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Rewards for falling off a horse: Bad corporate governance is enabling managers to receive pay for luck[☆]



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“In ancient times there was an old man in China called Po Sou. He was fortunate to own a strong horse . . . the old man’s son mounted the horse, fell off, and broke his arm. Hearing about this, people came to pay their condolences, but . . . the old man said, “Why get excited? It may or may not be a good thing.” People . . . found this strange. A year later there was a great war throughout the country. When soldiers were drafted for this conflict, men were also called up from the old man’s area. All went to war, and all died. Because the old man’s son had only one good arm, he escaped this fate.”

Tale 31: The Old Man Po Sou’s Horse (Geddes, 1999, pp. 32–33)

The story demonstrates the Taoist way of life – not to actively try to influence one’s own fate, but to accept the course of nature. This is because the consequences of any decision, action or event cannot be foreseen. The imperative for executive employees’ rewards is exactly the opposite;

managers should, with the use of their understanding and anticipation of the market, be able to strategically decide and achieve success, for which they will be rewarded by shareholders, or punished for failure. Moreover, the reward should be based on their relative performance; it should not be influenced by the observable common shocks, whether positive or negative, which affect all players in the sector. This is, contracts should be based on relative performance evaluation. However, only a third of S&P 500 firms used some form of relative performance evaluation in 2007, even just as a part of CEOs pay package; but we must note that this proportion has been constantly growing as of late. Nevertheless, there is an inherent complexity of how to determine the method of compensating.

The purpose of this short article is to show that shareholders often reward the managers for falling off a horse. Just as Po Sou’s son, they had blind luck, and by making none or bad decisions or actions, they brought their companies to success in the end. In their influential study, Bertrand and Mullainathan have shown that rewards of CEOs come from performance that arose from luck. That is, exogenous events that managers did not influence, such as windfall profits resulted in large bonuses. Currently, CEOs are rewarded for the improvement of aggregate economic or sectorial conditions, even though sector performance is outside their control. For example, CEOs of oil companies receive rewards for the rise of oil prices; and CEOs of companies trading on the

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international markets benefit from exchange rates. Bertrand and Mullainathan concluded that CEO pay is due to a lucky dollar just as it is due to an earned dollar.

On the other hand, and to a lesser extent, the opposite effect occurs. CEOs are sometimes punished for bad luck. In a recent study, Jenter and Kanaan found that “underperforming CEOs are more frequently dismissed in recessions than in booms, while outperforming CEOs are almost unaffected by peer performance . . . outperforming CEOs should only rarely be dismissed, as they can always point out that competitors are performing worse and induce the board to use relative performance evaluation. Underperforming CEOs, in contrast, are less able to mount a strong defense against incorrect performance attribution in recessions, but will be happy to hide behind good industry and market performance in booms.” Given that executives realize they may be punished for bad luck, they often demand larger rewards for good luck to compensate the impact of this risk on their income.

In the following section, I describe the reasons why pay for luck exists. I will do so by explaining psychological mechanisms and cognitive errors from which board members can suffer, namely attribution error and illusory correlation. Secondly, I will focus on the rational causes of paying for luck, which are largely neglected in the management literature.

INCORRECT ATTRIBUTION OF SUCCESS AND ILLUSORY CORRELATION

Bertrand and Mullainathan found that companies with good corporate governance, especially those with the presence of a large shareholder, did not pay CEOs high bonuses for luck. In fact, a large shareholder reduces pay for luck by 23–33%. CEOs assert their interests with weak boards; as Goergen and Renneboog put it “self-serving executives skim corporate profits and expropriate shareholders”. Although the pay for luck could be explained by CEOs staffing a board with sympathizers and thus influencing the pay-setting process, the ubiquity of the bonus for luck shows that this is not the only reason. Based on the identical results of widespread CEOs’ pay for luck in British firms, Bell and Reenen conclude: “CEO remuneration plans are sufficiently complex that shareholders have difficulty effectively monitoring the contracts . . . Governance matters more than formal contract structure, which implies that government policies to mandate contractual forms are likely to be gamed. Attention needs to be more focused on how to improve governance.”

A psychological factor that enables CEOs to receive bonuses for luck is an attribution error made by board members. That is, a tendency to attribute results to skill and personal traits, rather than to external situational factors or chance. According to a seminal study of Ross, an attribution error is “[the] general tendency to overestimate the importance of personal or dispositional factors relative to environmental influences.”

Identifying and retrieving information on potential factors that causally influence events around us is beyond human capacity. Even professionals form their beliefs from a limited and skewed sample of realized outcomes. They underestimate the impact of their emotions on the evaluation of a situation. They overestimate information that is

fluent, distinctive, and salient. An illustrative example of an illusory correlation between success and ability is an experiment by Powdthavee and Riyanto. In their experiment, the participants could bet on five throws of a just coin with a possibility of receiving a monetary reward. In front of the participants lay a sequence of five sealed envelopes. The envelopes included a so-called expert prediction on the outcome of each of the five throws. After each throw, they were to open the appropriate envelope and verify the accuracy of the prediction. They could also pay a fixed sum to be able to consult the appropriate envelope before the throw.

Different participants experienced a different precision of their envelopes: Roughly $1/2$ of the participants in the first throw ascertained that the envelope correctly predicted the side of the coin. In the second round $1/2 \times 1/2$ of the participants saw that both envelopes were not mistaken, etc. The results of the study showed the participants were willing to pay for the objectively useless information, and simultaneously used predictions in their betting. The trust in predictions grew with every random success of the envelope in a previous round. Buyers of envelopes placed higher bets on respective throws than non-buyers.

In another study, participants played an experimental coordination game, one in which large groups usually do not attain effective results, while small groups do. First, leaders both for the large and small groups were assigned. Next, each leader had to persuade her/his team players to play optimally. Those in small groups afterwards evaluated their leaders as effective, whereas those in large groups labeled the leaders incompetent. Both groups ignored the environmental factor (size of the group), which had single-handedly influenced the result. Those in large groups were also more willing to change their leaders. In short, people succumbed to an illusory correlation; they saw their failure/success in the qualities of the leader, rather than due to environmental influences.

An attribution error enables us to transform the unprocessable complexity of reality into an easily understandable scheme – things happen thanks to right/wrong decisions or good/bad character traits of wo/man rather than due to factors beyond individual’s control. If someone is able to get a good job after graduation, we see it as a reflection of his/her talent and skill. We tend to underestimate that chance plays a crucial role at the beginning of a career, and that e.g. time when the graduates enter the labor market has an influence. In times of deep economic recession, there are fewer suitable positions and graduates tend to enter worse jobs. “The lucky ones” graduating during an economic boom, on the other hand, have little problem finding a prestigious job. Effect of time of entering the labor market may persist in wages for up to 10 years. In politics, the incumbent party or politician is favored if the economy is doing well, and vice versa. As Wofers found in gubernatorial elections in the US, “voters in pro-cyclical states are systematically fooled into re-electing incumbents during national booms, only to dump them during national recessions. Similarly, voters in oil-producing states tend to re-elect incumbent governors during oil price rises, while voters in oil-dependent states oust their incumbents.”

Corporate results are also disproportionately attributed to the abilities of senior executives without regard for how those abilities influenced a firm’s outcomes. In an intriguing

study, Hogarth and Kolev showed that the rewards given to a CEO correlated with his golf handicap. The better golf player the CEO is, the greater rewards he receives. Yet, a golf handicap does not correlate positively with indicators of corporate performance; rather, it correlates negatively. Similarly, Lopez and Ensari assumed that employees identify themselves with charismatic leaders, unlike autocratic ones; they gain inspiration from them and accept them as their role models. The authors confirmed that subordinates attribute success to charismatic leaders, while, on the other hand, autocratic leaders receive more blame for organizational failures.

RATIONAL EXPLANATIONS FOR REWARDING LUCK

The ubiquity of the pay-for-luck phenomenon, as Liu and de Rond have stressed, “implies a large discrepancy between people’s romanticized perspective on how corporate elites are responsible for [a] firms’ destiny and the reality of how luck dominates the performances . . . the exaggerated high compensation of top executives creates problems for redistributive justice and endangers the stability of societies.”

In summary, CEOs are rewarded for good luck and minimally penalized for bad luck. However, if we set aside CEO-controlled boards, why don’t shareholders use some form of relative performance evaluation as an indicator of how much companies and CEOs’ rewards are influenced by luck?

Most importantly, a company must pay its executives in ways reflecting changing conditions in the labor market. Sometimes this will be above an immediate benefit to the company. As managers’ external job opportunities depend on market and sectorial factors correlated with profit and the company’s share price, managers are rewarded for luck in order for the company to retain them. Talent flows to where it is highly rewarded; reward for luck can sometimes be a benchmark of managers’ opportunities. A study by Bizjak et al. empirically confirmed that the sensitivity of CEOs’ rewards on luck is strong in those whose pay is below the peer group median. They concluded that “the relation between pay and luck is an artifact of the use of competitive benchmarking as a tool for gauging the reservation wage of the CEO.” Feriozzi has argued similarly; besides explicit rewards and punishments, CEOs also face implicit ones. The most important implicit punishment for a CEO is the company’s bankruptcy, as this has a notable impact on a manager’s immediate rewards as well as long-term human capital. In bad times, these implicit costs are significant, a CEO is directly motivated by them and there is no need for large explicit rewards. Conversely in good times, the implicit punishments diminish and CEOs have to be motivated by larger explicit rewards for their success, including rewards for luck. This asymmetry in the significance of implicit punishments thus is one rational explanation of pay for luck.

Another reason for CEOs’ pay to correlate with sector performance is setting up motivation for CEOs of multi-sector companies and companies in highly innovative sectors to choose an optimal exposure of the company in different sectors. A study by Gopalan et al. confirmed that rewards for luck appear chiefly in multi-sector companies that have sales and assets in more than one Standard Industrial Classification

Code industry, as well as in sectors spending more on R&D. All of these reasons mean that although substantial rewards for executives may be unwarranted as they could be seen as the result of luck, they will remain in practice.

CONCLUSION

I have presented several reasons explaining why executives receive rewards for luck. Processes enabling this phenomenon are psychological, that is they are due to an incorrect attribution of success to CEO skills, as well as rational, dependent on the mechanisms of rewarding executives, the labor market or optimal sector diversification.

Empirical literature favors especially the retention effect coming with growing external career opportunities. As roughly half of company profit can be explained by factors outside managerial control, the influence of chance on the performance of companies and managers’ rewards is ubiquitous. Because many companies’ results are influenced by luck, even small differences between CEOs’ talents could lead to radically different rewards, amplified by growing capitalization and emergence of markets governed by winner-takes-all effects. These dynamics will lead to a growing discrepancy between CEOs’ rewards and increasing benchmark demanded by other CEOs; it can thus be expected that the pay-for-luck phenomenon will continue growing.

It is a great challenge for shareholders to suggest an optimally motivating contract that rewards executives not only for luck, but promotes retention and motivates a CEO to attain an optimal exposure of the company in different sectors. An increase in empirical studies attempting to filter out the effects of chance or estimating costs associated with replacing or retaining the executives should be helpful in these efforts.

Weak external control of CEOs, proxied by lower institutional ownership, enables CEOs to achieve undeserved pay for luck: in weakly governed companies, even if CEOs fail to meet the terms of their contract, they are able to achieve rewards by other means, e.g. an advantageous future contract. CEOs are also able to bypass compensation peer benchmarking by persuading their firms to strategically construct peer groups to justify higher levels of their pay. Faulkender and Yang confirmed that “strategic peer benchmarking [is widespread] at firms with low institutional ownership, low director ownership, low CEO ownership, busy boards, large boards, and non-intensive monitoring boards, and at firms with shareholders complaining about compensation practices. The effect is also stronger at firms with new CEOs”.

Good corporate governance is more important than specific structure and conditions of CEOs’ rewards. The positive correlation of high concentration of institutional investors with pay-for-performance sensitivity of executive compensation is well-known. At the same time, it is negatively related to the level of compensation. Both suggests that large institutional investors suffer less from informational asymmetry and have the tools for more efficient monitoring of managers’ performance. Thus, they decrease the effect of agency problem between shareholders and managers. As Hartzell and Starks explain: “The influence of institutional investors could occur indirectly through their trading

behavior as well as through direct pressure . . . portfolio managers' investment decision algorithms often consider quality of management, and in turn, executive compensation practices."

The same positive impact can be seen if CEOs have less power over the board. Guo and Masulis used new NYSE and NASDAQ listing rules requiring the boards of publicly listed

companies to have a majority of independent directors, and fully independent nominating, compensation, and audit committee. They conclude their study by stating "that greater board independence and full independence of nominating committees lead to more rigorous CEO monitoring and discipline."



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