traditional treatment for peptic ulcers. And I don't just mean because they can both cause nausea or a loss of appetite.

Rather (stay with me here) it's because both the modern formula for executive compensation and the supposed cure for peptic ulcers stuck around, or continue to do so, because they were — or are — backed up by a well-articulated theory that makes a lot of sense on its face, even if it doesn't produce results.

Just like old habits, old theories die hard, especially when they have an evocative story behind them.

For years, doctors thought of the stomach like a bag lined with delicate material that could be damaged by excessive acid, causing ulceration. Ever since a German doctor wrote an article in 1910 stating "no acid, no ulcer," a treatment of antacids and bland diets to keep down stomach acidity became the norm.

This regimen continued for decades despite increasing evidence that it was ineffective.

Then in the early 1980s, two Australian researchers, Barry Marshall and Robin Warren, proposed that it was actually the bacterium *h. pylori* that caused ulcers. But the medical establishment, attached to the compelling "no acid, no ulcer" theory, rejected the idea so thoroughly that Marshall ingested *h. pylori* himself to prove his point. It wasn't until a decade later, however, that bacterial infection finally emerged as the dominant explanation.

Modern executive compensation is set up on a similarly entrenched theory. The idea that stock-based compensation aligns the interests of shareholders and management makes loads of sense, on its face: If shareholders do well, executives do well. If shareholders do badly, executives will too. What's not to like about that?

The problem is that this theory doesn't really work. The first part is true: When company performance goes up, CEOs tend to do well. But all too often, poor performance does not equal similarly lower payouts for top management. Consider, for instance, the year 2008, when the S&P 500 stock index tumbled more than 37 percent. The median CEO pay package edged downward just 0.08 percent.

Even worse, stock-based compensation causes executives to focus on manipulating the market's expectations about future performance rather than working to improve the actual performance of the company. That results in a track record of lower shareholder returns and higher volatility — but also higher executive compensation. Since the theory is viewed as so very sound, however, the reaction by boards and their compensation consultants is that the theory works but the implementation needs to be tweaked. These minor changes, however, are never big enough, as they leave the underlying theory in place.

Marshall and Warren, the ulcer researchers who were recognized decades later with a Nobel Prize, showed the greatest kind of leadership: taking on an ensconced but adverse theory and proving it wrong. Similar leadership needs to be shown in demolishing the

deeply flawed “alignment” theory behind stock-based compensation.

It is not as though no one has taken it on. When Robert Wood Johnson took Johnson & Johnson public in 1948, he made it clear in his credo that shareholder interests came after those of customers, employees and the communities in which J&J works, noting that investors would earn a ‘fair return’ if the company took care of the other three groups first. In Google’s IPO, Larry Page and Sergey Brin said the company would never give earnings guidance — and have stuck to their promise. Meanwhile, former Procter & Gamble CEO A.G. Lafley showed leadership when he worked with his board to set up his stock-based compensation so that it vested in ten equal parts in each of the ten years *following* his retirement. That ensured that his incentive was tied to the long-term prosperity of the company.

Right now we need pension fund leaders, who are responsible for the majority of shares that can be voted on, to wield the power they have for change. Currently, they vote largely in favor of incentive-laden stock-based compensation packages because they believe this is in the interests of their pensioners. Sadly, it actually works directly against them, and they are the only force strong enough to reverse the tide.

The good news? All they need to do is start voting differently. The criticism they’ll receive from the business establishment may be a bitter pill to swallow, but at least they don’t have to ingest bacteria.

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