In this article I examine how the performance sensitivity of CEO compensation is related to the level and turnover of outside block ownership. Separating firm performance into firm-specific (Skill) and exogenous (Luck) components, I find that pay sensitivity to Luck increases with blockholder turnover, whereas pay sensitivity to Skill increases with blockholding size. Furthermore, when blockholder turnover is higher, CEO pay increases more with positive Luck but does not decrease as much with negative Luck; also, excess CEO compensation is larger. Thus, the rent accruing to CEOs via asymmetric pay sensitivity to Luck is partly explained by short investment horizons of large shareholders.

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The traditional contracting view of pay-performance benchmarking suggests that rewarding CEOs for exogenous changes in firm value (i.e., changes that are beyond management control) is suboptimal because this would make contracts riskier and costlier and would not create incremental alignment of incentives (Holmstrom, 1979, 1982). Therefore, following Bertrand and Mullainathan (2001) and Garvey and Milbourn (2006), I split firm performance into two components: firm-specific performance (Skill) and firm performance driven by exogenous factors such as industry performance (Luck). I relate the level and the turnover rate of block ownership to the sensitivity of CEO pay to overall firm performance, each of the Luck and Skill components of performance, and the asymmetry in the relation between pay and Luck.

Following the literature, I measure outside block ownership as the sum of ownership stakes that individually constitute at least 5% of the voting rights and that are not affiliated with firm management. The extant literature examining ownership turnover focuses on institutional ownership and captures the effect of turnover by classifying institutional owners based on the frequency with which they turn over stocks in their portfolio (Bushee, 1998, 2004; Gaspar et al., 2005; Chen et al., 2007). By examining the turnover of block ownership at the investee firm level, I extend the literature on investor horizons to this important group of investors. I calculate block ownership turnover as the proportion of total block ownership that changes hands annually, thus developing a firm-specific measure that allows for heterogeneity in a particular blockholder’s behavior across firms. A greater rate of block ownership turnover indicates a shorter average investment horizon. All else equal, blockholders with longer investment horizons are assumed to be more active in monitoring, and thus turnover rates of block ownership are used as an inverse proxy for blockholder monitoring.2

I start my examination by relating the pay-performance sensitivity (PPS) of CEO compensation to outside block ownership and find that the sensitivity of CEO compensation to firm performance is positively associated with both the level and the turnover rate of outside block ownership. However, the sources of the increased PPS due to each of these dimensions of block ownership are different. When I split total firm performance into Skill and Luck, I find that higher blockholder turnover (i.e., shorter average investment horizon) is associated with increased pay sensitivity to Luck, whereas higher level of block ownership is associated with increased pay sensitivity to Skill. These results suggest that CEO compensation is more sensitive to Skill than Luck when firms have better monitoring by blockholders as measured by their larger stakes and longer investment horizons.

I next test whether large shareholders reduce asymmetric pay-performance benchmarking by examining the effect of block ownership and blockholder turnover on PPS when firm performance is conditioned on the sign of Luck. I find that the level of block ownership is not differentially associated with PPS based on whether Luck is positive or negative. However, greater blockholder turnover makes CEO pay more sensitive to Luck only when Luck is positive. When Luck is negative, greater blockholder turnover leads to smaller PPS to Luck, preventing CEOs from being penalized for poor Luck.3 This result suggests that shorter investment horizons of blockholders can exacerbate the asymmetry in pay-performance benchmarking.

I further examine the effect of blockholder turnover on the asymmetric sensitivity of pay to Luck. First, I test whether the exacerbating effect of blockholder turnover on this asymmetric sensitivity is mitigated by the existence of a director blockholder. I expect that a director blockholder compensates for limitations in monitoring arising from short horizons of other blockholders. Consistent with this expectation, I find that the presence of a director blockholder considerably decreases pay sensitivity to Luck in general and increases the sensitivity of pay to Luck when Luck is negative, thus making CEO pay sensitivity to Luck more symmetric.

Second, I test whether pay sensitivity to Luck and Skill varies across the following blockholder types: (1) banks, insurance companies, investment companies, and investment advisors; (2) pension funds; (3) corporations; and (4) activists and individual investors. Although in the current sample these four groups of blockholders are generally similar in terms of their blockholding size, their turnover rates differ from one another. The average turnover rate is 24.89% for banks, insurance companies, investment companies, and investment advisors; 13.43% for pension funds; 6.14% for corporations; and 4.99% for activists, and individuals. Consistent with this variation in turnover rates, pay sensitivity to Skill generally increases in the level of block ownership when the block is owned by pension funds or by activists and individual investors. In contrast, pay sensitivity to Skill decreases in the level of corporate block ownership, suggesting that the motivations of corporate blockholders differ from those of activist or individual blockholders. When the block is owned by banks, insurance companies, investment companies, or investment advisors, an increase in pay sensitivity is observed only for cash compensation. More importantly, the relation between blockholder turnover and asymmetric pay sensitivity to Luck continues to hold even after accounting for the effect of block ownership type, suggesting that blockholder turnover and blockholder type, despite their similarities, are not perfect surrogates for each other.

Finally, I test whether greater asymmetry in pay-performance benchmarking due to higher blockholder turnover results in greater excess CEO compensation. I expect it will because CEOs of high-blockholder-turnover firms are more likely to receive higher pay when Luck is positive and smaller penalties when Luck is negative, thus resulting in higher pay on average. I find that total CEO compensation and equity-based compensation are larger in firms with higher blockholder turnover, whereas cash-based compensation is not.

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1 Details of the measurement are in Section 3, and Appendices B and C.
2 I recognize that low turnover rates of block ownership could also be driven by blockholders with passive investment strategies, such as index funds. To the extent that low turnover reflects such passivity, blockholder turnover will not be systematically associated with benchmarking of CEO compensation and hence will bias against finding significant effects.
3 This asymmetry is primarily from the equity-based component of total CEO compensation. A potential explanation for this result is that during the sample period, stock options in CEO compensation did not affect the firm’s net income whereas cash compensation did (based on APB No. 25, firms were not required to expense stock option grants if the granted options were at the money on the grant date). Therefore, firms would have found it easier to use stock options than cash to pay CEOs for Luck without raising a red flag to shareholders and the public.
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