February 2, 2018

Dear XXXXXXX,

Active money managers are well advised to avoid investing in companies that overpay their CEOs and engage in massive buybacks. But passive investors make no judgments about CEO pay (or most other issues) before investing. The desire to simulate an index drives investment decisions.

Nonetheless, it is still in your self-interest to be concerned how much and how CEOs are paid because passive investment strategies will perform better if CEO pay increases become less outrageous.

Companies that overpay their CEOs are usually poor investments. This is confirmed by a number of recent studies cited in Attachment A: *CEO Pay and Company Performance*.

Why does outsized CEO pay lead to poor performance? The millions that companies waste on executive pay is a small part of the cost. The effects on employee morale are much more expensive. However, the most harmful effect is that the methods used to pay CEOs encourage short-term thinking. Consider stock buybacks.

The average Fortune 500 CEO serves only 4.7 years, receives 85% of total compensation in equity awards, and typically cashes out soon after vesting. Moreover, since stock price is often a metric that drives bonus levels, CEOs have a compelling incentive to realize a high stock price.

The CEO has two paths toward this: (1) The hard path is to beat the competition by developing new products, training the workforce, employing new technology, increasing productivity, providing excellent customer service, controlling costs, etc. (2) The easy path is to buy back your own stock.

From 2005 to 2016, stock buybacks by America's 500 largest public companies exceeded $4.9 trillion. This was double what they paid in dividends. Rather than building trust and loyalty with shareholders through higher dividends, these companies chose to decapitalize. Buybacks consumed over half of their net income. According to accepted finance theory, buybacks make sense only when a company has excess cash, poor investment opportunities, and a stock below its "intrinsic" value. But the S&P 500 buybacks continued at the rate of over half a trillion dollars in 2017 as stocks soared to all-time highs.

Buying back your own stock in frothy markets—creating a short-term high followed by a painful hangover—is a self-defeating strategy. Buybacks have depressed capital investment. Capital expenditures to revenue levels are at a 20-year low and down 20% since 1995. R&D expenditures have dropped by roughly 50%. When buybacks impede innovation and new products, short-term gains turn into long-term losses.

Studies listed in Attachment B: *Stock Buybacks and Company Performance* substantiate that eating the seed corn does not pay off in the long run.

Similarly, CEO bonuses based upon earnings-per-share or other annual financial metrics focus attention on year-end results instead of the future, bringing immediate relief at the cost of chronic pain.

Unlike publicly traded companies, the time horizon of successful family companies encompasses generations. They stress the values of stewardship and responsibility; they treat and pay employees fairly. This allows them to successfully compete despite problems caused by nepotism, family rivalries, and the

inability to access public markets.

The short-term focus at publicly traded companies is not the sole cause of colossal CEO pay. The procedures used to determine CEO pay such as peer groups, percentile rankings, and bonus metrics and ranges, ensure continued escalation in CEO pay. The often cozy relations between the board, compensation consultants, and the CEO have deterred any attempts to contain the upward spiral.

Why do directors continue to overpay CEOs in light of persuasive documentation of its toxicity? Because it is accepted procedure and everyone else does it. Directors listen to pay consultants, falsely believe that their pay system motivates and rewards performance, and claim they must pay a market rate when there is no market (companies rarely hire another company's CEO because their knowledge and skills are seldom portable).

CEO pay will never be restrained as long as large companies employ procedures recommended by pay consultants that constitute a pay machine.

The US based managers of index funds such as Vanguard, BlackRock, and State Street are often the largest shareholder in companies with outrageous CEO pay packages. Unfortunately, they vote to approve these egregious pay packages 97% of the time, contrary to their fiduciary responsibilities to control costs for investors whose money they manage. This is in stark contrast to European based managers who vote against a substantial number of these pay packages. For example, in the first half of 2017, HSBC only supported 2.7% of say-on-pay votes at US companies and Dutch pension fund PGGM opposed all but 3.9%. Some domestic investment funds are moving in this direction. According to the non-profit organization As You Sow, Russell, VanEck, Dimensional, and RidgeWorth voted against more than 50% of pay plans for CEOs identified among the 100 most overpaid.

Token votes against the most egregious CEO pay packages will have no impact. *We suggest that the default position for all passive investors should be to vote no on all say-on-pay votes.*

We further suggest the yes votes should be considered only when:

1. The company has *not* engaged in large stock buybacks.

2. The board has *not* used absurd pay procedures such as:

    a. Using a peer group that includes companies and industries that would never hire this CEO.

    b. Using a peer group that excludes foreign companies even when they are the fiercest competitors.

    c. Using a peer group to set CEO pay but never testing company performance against the same group.

    d. Awarding equity bonuses with no precise explanation of how bonus levels were established.

    e. Awarding equity bonuses with no performance requirement.

    f. Adjusting earnings, or other financial metrics, upward to account for unusual events.

g. Using bonus metrics that can be easily manipulated such as earnings-per-share for a single year.

h. Using bonus metrics like EBITDA that ignore the capital and financing costs.

i. Awarding bonuses for nonfinancial achievements such as meeting milestones or management objectives.

j. Targeting CEO compensation above the 50th percentile of the peer group without explicit justification.

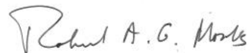
3. The CEO is reasonably paid. One indication, now a required disclosure, is the ratio of CEO to median employee pay. According to Plato, this ratio should not exceed five. Management guru Peter Drucker suggested an upper limit of 20 times because a larger gap made successful teamwork difficult. For the S&P 500, this ratio now runs from 271 to over 400 depending on the definition of pay. There are more sophisticated, multifactor measures to judge CEO pay equity. We urge you to develop and promulgate guidelines that identify unreasonable pay for CEOs.

We would be happy to discuss this subject with you, your board, and your advisors at your convenience. Whatever your position may be, the undersigned—persistent engagers for shareholder rights—would appreciate the courtesy of a written response.

Sincerely yours,

Stephen Silberstein, cofounder of Innovative Interfaces Inc. and trustee of the $2.3 billion Marin County (CA) Employees Retirement Association.

Ralph Nader, consumer advocate and author who has established many citizen groups.



Robert Monks, former CEO, former bank chairman, federal and state executive, director on many private and public boards, cofounder of ISS and Lens Fund, and author of several books on corporate governance.

Steven Clifford, former CEO, director on a dozen private and public corporate boards, and author of *The CEO Pay Machine* (New York: Blue Rider Press, 2017).

Responses may be mailed to:
Ralph Nader
Center for Study of Responsive Law

PO Box 19367
Washington, DC 20036

or they may be emailed to: info@csrl.org

Attachment A

CEO Pay and Company Performance

- Professors Michael J. Cooper of the University of Utah, Huseyin Gulen of Purdue University, and P. Raghavendra Rau of the University of Cambridge examined the relationship between CEO pay and stock performance at the 1,500 companies with the largest market capitalization. In the three-year periods from 1994–2015, they found the more CEOs got paid, the worse their companies did.

  The top 10% of CEOs in pay returned 10% less to their shareholders than did their industry peers. While these CEOs were paid an average of $21 million a year, the shareholders of these companies received $1.4 billion less than comparable companies with lower paid CEOs. The more CEOs were paid, the worse they performed. The companies in the top 5% in CEO pay did 15% worse, on average, than their peers.

  The study also found that the longer CEOs were in place, the worse their firms performed. Cooper says this is because those CEOs are able to appoint more allies to their boards, and those board members are likely to go along with the bosses' bad decisions. "For the high-pay CEOs, with high overconfidence and high tenure, the effects are just crazy," *Forbes* says. "They return 22% worse in shareholder value over three years as compared to their peers." [1]

- "Companies that awarded their Chief Executive Officers (CEOs) higher equity incentives had below-median returns based on a sample of 429 large-cap U.S. companies observed from 2006 to 2015. On a 10-year cumulative basis, total shareholder returns of those companies whose total summary pay (the level that must be disclosed in the summary tables of proxy statements) was below their sector median outperformed those companies where pay exceeded the sector median by as much as 39%. "Has CEO pay reflected long-term stock performance?" the author asked. His answer was, "In a word, 'no.'" [2]

- A subsequent MSCI study of 423 companies found CEO equity awards to be negatively correlated with performance. The lowest fifth in CEO equity awards outperformed the top fifth by nearly 39% on average on a 10-year cumulative basis.[3]

- In 2014 the non-profit organization As You Sow developed algorithms to identify overpaid CEOs in the S&P 500. Over the next two years, the 100 most overpaid CEOs companies underperformed the

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[1] Susan Adams, "The Highest-Paid CEOs Are the Worst Performers, New Study Says," *Forbes*, June 16, 2014, https://www.forbes.com/sites/susanadams/2014/06/16/the-highest-paid-ceos-are-the-worst-performers-new-study-says/#78f288547e32.

[2] Ric Marshall and Linda-Eling Lee, "Are CEOs Paid for Performance?:Evaluating the Effectiveness of Equity Incentives," MSCI ESG Research, July 2016, https://www.msci.com/documents/10199/91a7f92b-d4ba-4d29-ae5f-8022f9bb944d.

[3] Ric Marshall, "Out of Whack U.S. CEO Pay and Long-Term Investment Returns, MSCI ESG Research, October 2017, https://www.msci.com/ceo-pay.

S&P 500 by 2.9 percentage points. The firms with the 10 most overpaid CEOs underperformed the S&P 500 index by 10.5 percentage points.[4]

- Harvard Professors Lucian Bebchuk and Jesse Fried in their book *Pay without Performance* and subsequent papers have shown that CEO pay is negatively correlated with profitability and market valuation relative to book value. Firms with high CEO pay are not the best performers.[5]
- A 2009 study by researchers at Purdue University and the University of Utah found that the companies with the highest-paid CEOs (the top 10%, adjusted for size and type of company) fall more than 4% behind expected average stock-market returns every year.[6]
- A meta-analysis (a study of 137 prior studies) calculated that performance explained less than 5% of CEO pay.[7]

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[4] As You Sow, "The 100 Most Overpaid CEOs: Are Fund Managers Asleep at the Wheel?" http://www.asyousow.org/ays_report/the-100-most-overpaid-ceos-are-fund-managers-asleep-at-the-wheel/.

[5] Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2006).

[6] Sarah Morgan, "10 Things CEOs Won't Tell You," *MarketWatch*, July 1, 2011, https://www.marketwatch.com/story/10-things-ceos-wont-tell-you-1309551879312.

[7] Henry L. Tosi, Steve Werner, Jeffrey P. Katz, and Luis R. Gomez-Mejia, "How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies," *Journal of Management* 26, no. 2 (April 2000), https://www.researchgate.net/publication/247569983_How_Much_Does_Performance_Matter_A_Meta-analysis_of_CEO_Pay_Studies.

Attachment B

Stock Buybacks and Company Performance

- Researchers at the leading international business school INSEAD, led by Emeritus Professor Robert Ayres, analyzed 6,516 stock buybacks at 1,839 US firms.

  They found that "the more capital a business invests in buying its own stock … the less likely that company is to experience long-term growth in overall market value."

  "We show that the more the company spends on buybacks, the less it is likely to grow, over a five year time-scale," they wrote. "Companies that have spent a large fraction of their current market cap on buybacks are virtually guaranteed to decline in the coming years. Exxon Mobil (88.7% of market cap is buybacks), Xerox (119.2%), IBM (107.4%) and HP (271.7%) are all in this category."

  "Firms that have 'invested' in buybacks (to support the price of the stock and to keep the senior executives happy) have actually wasted swallowed money that should probably have been invested in the business, especially in R&D," the authors conclude.[1]

- A Boston Consulting Group study showed that companies that make large capital investments, rather than buying back their own stock, are better investments. "Our analysis shows that outperformers—companies in the top third of stock market valuation relative to their peers—invest approximately 50% more in capex than their peers and achieve approximately 55% higher returns on assets and approximately 65% higher sales growth," the authors wrote.[2]

- Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund show that repurchases that are motivated by the desire to beat earnings-per-share forecasts lead to reductions in employment and investment, and a fall in cash holdings.[3]

- Another study by Paul A. Griffin and Ning Zhu concluded that investors experience "reliably negative stock returns over the six months around the [buyback] announcement, other than a positive 1.78 percent three-day announcement return." [4]

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[1] Robert Ayres and Michael Olenick, "Secular Stagnation (Or Corporate Suicide?)," (INSEAD Working Paper, July 11, 2017), https://ruayres.wordpress.com/2017/07/.

[2] Ulrich Pidun, and Sebastian Stange, "The Art of Capital Allocation," The Boston Consulting Group, March 27, 2017, https://www.bcg.com/publications/2017/corporate-development-finance-function-excellence-art-of-capital-allocation.aspx.

[3] Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, "The Real Effects of Share Repurchases," *Journal of Financial Economics* 119, no. 1 (January 2016), https://doi.org/10.1016/j.jfineco.2015.08.008.

[4] Paul A. Griffin and Ning Zhu, "Accounting Rules? Stock Buybacks and Stock Options: Additional Evidence," December 31, 2009, https://gsm.ucdavis.edu/sites/main/files/file-attachments/ssrn-id1316623.pdf.

- On February 4, 2015, the investment management firm SPDR launched an exchange-traded-fund to invest in the 100 companies in the S&P 500 with the highest stock buyback ratios. Since inception, the fund has underperformed the S&P 500.

- Perhaps most revealing when a professor of finance defended share buybacks in an article in *Harvard Business Review*, the only evidence he could present that shareholders benefited came from a study of buybacks between 1980 and 1990 when share prices were low and buybacks miniscule.[5]

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[5] Alex Edmans, "The Case for Stock Buybacks," *Harvard Business Review*, September 15, 2017, https://hbr.org/2017/09/the-case-for-stock-buybacks.