New HPC Report on Performance-Related Pay - a Response

Damien Knight, principal at remuneration consultants MM&K, casts a critical eye over the High Pay Centre analysis of performance-related pay reported in last month's ECB.

In the run-up to Christmas it has become a British tradition to grumble about the obscene level of pay paid to the executives running our largest corporations and how it contrasts with the meagre earnings of the 58 million hard-working rest of the population. The ritual kicks off in October, when IDS (now owned by Thomson Reuters) manages to squeeze out another statistic to confirm our unwavering faith in executive greed.

This year their figure was a 20.7 per cent median (40.2 per cent average) increase in pay for a "matched group" of FTSE 100 directors in the past year, proving yet again that directors don't get it. Following tradition, the government has threatened tighter regulations and Labour have repeated their plans to put workers on remuneration committees, to sort the problem out once and for all.

The only rather large pellet in the seasonal pheasant is the fact that, on any statistic that reflects recent pay award decisions by remuneration committees, the total remuneration of FTSE 100 CEOs has actually gone down for the second year running.

The November 2014 update of the Manifest/MM&K Total Remuneration Survey (based on data taken from the most recent annual reports) shows a 0.1 per cent fall in total remuneration awarded. This figure includes the expected value of new share incentives granted. But even when Manifest/MM&K include the value of share incentives vesting in the latest year – generated by share grant decisions made back in 2010 – there is only a 2 per cent increase in total remuneration, year on year.

IDS have form in whipping up public opinion on executive pay excesses. Back in 2011, at the beginning of Vince Cable's crusade to reform directors' pay governance, they published the notorious statistic that FTSE 100 directors' pay had increased by an average of 49 per cent in the previous year. In the ensuing outrage, even the Prime Minister and the Archbishop of Canterbury felt obliged to express shock. But it was a statistical illusion: five companies had increases of well above 100 per cent, all quite legitimate and a consequence of the timing of share incentive vesting. Without these five the average increase was 13 per cent (the same as the median), still generous, but not enough to fire up the Archbishop! Such is the danger of averaging percentage increases.

Given this track record, it is not surprising that IDS were chosen by the High Pay Centre to conduct its latest piece of research. The HPC (though now independent) was started by Compass - the socialist pressure group - with a mission to expose capitalism's failure to distribute wealth fairly. Having achieved wide acceptance of the (valid) premise that directors' pay has increased much faster than average wages over the past 30 years and a popular belief (invalid) that it continues to do so, HPC faces one problem. While its enemy is the sheer scale of executive pay, the government and institutional investors continue to profess that they have no problem with high earnings provided they are justified by high performance. So the HPC has had to set about proving that directors' pay has gone up without such performance justification.

The report on the first stage of IDS' research was published in late October. The analysis focused on FTSE 350 data from annual reports covering a period from 2000-2013. The conclusion of the report was unequivocal: "increases in all the key elements of FTSE remuneration have far outstripped a range of corporate metrics, and there is little discernible link between directors' earnings and corporate performance." So it is just as we all suspected. At the report's launch, even the Hermes representative on the panel admitted he was not surprised by the findings – so easily do research headlines slip into our psyche so long as they confirm our prejudices.

But is this research rigorous? The methodology is, in my opinion, flawed throughout, although it certainly delivered the result the HPC hoped for. Let's look at the methodology.

Any scientific experiment has to begin with a testable hypothesis. If the result of the experiment is to be used, by induction, to draw wider conclusions about nature or society, this testable hypothesis should be a logical consequence of a wider theory. The wider theory in this research (only indirectly expressed in the report and set up to be disproved) is that "generous rewards in large British companies are justified by strong long-term performance".

The first testable hypothesis appears to be: "weighted average bonuses in the FTSE 350 should have increased over the 13 years to the same extent as earnings per share or profits before tax". The research found that bonuses increased twice as fast as profits. Leaving aside the huge spread of turnover in the FTSE 350 (from a couple of hundred million pounds to a couple of hundred billion) and the absence of any explanation of how EPS was "weighted", it is not at all clear that the hypothesis is a consequence of the general theory. The report itself demonstrates that the bonus opportunity (i.e. the target and maximum values) increased by a factor of 2-3 times over the 13 years, so this by itself would more than explain the higher rate of increase in bonus earnings. Of course, a dissenter might argue that increasing the bonus opportunity is giving money away for nothing. But the research shows that average profits increased at a compound rate of 6 per cent p.a. over the period (our own research, by the way, shows that, for surviving FTSE100 companies over the past 10 years, the figure was 19 per cent compound). Only investors can say whether upping the incentive opportunity was worth the return, and they would need to look on a company by company basis.

The next testable hypothesis is: "for the FTSE 350 companies [presumably the same 350 companies over the 13 years, though that would have been hard to track], the absolute level of increase in pay should correlate with the absolute level of pre-tax profit increase. IDS calls this the "real" increase, but it is clear it means the absolute increase. The report shows a scattergram with a linear trend line with an R2 of 0.013 and the researchers' conclusion is that there is no relationship between bonus increases and profit performance. Both the hypothesis and the conclusion are flawed. The wider theory does not require that there should be a demonstrable correlation between bonus increases and profit increases across the whole FTSE 350 over 13 years. It would appear from the presentation of results that about 50 companies increased bonuses though profits fell. An investigation into these individual companies would be merited. The majority of the remainder appear to show a fall in bonuses (which does not match the findings of the first experiment) and analysing the correlation of this fall and the change in profits over the period contributes nothing to the wider theory of generous rewards. The final group show an increase in both profits and bonuses.

A second version of this scattergram shows the relationship of the absolute increase in bonuses to absolute (i.e. pence per share) increase in EPS (R2 = 0.0003). EPS is a return measure which is independent of company size. Bonuses (and hence bonus increases) are closely related to company size since larger companies generally pay higher salaries and award higher bonuses as a percentage of salaries. You might just as well look for a correlation between bonus payments and the number of pages in the annual report!

Their third experiment is bizarre. The 350 companies are ranked for absolute levels of vested LTIP awards for each of the 13 years. They are then separately ranked for their total shareholder return performance for the previous three years (the typical vesting performance period). The testable hypothesis is that there should be a statistical correlation of these two ranks. It should be noted that IDS refers to the "three-year change in TSR", but it seems clear it is referring to the increase of the TSR index over the period, which is of course the actual total shareholder return, not the change in shareholder return.

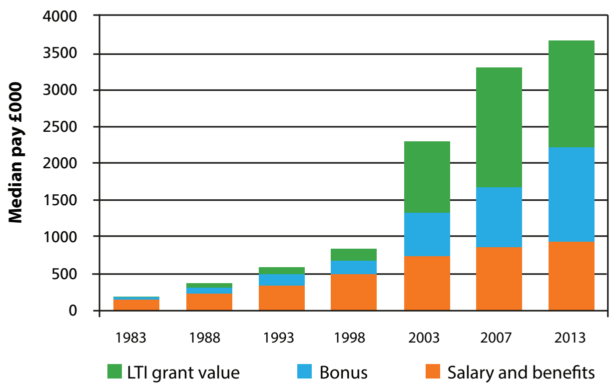
Not surprisingly, there was a very low correlation – with an R2 between zero and 0.24. The report concludes that there is little or no relation between reward and performance. This experiment appears to me to be badly flawed. To begin with, it is very questionable whether mixing companies with a market range of 1,000 times difference from largest to smallest can yield any meaningful conclusion about company behaviour. More seriously, one ranked factor is a relative increase (TSR) which is independent of company size, whilst the other is an absolute measure (vested LTIP) which is strongly related to company size (larger companies pay higher salaries and make larger LTIP grants as a percentage of salary). The two factors should never be expected to correlate. Using ranking is an additional complication that does not remove this flaw.

A second LTIP experiment using the return measure of EPS is similarly flawed. But apart from these errors, the report's own evidence is that LTIP grants have roughly doubled over the 13 years; these increases would interfere with any correlation, even if one were expected. This is the same problem we find with the bonus experiment.

Having found that the evidence does not support any of their three testable hypotheses, the report draws its general conclusion about the lack of justification of performance payments and thus fulfils its required purpose.

The question as to whether executive rewards are justified by company performance is a serious question and it deserves to be addressed properly. Ideally, it would be researched by independent academics able to formulate meaningful hypotheses and who understand how to relate the findings to those that might be generated by random relationships. This would certainly require the selection of smaller, more closely related groups of companies. It might require a company-by-company examination, with data normalised for size. But certainly the research in question produces little of value apart from some useful historical statistics about profits, bonus opportunity and bonus levels.

Chart 1: 30-year development of FTSE 100 CEO pay



Nobody disputes the increase in executive remuneration over the past 30 years – my own research combining data from Hay surveys and the Manifest database shows that total pay for FTSE 100 CEOs has gone up 20 times since 1983 (see chart). Average earnings over the same period have increased from £6,000 per year to £25,000, just over four times. The justification for this differential is highly debatable. But at a time when there are deep rifts appearing in capitalism (even though most people believe that a market economy is the most effective way to run society), respected institutions like the High Pay Centre have a responsibility to ensure their research has a sound foundation and is not just political puff.

Happy Christmas!

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