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SUMMARY AND EVALUATION

THE ISSUE OF THE RELATIONSHIP between the personal economic objectives of the senior corporate executive and the pecuniary interests of his firm's common stockholders has been a topic for scholarly discussion ever since it became apparent that the large aggregations of scarce resources demanded by industrialization would require an increasingly professionalized managerial group for successful administration. The consequent separation of the capital-supply and capital-management functions raised the possibility that the decision-making process within the firm would take on a different character, and be directed toward different goals, than was true in a simpler commercial environment wherein the two functions resided in the same individuals. The usual conclusion in the literature of business and economics over the past several decades has been that this possibility has indeed become a reality, and that a viable mechanism no longer exists for eliciting a congruence of managerial and ownership objectives in the operation of the widely held corporate enterprise.

The task of the present investigation has been to raise anew the question of the soundness of that conclusion. Because our tax laws encourage corporations to reward their employees through devices which depend for their value on the market price behavior of the company's common shares, and because even a casual inspection of annual proxy statements suggests that many top executives maintain significant direct equity investments in their own firms, the chance that a more important link than was generally recognized existed between the personal income of management and the returns which shareholders enjoy seemed worth examining. The evidence offered in the preceding chapters appears to support this hypothesis. The annual income of executives depends very heavily, very directly, and very persistently, on the dividends received and capital gains experienced

by such men in their roles both as stockholders of their employer companies, and as beneficiaries of stock-related compensation arrangements. Accordingly, the often-expressed concern that the professional manager is likely to display a massive indifference to the traditional profit-seeking orientation of the firm is regarded here with skepticism, despite the unarguable shift from entrepreneurship to administration as the dominant activity of the executive class.

The Data

The senior officers of three categories of firms were chosen as the sample to which the analysis was addressed. The main focus was on a group of fifty large manufacturing corporations, with data from fifteen small manufacturers and fifteen chain-store retailing organizations being compiled to supplement and test the broader applicability of the initial findings. The investigation covered the period from 1940 through 1963, thereby encompassing an interval in which a number of major structural changes occurred in the economy. Out of the extensive body of evidence developed, the particular set of figures which seems to provide the best summary of the historical record is gathered in Table 48 and depicted in Chart 17. These figures portray the ratio, year by year, of total ownership-related after-tax personal executive income to concurrent after-tax fixed-dollar employee remuneration for all three company samples. The group considered consists of the five highest-paid individuals in each firm taken together, and the underlying data are the mean annual values determined after exclusion of extreme observations of stockholding and compensation. Thus, the time series shown are the final columns of Tables 24, 35, and 46, above, in which the relationships between ownership income and remuneration were documented for the top-five category in the three samples separately.

These figures are taken to represent the most suitable synthesis of the results of the analysis because, first of all, they do abstract from the effects of extraordinary individual circumstances. While the full-sample averages would tell a much more impressive story, they are apt to be misleading as measures of the norm for the relevant

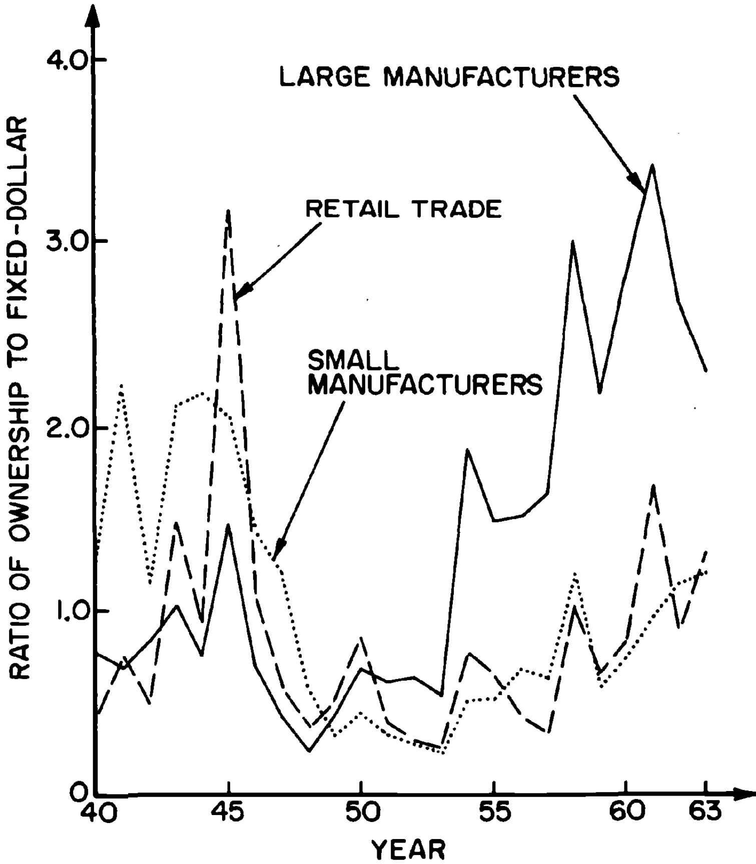
TABLE 48

The Importance of Ownership Income to Senior Executives: A Summary for the Years 1940 Through 1963 for the Top Five Executives in Each Firm, Extreme Values Deleted

	Ratio of Dividends Plus Absolute Capital Gains Plus Stock Compensation to Fixed-Dollar Earnings		
Year	Large Manufacturers	Retail Trade	Small Manufacturers
1940	0.757	0.443	1.245
1941	0.684	0.766	2.223
1942	0.830	0.501	1.143
1943	1.039	1.482	2.118
1944	0.741	0.951	2.160
1945	1.466	3.168	2.063
1946	0.685	1.069	1.407
1947	0.441	0.568	1.200
1948	0.230	0.357	0.581
1949	0.434	0.504	0.317
1950	0.690	0.863	0.418
1951	0.595	0.389	0.320
1952	0.636	0.304	0.276
1953	0.524	0.262	0.232
1954	1.887	0.784	0.521
1955	1.502	0.635	0.508
1956	1.520	0.440	0.685
1957	1.627	0.326	0.631
1958	3.007	1.047	1.213
1959	2.170	0.654	0.559
1960	2.803	0.832	0.760
1961	3.425	1.675	0.981
1962	2.673	0.899	1.134
1963	2.287	1.307	1.191
Averages for:			
1940–44	0.799	0.801	1.752
1960–63	2.795	1.178	1.017

CHART 17

RATIO OF OWNERSHIP INCOME ITEMS TO FIXED-DOLLAR EXECUTIVE EARNINGS, 1940-63



managerial group. The severe impact of eliminating extreme values from the small-manufacturing data perhaps best illustrates this concern. Secondly, it seems desirable to cast up the findings from as broad a base as possible. Even though the differences between the experience of the highest-paid man in each firm, and the five highest-paid together, turned out to be of interest in several contexts, the latter group—which is the largest the available proxy statement information permits to be examined—serves as the better vehicle for summarizing over-all income patterns at the senior executive level. Finally, the addition of the value of stock-related compensation to annual dividends and capital gains in making comparisons with fixed-dollar earnings provides a more comprehensive index of the true degree of executive exposure to the contingencies and uncertainties of ownership than the dividends and gains alone would furnish. The securities market's response to the firm's activities is as much a determinant of the worth of stock-based pay arrangements as it is the genesis of shareholder returns. For these reasons, Table 48 and Chart 17 appear to combine the most meaningful, as well as the most comprehensive, elements of the historical income profile.

The impression they convey is one of substantial involvement on the part of executives in the ongoing rewards and penalties of an equity or equitylike position. The average annual after-tax increments to personal managerial wealth which arose from ownership-connected income sources after 1960 exceeded the corresponding increments from fixed-dollar employee remuneration for all three samples. In the case of large manufacturing company executives, in particular, ownership items were nearly three times the size of fixed-dollar earnings. The conclusion therefore would be that the personal economic well-being of the senior professional manager is, of necessity, tied very closely to that of his firm's shareholders—sufficiently closely, in the view here, as to imply that the pursuit of administrative policies inimical to the profit objectives of shareholders would be irrational in terms of the man's own self-interest. A finding that the executive stands to gain much more from the successful operation of the firm than from the mere retention of his job follows, it should be emphasized, from an investigation which has focused on precisely

those large and widely held enterprises that are most frequently cited as examples of the disengagement of management from ownership attitudes and sanctions. As it happens, executives are not insulated from the consequences of poor company performance—even in the short run—and are demonstrably able to reap significant benefits from a successful situation.

The pattern of changes over the years in the strength of the ownership income link is also worth noting. For both the large-manufacturing, and retail-trade, samples, ownership returns were *more* important in the 1960's than they had been during the early 1940's, whereas a decline is observable for the senior officers of small-manufacturing firms. A consistent tendency toward a growing importance in all three cases would, of course, reinforce the interpretation placed here on the data. A more careful look at the findings, however—especially as portrayed in Chart 17—suggests that a generalized upward trend is indeed present. The ratio of dividends plus gains plus stock compensation to fixed-dollar inflows can be seen to have bottomed out in the late 1940's and early 1950's for every sample, and to have risen in a clear and fairly steady manner ever since.[1] The fact that the ratios in the 1960's for the small-manufacturing sample are still below their prewar levels thus seems less relevant than the evidence as to what has been happening in the interim. From that standpoint, an increasing secular role in the executive income structure for ownership elements is apparent throughout. This phenomenon can be expected to continue in the future if only as a consequence of the growing reliance by corporations on stock-related pay arrangements for their top officials. The analysis in Chapter 3 of the managerial compensation package enjoyed by all three groups amply documents this expectation.

One feature of the data in recent years which runs particularly counter to the usual folklore is the greater relative dependence of income on stock price changes and company dividends evinced among executives of very large firms as compared with their counterparts in smaller organizations. Quite the reverse circumstance would almost

[1] The availability to executives of such instruments as stock options, beginning in the early 1950's, undoubtedly contributed to this recovery of ownership.

certainly be the prediction in most of the current literature.[2] As we found earlier, differences both in the magnitude of the stockholdings in question and in the use of stock-based instruments of remuneration account for this conclusion. Whatever their source, the figures belie the contention that the more a growing enterprise requires professional administration, the less likely are the interests of shareholders to be translated into an effective personal monetary payoff for management consistent with those interests.[3]

Commentary

The foregoing arguments, it may be recalled, would be buttressed substantially were we to employ the full-sample time series of Tables 19, 32, and 43 in the comparisons. Moreover, the figures in Table 48 almost certainly understate the case as they stand, because it has been assumed implicitly in our discussions that there is no real connection between any of the *fixed-dollar* rewards which executives receive and the performance of their companies. To the extent that such a relationship does exist, the income link reported here will emerge in still bolder relief. That issue has been addressed elsewhere by the author with encouraging results.[4] There turns out to be a definite and persistent correlation between the salaries and bonuses of the senior corporate executives in the large-manufacturing sample [5] and the profits and equity market values of their employer firms. By

[2] And quite the reverse can, of course, be seen in Table 48 to have been true during the 1940's.

[3] There is, on the other hand, the possibility of some bias in this respect in the small-firm sample. Since the information contained in corporate proxy statements is necessary to the analysis—and since closely held firms where the management and ownership groups are one and the same are not ordinarily forced by SEC regulations to issue proxy statements—we may end up including in the sample predominantly those smaller firms in which management's equity position *is* fairly small. Nonetheless, the point that large company size is by no means a deterrent to a significant interdependence between executive incomes and stockholder returns is strongly supported by the data.

[4] W. G. Lewellen and A. B. Huntsman, "Managerial Pay and Corporate Performance," *American Economic Review*, Vol. LX, No. 4 (September 1970).

[5] Only the large-manfacturing sample was examined in this manner, since the sample sizes in the retail trade and small-manufacturing groups were too small to allow the execution of meaningful statistical tests of significance.

the same token, it was found that no systematic link between cash compensation and the most commonly proposed nonprofit measure of company size—annual sales volume—could be established. Thus, in a cross-sectional multiple regression framework, the profit and equity market value coefficients tested as significant at the .01 level in virtually every year, whereas the sales coefficients were nowhere significant. Those elements of the managerial pay package which are not *automatically* tied to company success as shareholders perceive it, can therefore be shown to be tied indirectly through extant corporate compensation practices.

The Compensation Record

While the historical evidence relating to executive remuneration has been utilized primarily as a frame of reference for a treatment of the impact of stock ownership patterns, that evidence merits some attention in its own right. We observe that total after-tax executive pay—whether defined for the highest-paid indivduals in the respective firms or for the five highest-paid combined—almost exactly doubled between 1940 and 1963 within each sample at issue. The consistency of this finding for three such diverse segments of the economy is striking enough to imply that the phenomenon may be a general characteristic of the structure of managerial rewards, as it has developed during the last quarter-century under the pressure of major revisions in federal tax policy. The impact of taxes is clearly discernible, both in the shift away from direct cash payments over time toward an increasing emphasis on deferred and contingent compensation devices for all firms, and in the interfirm differences within given years in the implementation of those devices. For example, large manufacturing corporations—wherein the aggregate levels of executive remuneration were highest—relied most heavily on noncurrent rewards as vehicles for sidestepping the effect of progressive ordinary personal tax rates. The somewhat smaller amounts of compensation recorded among the retail trade group were comprised proportionately less of deferred arrangements, and the still lower-paying small manufacturing sample emphasized cash compensation

most strongly. The logic of tax planning, therefore, appears to have made the appropriate impression. Recognition that many of the newer deferred and contingent instruments adopted are designed around shares of the employer corporation's common stock as the means of payment is, of course, a key element in our investigation of the management-shareholder income relationship.

Ownership Proportions

A sidelight to that relationship is the secular decline in the fraction of their firm's outstanding equity securities which senior executives hold. A drop from 1940 to 1963 in percentage ownership occurred in each of the three samples, although the usefulness of this observation must be qualified by noting that the holdings involved were so small throughout—i.e., most often in the range of 1 per cent or less of the outstanding shares of the sample companies—that even large variations within that range do not appear to be of much real significance. A decline of this sort is, nonetheless, a standard bench mark for discussions which seek to establish the progressive dissociation of management from an identification with shareholder interests. While not denying that today's executives do own a rather smaller fraction of their companies' total common stock than was true of their predecessors in 1940, the contention here is that the relative importance of the income flows attendant upon such ownership in the aggregate *personal* income profile of the individual executive should be our concern instead. So long as those flows account for as much of observable annual increments to wealth as they currently do, a sensitivity by management to the shareholder viewpoint seems a reasonable expectation, regardless of whether or not substantial percentage minority ownership positions are involved.

Portfolio Turnover

Another dimension of the executive's stance toward the organization for which he works has to do with the degree to which the portfolio commitments in the company's shares that he undertakes are specu-

lative in nature. If we should discover that the senior management group is continually engaged in a great deal of short-term trading, riding the peaks and troughs of market sentiment on inside information, this would negate the conclusion that an effective and beneficial exposure to the ongoing contingencies of ownership prevails. Quite the reverse situation, however, is indicated by the data. Executives overwhelmingly buy and hold, as evidenced by the finding that in the large-manufacturing and retail-trade samples, transactions which resulted in a reduction in a man's own-firm stockholdings occurred, on the average, in just one out of every six years of his career experience. In the case of the small-manufacturing category, the rate was an even lower one year out of ten. Put differently, the annual capital gains and losses listed in the comparisons with executive compensation are predominantly *accrued* rather than *realized* increments, implying that the typical upper-level professional manager in fact foregoes possible speculative profits in favor of the kind of long-term participation in company fortunes that would support the arguments offered here.

The Remainder of the Portfolio

One aspect of the personal circumstances of the men in the sample which has not been examined, and which would bear on the credibility of the conclusions drawn, concerns the role which the observed employer-company stockholdings play in the *total* executive securities portfolio. We may be able to assert that the dividends, capital gains, and stock-related rewards which result from an individual's employment and investment association with his firm dominate the total income flows generated from *that* source, but the inference that this is an important phenomenon in terms of identifying with shareholder objectives would lose some of its impact if the men involved had such large *aggregate* securities portfolios that the items we can measure were trivial in comparison with the dividends, capital gains, and interest earnings from other investments. Since no data exist which permit a determination of the size of the remainder of executive portfolios—holdings only in one's own company being reported in

proxy statements—it is difficult to assess the extent to which the analysis would be modified by a more comprehensive set of figures.

There is cause to suspect that the bulk of senior management's investments must indeed be comprised of employer-company shares if only because the magnitude of the holdings we *can* observe already surpasses what would seem a reasonable expectation of total executive wealth. A finding that average per capita ownership positions are in the neighborhood of $2.5 million (for the full-sample large manufacturing group) or even $1 million (when extreme values are eliminated) exceeds by a substantial margin at least this writer's *ex ante* notions of likely dollar amounts. Offhand, it is hard to see how these men could have funds left for alternative portfolio commitments.

Furthermore, if we believe that executives, like other investors, are most comfortable when investing with knowledge, we would expect them to be strongly attracted to their own corporation's securities simply because they know more about those firms than they do about any others. Considerations of broad portfolio diversification might, in short, be given less *personal* weight by top management than by the investment community in general. These interpretations are, however, quite unsupported by empirical evidence and must remain conjectural. Clearly, there is a need for additional research. The feeling here is that just as ownership returns predominate in the observable executive income profile, so do employer-company stockholdings predominate in the total executive securities portfolio. Nonetheless, it must be admitted that if the latter contention should prove incorrect, the implications of the former would be diluted.

The Merger Trend

On the other side of the coin, there have been some recent developments in the business environment which should operate to heighten senior executives' sensitivity to the issue of profit maximization or share price maximization, even apart from the factors considered in the current discussion. Beginning in the 1960's, a significant upsurge in the frequency—some might say, the audacity—of corporate merger efforts has become apparent, resulting in the formation of a wide

variety of so-called conglomerate enterprises. The intensity of this activity suggests that very few top management groups nowadays can afford the luxury of less than full attention toward utilizing their company's resources in an efficient manner, on penalty of having some more vigorous organization go over their heads directly to shareholders with the promise of improved performance. Today's captains of industry, in effect, expose themselves to the distinct prospect of being demoted to lieutenants if they do not address their responsibilities in a way that produces adequate returns to owners. The fact that the demotion is apt to originate with some third party makes it no less a real concern, and the demonstrated skill of that third party in implementing the rebellion may make the threat more persuasive than one arising from a coalition of dissatisfied current stockholders.

Summary

The contention, then, is that there exist a number of mechanisms which should go a long way toward overcoming any tendency for the separation of corporate owners and managers in the contemporary economy to be accompanied by a separation of their respective interests and objectives. The attempt has been to document—and to appraise the dimensions of—what seems likely to be the most important such mechanism: the link between executives' personal incomes and the market returns to shareholders. Upon investigation of the historical compensation and ownership experience of a large and diverse sample of senior corporate officers, that link has been shown to be strong, immediate, and persistent. While the evidence presented obviously cannot be described as a *proof* that executives will necessarily perform their duties with the welfare of stockholders paramount in their minds, it can be offered as clear support for the proposition that it would be very much in their self-interest to do so. The findings are at least consistent with the notion that "what's good for the company is good for the executive." To date, the contrary viewpoint has not had the benefit of similar hard evidence.

APPENDIXES