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Investors Do Better Than the Chiefs for a Change: Graef Crystal

By Graef Crystal

April 18 (Bloomberg) -- Surprise, surprise. Total pay growth for U.S. chief executive officers has moderated for the second year in a row. If this keeps up, I'm going to end up like the Maytag Repairman.

What's even more newsworthy is that shareholders of these companies did better than the CEOs. It's hard to remember too many earlier years when that happened. Between 2005 and 2006, the median pay increase for CEOs was 9 percent, according to my study of 206 companies with a market value of at least $3 billion. Each CEO had held his job at least in 2005 and 2006. An earlier study I did showed that between 2004 and 2005 total compensation rose just 6 percent.

As for shareholders, the median company among the 206 generated a total return of almost 18 percent in its fiscal year 2006.

After subtracting from the company's result on the Standard & Poor's 500 Index during the same period, the median excess return was 2 percent. So the shareholders of these companies collectively not only beat their own CEOs in wealth creation, they beat the market.

You wouldn't have come to this modest pay growth conclusion by comparing the numbers in the new format of proxy statements to those in the old. At first glance, it appeared that the median increase in total pay, year-over-year, was more like 30 percent than 9 percent.

One reason for this disparity is that pension costs were counted as part of 2006 total pay, whereas they weren't in 2005.

A second reason is a misguided last-minute decision by the U.S. Securities and Exchange Commission. The SEC included in total pay, not the value of grants made in 2006, but, rather, the portion of 2006 grants that were charged to earnings in 2006, as well as similar charges made in 2006 from earlier years.

Shareholder Return

So a 9 percent pay rise for CEOs and an 18 percent total return sounds as close to nirvana as shareholders are likely to get.

Nevertheless, there is one disquieting piece of news to report: There is hardly any correlation between the size of a CEO's raise in 2006 and the company's shareholder return. Although the relationship is positive and it is statistically significant, you can account for only 6 percent of the variation in pay raises by knowing the company's total return. The remaining 94 percent? Your guess is as good as mine.

Two examples, both in the semiconductor business, show this lack of correlation between CEO compensation and shareholder return.

Micron Technology

The first involves Steven Appleton, the CEO of Boise, Idaho-based Micron Technology Inc.

During the company's 2006 fiscal year, which ended Aug. 31, 2006, Appleton's total pay advanced by 27 percent, to $5.8 million. He received a salary increase of 6.8 percent, and his bonus almost doubled to

$1 million from $543,000 the year before. He was also given a free share grant that was 4.4 times larger than his 2005 grant. He didn't, though, receive any new option grants in 2006.

A raise of 27 percent is quite high, though Micron's performance was also up there. Total shareholder return was 45 percent during its 2006 fiscal year, 36 percentage points above the 8.9 percent return on the S&P 500 Index.

So who's complaining? No shareholders that I know of.

Now for the other side of pay-for-performance, where pay is supposed to drop when performance goes south.

Advanced Micron Devices

That isn't exactly what happened to Hector Ruiz, the CEO of Sunnyvale, California-based Advanced Micro Devices Inc. He received a 10 percent increase in base salary, although his bonus dropped to $2.6 million from $4 million in 2005.

In all, his 2006 pay package of $10.6 million was 2 percent higher than his 2005 pay package of $10.4 million.

For his shareholders, however, total return for the year ended Dec. 31, 2006, was negative 34 percent. After subtracting the positive 16 percent return on the S&P 500 Index, AMD's shareholders received a negative excess return of almost 50 percent.

I guess Ruiz's idea of shared sacrifice was to accept essentially no pay raise in 2006. The possibility of Ruiz cutting his pay to keep faith with his shareholders seems to have escaped him.

Ruiz made a structural change in his 2006 pay package. In 2005, he received free share grants worth $1.1 million and options worth $3.4 million. With that bad news in 2006, Ruiz began to hedge his bets. His free share grants effectively tripled to $3.4 million, while his option grants dropped to $1.9 million in present value.

So not only didn't Ruiz cut his pay to match his company's horrible performance, he restructured his pay package to make it less risky in the future. And this passes for pay-for- performance.

Now you know why there is so little correlation between CEO pay and shareholder return.

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Total pay in 2006 includes: base salary; bonus; my estimate for the present value at grant of option grants made in 2006; the value of free share grants made in 2006, measured at the time of the grant; the company's estimate for the present value of future payouts under performance-based long-term incentive plans; and miscellaneous compensation. Data were derived from Equilar Inc. and Salary.com's CompAnalyst databases.)

(Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

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