

THE EFFECT OF COMMON SHAREHOLDERS ON LISTED COMPANIES

AN ADDITIONAL CHALLENGE FOR EXECUTIVE COMPENSATION: COMMON SHAREHOLDERS



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Some CEOs' compensation packages keep growing, sometimes even when the company's results don't grow with them. How is this possible? The increasing presence of common investors in listed companies in the same sector has a lot to do with it.

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Imagine that a company's performance hasn't improved – or even that it's worsened – in the last year. If you were a company shareholder, would you be in favor of raising the CEO's salary? Common sense and economic theory on optimal incentive provision would advise against it. However, according to data by Proxy Insight cited in the New York Times, investment fund managers like BlackRock, Vanguard and Fidelity vote in favor of the compensation packages they are presented with 96 percent of the time, without considering whether compensation levels are linked to company performance.

How can we explain this seemingly contradictory situation? The study that we conducted with professors **Florian Ederer** (Yale School of Management) and **Martin Schmalz** (Michigan Ross) links upper management salaries with the growing presence of common inves-

tors with an interest in listed companies of the same sector. These investors have no incentive to reduce salaries if these salaries ease the competition among the companies they hold.

A common way to offer incentives to managers is to link their salaries to company performance. The drawback of this approach is that sometimes performance is positive because the industry is doing well or because the cost of oil has fallen. In this case, a shareholder can think, "I'm paying the CEO for sheer luck!" For this reason, shocks (whether positive or negative) that don't depend on the CEO's work tend to be filtered out.

Instead, managers should be paid more when a company performs better than its competitors (following what is known as the relative performance evaluation). That's to say, we pay the CEO more when his or her company is doing well, but less if competitors are also performing really well.



INVESTORS WHO HOLD SHARES IN MULTIPLE LISTED COMPANIES EARN MORE PROFIT FROM INDUSTRY PERFORMANCE THAN FROM COMPANY PERFORMANCE

This approach to compensation gives managers a clear incentive to compete aggressively and achieve better results than the rest of the sector's firms. This competition can take many forms; for example, the price war. However, a price war becomes unlikely when a given sector has a large overlap in ownership – that is, a high proportion of “common” shareholders. In this scenario, common shareholders maximize the value of their portfolios when the companies they hold compete against each other less aggressively.

One way to lower competition is to rely less on the relative performance evaluation in compensating managers; that is, companies don't penalize managers when their competitors do well. I'll pay you more if you perform well, but I'll also pay you more if everyone else performs well! In this way, all the competitors keep the share of the pie and common shareholders maximize the value of their investment portfolios.

COMMON SHAREHOLDERS TRENDING UPWARD

● But who are these common
● shareholders? They tend to be investment fund managers, like the American firms BlackRock, Vanguard and Fidelity, which have major stakes in thousands of publicly traded companies. The objective of these firms is clear: maximize the value of their entire portfolio, more so than the performance of each of the companies within it. Therefore, they prefer a scenario of less competition among their holdings, so that no one loses. In this sense, their right to vote gives them great power to influence certain decisions, like those about compensation packages for executives.

In reality, it's not completely accurate to say that with these actions common shareholders aren't incentivizing high performance. It's just that instead of linking CEO salaries to the performance of the company they lead, they link them

to the overall sector results. The reason is obvious: because they have shares in multiple listed companies, shareholders obtain greater benefits from the performance of the entire industry than of a single company.

These practices are related to the change that is underway in the ownership of many publicly traded U.S. companies (and also those of other countries). For example, the fund manager BlackRock is the main shareholder of one in five listed U.S. firms, including the largest competitors inside a single sector. Another case is the investment fund Fidelity, which is the largest shareholder of one in ten listed companies, generally having between 10 and 15 percent ownership. To give an idea, Bill Gates owns five percent of Microsoft shares, a tiny proportion compared to that of the company's five largest common shareholders, which together hold over 23 percent ownership.

For companies of a single industry to share investors is a relatively new phenomenon. Some investment firms, like BlackRock or Vanguard, have grown so much that they are now among the top ten shareholders of many companies. Twenty years ago, these large investors didn't have such a major proportion of the markets, which made it much less likely that companies would share stockholders. On average, the presence of common shareholders has nearly doubled in the last 20 years in finance, construction, manufacturing and services.

HIGHER SALARIES, LOWER COMPETITION

● To understand the effect of
● common shareholders on CEO salaries, in our research we analyzed the total compensation (including the value of stocks and stock options) of the top five executives of all S&P 1500 companies, which cover approximately 90 percent of U.S. market capitalization, and of another 500 listed companies, from 1993 to 2014. We studied the relationship between compensa-

tion and company performance, rival firm performance, market concentration measures and common shareholders of the sector. We also analyzed interactions among the variables of profit, concentration and common investment.

This approach allows us to estimate both the relationship between executives' compensation and the performance of their own companies and the relationship between their compensation and the performance of other companies from the same sector. We also estimate the impact of the presence of common shareholders. In order to show that the relationship is causal – that in effect the overlap of ownership leads to a change in manager compensation – we used an unexpected change in the ownership structure of many publicly traded companies, a scandal in 25 families of funds in 2003 in the United States.

These funds were accused of illegal operations, which was a major blow to the world of investment funds. As a result, many individual investors withdrew money from the involved funds and took it to others. That is, there was a reshuffling in the property structure of many companies that had institutional investors. This experiment allows us to see how “surprise” changes in shareholding structure can affect executive compensation.

Our study demonstrates that an increase in the proportion of common shareholders leads to an increase in executive compensation. One fact: in sectors with few common shareholders, executive salaries are 50 percent more sensitive to changes in company performance than in sectors with a high concentration of common shareholders.

In reality, the presence of common shareholders influences not only incentives but also base salary. Our research shows that base compensation – the part that doesn't depend on performance or the market – is also higher in industries with more common investors.

THE BRIGHT SIDE AND THE DARK SIDE OF COMMON OWNERSHIP

● This isn't the first time that the presence of common shareholders in companies of a given sector has been linked to diminished competition among them. Other studies, like that of our colleague José Azar, an IESE faculty member, have identified the anti-competitive effects of common ownership. His research links the presence of common shareholders to the price increases in the banking and airline industries.

The underlying economic reason is simple: if investors have holdings in not one, but in two or more companies that compete in the same industry, these shareholders earn greater profits if the companies cooperate instead of aggressively competing among themselves. For example, if there were a price war in banking, the overall profit margin of companies in this sector would suffer, which in turn would harm management firms with a stake in the sector. But it would benefit customers, who would enjoy lower fees.

The concentration of shares in the hands of a few common investors can be dangerous because it can encourage oligopolies. We know that the lack of competition can also have a negative impact on consumers. In fact, shareholders benefit from higher profitability in the sector, but society can also benefit from greater cooperation among companies if it leads to improvements in services. The presence of common shareholders is on the rise, given that passive funds will keep growing and the consolidation of the asset management sector will likely continue. We hope that our research will help us to understand better the possible effects of common shareholders on corporate decisions and the possible implications for consumers and society at large.

MORE INFORMATION:

Antón, M.; Ederer, F.; Giné, M.; Schmalz, M. “Research: Index Funds Are Fueling Out-of-Whack CEO Pay Packages,” *Harvard Business Review*, October 18, 2016.

THE CONCENTRATION OF SHARES IN THE HANDS OF A FEW COMMON INVESTORS CAN ENCOURAGE OLIGOPOLIES