Why company CEOs should have skin in the game

by Roger Montgomery

Regulatory change in recent years has given additional focus to the topic of executive remuneration. Investors can now find detailed reports on management compensation set out in companies' annual reports, and have the opportunity to lodge a protest vote at the AGM should they feel that the board has – on their behalf – been unduly generous.

This ability for shareholders to vote down a remuneration report has been criticised by some directors, who feel that shareholders have been given undue power, and may use it to 'punish' the board for weak share price performance, or for other outcomes that may be outside the board's control.

A difficult choice

Notwithstanding these developments, being CEO at a large listed company remains a very lucrative career choice. Boards of directors typically rationalise this on the apparently sensible grounds that the company wishes to attract candidates of the highest calibre. No board, it seems, is satisfied with a manager who is merely competent. Indeed, the universal prescription for attracting and retaining talent seems to be to direct large amounts of shareholder money into management's collective pocket to ensure a better-than-average outcome.

It may well be that paying higher salaries in pursuit of better talent is sensible on a case-by-case basis, but clearly this can't work in aggregate. If all companies do it, the pool of management experience and talent isn't going to suddenly become deeper. In aggregate, the only thing that will increase is salaries, and companies will effectively pay more, in aggregate, for the same talent.

Longer term, it is possible that higher remuneration attracts people who might have done other things in managerial roles. However, attracting the sort of manager whose life choices are dictated by financial gain also has the potential to work out badly.

The problems

There are a couple of vexing problems at work here. The first is an agency problem. Remuneration decisions involve the board spending shareholders' money, and if life is made easier for the board by spending more of it, then we should expect that that will happen. Just as IT executives in years gone by reduced career risk by buying IBM products regardless of price, boards reduce career risk by spending up on "premium" management. This is not to say that boards are malicious, just human.

A second problem is that it is fiendishly difficult to judge the quality of a manager. As investors, we try to do this as part of our assessment of investee companies, and we find it really, really hard. Success in corporate life owes an awful lot to luck – being in the right place, in the right industry at the right time. It can be near impossible to gauge the individual contribution of a manager until many years into their tenure (and in some cases not until after their tenure). In this, we feel for the board, which needs to make an assessment in limited time on the strength of an "executive search process".

These problems combine to create an unfortunate dynamic: a spending decision being made by directors who can't be certain what they're getting for the money, and won't feel the pain of spending too much of it, but face personal risk if things don't work out so well.

It's a bit like your health insurer letting you choose which doctor they will pay to perform your open-heart surgery. If Dr Rolex charges $100,000 and Dr Swatch charges $50,000, Dr Rolex has probably scored himself a new patient.

Why skin in the game is necessary

None of this should be seen as a criticism of company directors. While some will no doubt do a better job than others at discharging their duties, the problems outlined above are problems with the system, not the individuals involved.

One obvious way of addressing the issue might be to require better alignment of board and shareholder interests, for example by directors having a large part of their personal wealth invested in the companies they oversee.

In some cases, this would be an onerous requirement to place on directors, and it is probably unrealistic to expect that it could be broadly implemented in practice. However, directors who do not have a large part of their own wealth invested alongside shareholders should not complain when shareholders deliver a 'strike' against the remuneration report.

As the owners of the business, this is entirely their prerogative.

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