

# CtW Investment Group

March 20, 2014

Dear Long-term Investor,

In the wake of the financial crisis and the long recession shareholders are increasingly unwilling to take it on trust alone that boards of directors are properly overseeing management of key long-term risks and opportunities. A critical emerging area of such risk and opportunity is the management of human capital, which the Conference Board has called the top challenge for CEOs in 2014, while academic surveys indicate that a large fraction of US companies fail to employ evidence-based human capital management practices.<sup>1</sup> Moreover, growing public concern over income inequality increasingly centers on unbalanced human capital management practices across many industries: for instance, *The New York Times* has recently editorialized against both high-tech companies that allegedly conspired to suppress software engineers' wages, and McDonald's alleged theft of wages from its and its franchisees employees.<sup>2</sup> Indeed, in its annual report to shareholders, McDonalds has for the first time disclosed that concerns over income inequality, and the contribution of its human capital management practices to income inequality in the US, poses a potential risk to its business.

In response to these developments, long-term investors have formed coalitions to engage major companies around their human capital management practices and the board of directors' role in overseeing them. The CtW Investment Group participates actively in these efforts because we believe, based on our ongoing research, that corporate boards and in particular compensation committees, have allowed an unbalanced approach to human capital management to take hold, in which excessive resources are committed to rewarding and incentivizing senior executives, while neglecting to ensure that appropriate awards and incentives are in place for the rest of the company's workforce. Consequently, boards have left shareholders exposed to significant risks to long-term performance stemming from wasteful and myopic executive pay practices, as well as from an inadequately engaged and motivated workforce. Our research, described in detail in this letter, indicates that pay inequality within a publicly traded company has a materially negative, and statistically significant effect on long-term shareholder returns. By failing to ensure a balanced and evidenced-based approach to human capital management, too many boards are leaving money on the table in the form of missed opportunities to raise productivity and long-term shareholder returns.

This report will present the CtW Investment Group's view of human capital management as currently practiced by US public companies and their boards, our analysis of the negative relationship between pay inequality within publicly traded companies and long-term shareholder returns, and our assessment of the industries in which unbalanced human capital management practices pose the greatest risks to shareholders going forward. We look forward to discussing our analysis with you , and we hope you and other shareholders will join us in taking the necessary steps to ameliorate these risks and raise performance.

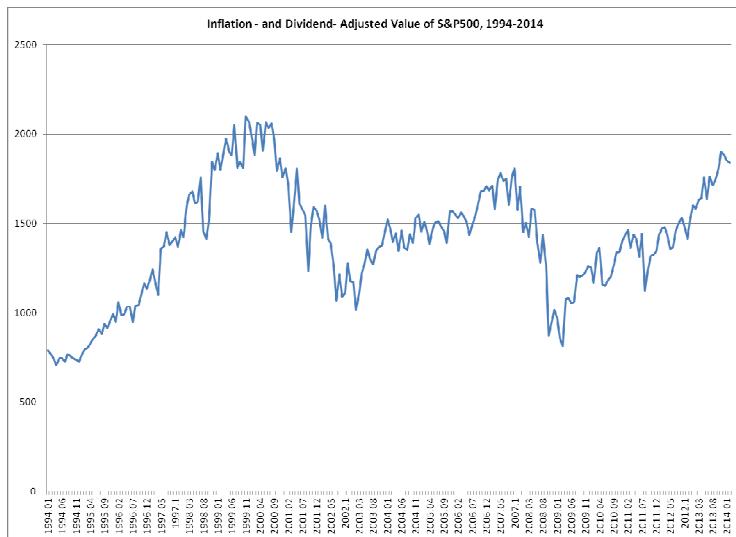
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<sup>1</sup> John Burn-Murdoch, Steven Bernard, and Andrew Hill "Challenges for CEOs in 2014" *Financial Times*, January 9, 2014; Jeffery Pfeffer and Robert Sutton, "Evidence Based Management" *Harvard Business Review* January 2006.

<sup>2</sup> The Editorial Board, "Colluding Against Programmers," *New York Times*, March 5, 2014; The Editorial Board, "Happy Meals, Unhappy Workers" *New York Times*, March 13, 2014.

## Evidence of an Unbalanced Approach to HCM

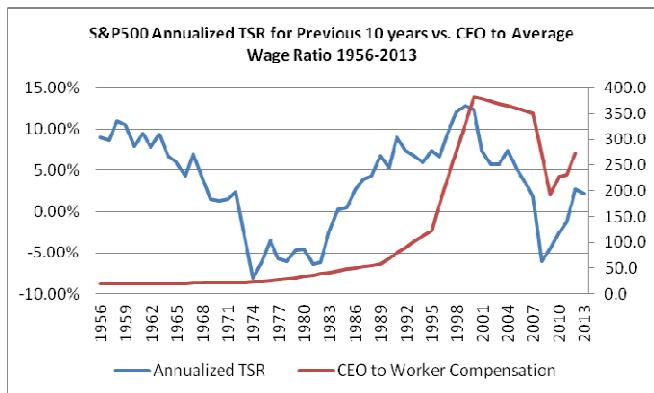
We see evidence of this unbalanced approach from a variety of sources. First, and most broadly, the aggregate pay of senior executives has been rising faster than either reported profits or shareholder returns over the past 25 years. For instance, Lucien Bebchuk and Yaniv Grinstein found that between 1993 and 2003, pay for public company executives doubled relative to corporate earnings.<sup>3</sup> Other broad measures of executive pay, such as the ratio of average pay for CEOs of large companies to the average wage, show a large increase over recent decades: average CEO pay has grown from about 100 times the average wage in 1990 to more than 250 times the average wage today.<sup>4</sup> During these same years, and despite periodic and much ballyhooed run-ups in stock prices, inflation-adjusted shareholder returns have been stagnant. The figure below shows that despite the large increase in share prices since mid-2009, the current value of the S&P 500, including historical dividend payments, continues to lag its historical peak, adjusted for inflation:



Moreover, rising pay for CEOs relative to typical employees does not appear to have incentivized superior shareholder returns. As the figure below shows, the dramatic rise in the aggregate CEO pay ratio followed rather than led a dramatic improvement in total shareholder returns starting in the early 1980's. This increased level of relative pay for executives was sustained despite the subsequent falls in inflation-adjusted total shareholder returns over the past decade and a half:

<sup>3</sup> Lucien Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy* Vol. 21, No. 2 2005.

<sup>4</sup> Jordan Weissman, "CEOs Now Earn 273 Times the Average Worker's Pay – Should You Be Mad?" [theatlantic.com](http://theatlantic.com), June 27, 2013.



Given this background, it is not surprising that executives and managers of non-financial companies comprise the largest group among the top 1% of income earners, and together with financial executives comprise almost half of the top 1%.<sup>5</sup> Consequently, rising executive pay has been a key driver of the divergent growth of top incomes in the US. From 1993 to 2012 the top 1% of income earners saw their incomes increase 86%, compared to 6.6% for the bottom 99% of the income distribution. Indeed, the top 1%'s share of national income has risen from 14% to 24% over this same period.<sup>6</sup> Economists increasingly suspect that this increase in income inequality bears significant blame for both the emergence of asset-price bubbles that culminated in the financial crisis and the subsequent slow recovery.<sup>7</sup> Partly as a consequence, The World Economic Forum has identified income disparity as the risk factor most likely to generate a new crisis.<sup>8</sup>

Second, reviewing the compensation committee charters on the one hand, and compensation committee reports to shareholders on the other, it is evident that while directors are charged with ensuring that appropriate compensation practices are in place throughout the company, shareholders are given precious little information about either the company's human capital management philosophy and practices, or the board's role in assessing the effectiveness of these practices and overseeing management's selection and implementation of them. Academic research into human capital management suggest that approaches which have repeatedly been shown to yield significant positive results ("high-performance workplace practices") nevertheless have not been put in place by numerous companies. Improving board disclosure of human capital management approaches is a major goal of the ongoing efforts of shareholder coalitions in which the CtW Investment Group participates.

Third, there is mounting evidence that the failure of boards of directors generally, and of compensation committees in particular, to oversee human capital management in a balanced fashion increasingly exposes companies (and hence shareholders) to regulatory, litigation, and reputational risks. The clearest example of such risks currently is the ongoing class-action suit brought by current and former software engineers against seven large, Silicon Valley-based high-technology companies, including Apple and

<sup>5</sup> Mother Jones "Who Are the 1%" <http://www.motherjones.com/mojo/2011/10/one-percent-income-inequality-ows>

<sup>6</sup> Data from World Top Incomes Database.

<sup>7</sup> Jonathan D. Ostry, Andrew Berg, and Charalambos G. Tsangarides, "Redistribution, Inequality, and Growth" IMF Staff Discussion Note, February 2014; Jared Bernstein, *The Impact of Inequality on Growth*, Center For American Progress, December 2013.

<sup>8</sup> World Economic Forum, *Global Risks 2014*, pg. 17.

Google. Court filings show that numerous high-tech executives and directors actively conspired to avoid competing with each other in order to prevent engineer pay from increasing despite the rapid growth in high-tech revenue and profits during the mid-to-late 2000's. These high-tech employers, as well as others including E-Bay, have either settled anti-trust charges with the US Department of Justice, or are currently under investigation by the DoJ.<sup>9</sup>

### **Why Unbalanced HCM is a Problem For Shareholders**

A substantial body of academic research developed over the past two decades strongly suggests that unbalanced human capital management practices are imposing a cost on shareholders because firms with high levels of internal pay dispersion suffer from lower employee engagement, lower morale and satisfaction, and lower productivity. We provide a brief bibliography of works in these fields in Appendix I of this letter. In short, this literature has consistently found that firm-level systems of pay determination have a large impact on employee engagement, turnover, productivity, and overall firm performance, and that these effects vary depending on

- The level of pay received by an employee, such that already highly paid employees respond less to a pay increase of a given size than do lower paid employees.
- The perceived fairness of pay decisions, which is crucial in generating positive effects from changes in pay practices.
- The relative pay of supervisors, managers, and executives compared to other employees which is one of the primary lenses through which perceptions of fairness are formed.

Researchers in these fields have found, for instance, that retailers which pay higher wages are perceived as providing substantially better customer service, experience lower levels of turnover, and also encounter substantially lower levels of employee theft.<sup>10</sup> Nevertheless, many of the researchers in these fields have found that despite the accumulation of evidence linking within-firm pay fairness to positive company-wide performance, in practice many firms do not implement high-performance pay and management practices and suffer high levels of employee dissatisfaction.<sup>11</sup> Several studies have shown that even publicly available data on employee satisfaction, such as the “100 Best Companies To Work For In America” list published by Forbes, is apparently not incorporated into stock market prices even though the firms making this list materially out-perform their peers on both a short- and long-term basis.<sup>12</sup> This finding suggests both that the management of human capital is a key determinant of company performance, and that investors currently have too little information concerning crucial human capital management practices, such as company-level pay dispersion.

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<sup>9</sup> Mark Ames, “The Techtopus: How Silicon Valley’s most celebrated CEOs conspired to drive down 100,000 tech engineers’ wages” Pando Daily, January 23, 2014.

<sup>10</sup> Zeynep Ton, “Why Good Jobs Are Good for Retailers” *Harvard Business Review*, January 2012.; Clara Xiaoling Chen and Tatiana Sandino, “Can Wages Buy Honesty? The Relationship Between Relative Wages and Employee Theft” *Journal of Accounting Research*, vol. 50, no. 4, 2012.

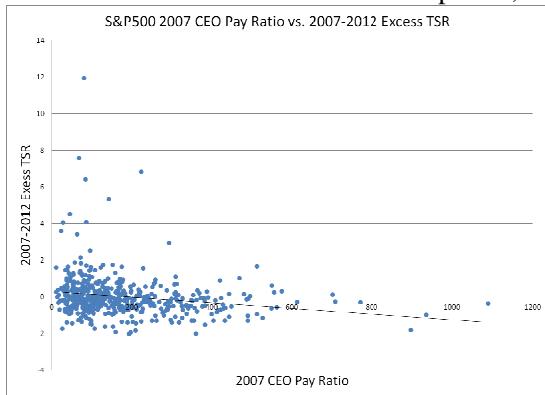
<sup>11</sup> Jeffrey Pfeffer, “Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained” *Journal of Economic Perspectives*, vol. 21, no. 4, Fall 2007.

<sup>12</sup> Alex Edmans, “Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices” *Journal of Financial Economics*, vol. 101, no. 3, 2011.; Alex Edmans, “The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility” *Academy of Management Perspectives*, November 2012.; Roger J. Best, “Employee Satisfaction, Firm Value, and Firm Productivity” Working Paper University of Central Missouri Spring 2008.

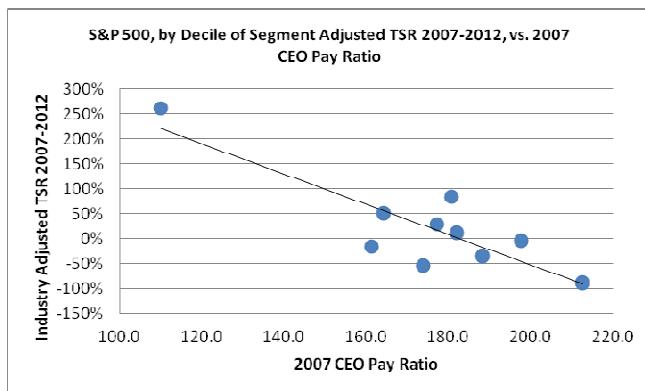
As the authors of a review of this literature note: “Because how people feel about their pay is a result of comparative processes, organizations with huge variance between executive and employee pay practices are likely to be populated with workers eagerly awaiting opportunities to move to other organizations.”<sup>13</sup>

To better understand the impact of high ratios between CEO pay and the pay of a company’s typical employee on long-term investors, we undertook an analysis of data on companies currently included in the S&P 500, the methodology of which we explain in Appendix II.

First, we found that there was a clear negative correlation between the estimated CEO Pay Ratio in 2007 and excess return over the 2007-2012 period, as shown below:



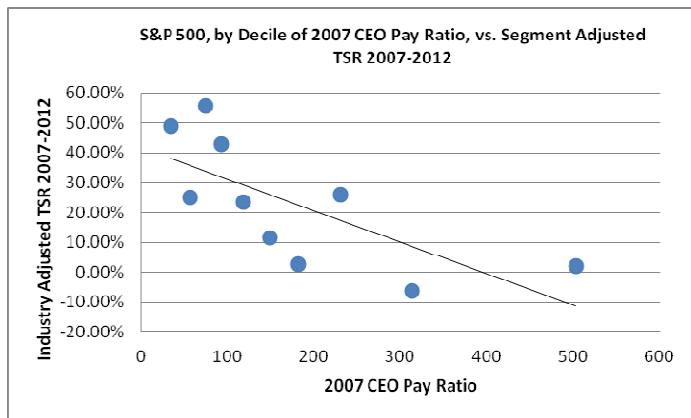
Second, we ranked the current S&P500 constituents by their segment-adjusted performance from 2007-2012, and calculated the average 2007 CEO pay ratio for each decile of this distribution. As you can see from the figure below, there is a clear negative relationship between performance deciles and average CEO pay ratios:



We also ranked the current S&P500 constituents by their 2007 CEO pay ratios, and for each decile of this distribution we calculated the (unweighted) average segment-adjusted total shareholder return. Again, we see a clear negative relationship between pay ratios and performance:

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<sup>13</sup> Sara L. Rynes, Barry Gerhart, and Kathleen A. Minette, “The Importance of Pay In Employee Motivation: Discrepancies Between What People Say And What They Do” Human Resource Management, Winter 2004, Vol. 43, No. 4, pg. 390.



Finally, we constructed a multivariate regression equation to test both the statistical significance of the negative relationship between CEO pay ratios and performance to determine if this relationship held when other variables associated with long-term performance are taken into account. Our model controls for variables representing market capitalization (since smaller companies typically outperform larger companies) the market-capitalization-to-book-value ratio (since companies with high market capitalizations relative to book value are frequently hypothesized to be overpriced), “momentum” (the share price change in the year prior to our study period), earnings per share growth in the year prior to our study period, the debt-equity ratio, and the price-earnings ratio. The full results of the regression are presented in Appendix III: in summary we found that *for every increase of 10(i.e. from 200 to 210) in the CEO Pay Ratio, the cumulative excess total shareholder return over the following six years declined by 0.91 percentage points or 91 basis points*. This relationship is statistically significant at above the 97% level. We also estimated an alternative version of this model, in which performance was measured against the weighted average of the full sample, and “segment fixed-effects” were separately estimated. In this alternative version, we found that *for every increase of 10 in the CEO Pay Ratio, performance declined by 1.08 percentage points or 108 basis points*, and that this relationships is statistically significant at the 99% level.

### What Can Shareholders Do?

The evidence we've reviewed in this letter provides a strong basis for investment fiduciaries to take action in order to protect their investments from the costs and risks imposed by unbalanced human capital management practices. We urge you and your institution to join us in the steps we are taking to minimize these costs, as well as take advantage of the opportunity to improve performance by rebalancing human capital management practices starting at the board level. As we have mentioned before, we are working with institutional investors who share our concerns to engage major corporations in a discussion of how they approach human capital management, how the board and the compensation committee review this approach and oversee its implementation, and how they disclose pertinent details of this approach to shareholders. At the same time, it is clear that the unbalanced approach all too common among US companies continues to impose costs on shareholders, and we will therefore be spearheading efforts over the next year to hold companies and directors accountable for unbalanced human capital management practices.

The proxy advisory service ISS has recently published a study of their own estimates of CEO pay ratios in the US since 2009 (though they do not compare these ratios to performance), and found that “industries such as Retailing, Food, Beverage & Tobacco, and Household & Personal Products exhibit both relatively

high median ratios and some of the highest ratios across all industries,” and that “while most industries maintained fairly stable median ratios over the period, a few (e.g., Food & Staples Retailing and Consumer Services) experience significant increases from 2009 to 2012.”<sup>14</sup> Our research suggests that the industries mentioned by ISS, which generally combine direct interaction between workers and customers, low-wage, high-turnover jobs, and high CEO Pay Ratios, are the ones with the most unbalanced approaches to human capital management. Additionally, the recent revelation that high-technology company executives and directors directly participated in cross-company efforts to suppress competition and wages for skilled software engineers from 2006 on clearly indicates that an inappropriate and unbalanced approach to human capital management prevails in this industry as well.

We will therefore be particularly focused on retail, fast food , and high-technology companies in the upcoming proxy season. Our initiatives will include challenges to both the Say on Pay proposals at this year’s meetings, as well as to the re-election of directors serving on compensation committees where appropriate.

We urge you to join us in improving the corporate governance of human capital management practices. We are convinced that together we can rebalance board focus and management approaches in order to mitigate risk and improve shareholder returns over the long term.

Sincerely

Richard W. Clayton III  
Research Director, CtW Investment Group

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<sup>14</sup> Liz Williams and Natalia Weaver, “CEO Pay Disparity: What Will the Numbers Show?” ISS, March 5, 2014.

## **Appendix I: Research on Pay Dispersion and Organizational Performance**

David Card, Alexandre Mas, Enrico Moretti, and Emmanuel Saez, “Inequality At Work: The Effect Of Peer Salaries On Job Satisfaction” NBER Working Paper 16396, September 2010.

Jeffrey Pfeffer, “Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained” *Journal of Economic Perspectives*, vol. 21, no. 4, Fall 2007.

Charles A. O'Reilly, James Wade, and Tim Pollack, “Overpaid CEOs and Underpaid Managers: Equity and Executive Compensation” Stanford Business Library Research Paper #1410.

Roger J. Best, “Employee Satisfaction, Firm Value, and Firm Productivity” Working Paper University of Central Missouri Spring 2008.

Jeffrey Pfeffer, “Building Sustainable Organizations: The Human Factor” Academy of Management *Perspectives*, February 2010.

Zeynep Ton, “Why Good Jobs Are Good for Retailers” *Harvard Business Review*, January 2012.

Sara L. Rynes, Barry Gerhart, and Kathleen A. Minette, “The Importance of Pay In Employee Motivation: Discrepancies Between What People Say And What They Do”, *Human Resource Management*, Winter 2004, vol. 43, no. 4.

Clara Xiaoling Chen and Tatiana Sandino, “Can Wages Buy Honesty? The Relationship Between Relative Wages and Employee Theft” *Journal of Accounting Research*, vol. 50, no. 4, 2012.

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Alex Edmans, “The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility” Academy of Management *Perspectives*, November 2012.

James B. Wade, Timothy G. Pollack, Joseph F. Porac, and Scott D. Graffin, “Star CEOs Benefit or Burden?” *Organizational Dynamics*, vol. 37, no. 2, 2008.

Rakesh Khurana, “The Curse of the Superstar CEO” *Harvard Business Review*, September 2002.

## **Appendix II: Regression Methodology**

Our dependent variable, Excess\_Return, is the total shareholder return between January 1, 2007 and December 31, 2012 for each company currently in the S&P500, minus the sector benchmark return for the same period. The sector benchmark return is the market capitalization weighted total shareholder return for each of the 10 sectors into which the S&P500 is divided: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, IT, Materials, Telecommunications, and Utilities.

Our independent variable of primary interest, CEO\_Pay\_Ratio, was calculated following the methodology introduced by journalists Elliot Blair Smith and Phil Kuntz from Bloomberg to estimate the annual pay and benefits of the median employee based on industry specific pay data collected by the US government. We computed the ratio between this pay figure and the total compensation reported on the proxy

statement for the CEO (or highest paid executive, if the CEO was not typically the highest paid) for fiscal year 2007 for each company currently in the S&P 500.

The scatterplot shown on page 5 of this letter displays our Excess\_Return variable on the Y axis and our CEO\_Pay\_Ratio variable on the X axis.

Seven companies currently in the S&P 500 (AbbVie, Inc., ADT Corp., Kraft Foods, The Washington Post Company, SAIC, Inc., TripAdvisor Inc., and Zoetis, Inc.) either did not begin trading until 2012 at the earliest, or have subsequently been taken private in such a way that data on their past share price performance is no longer available from Capital IQ or Google Finance, and so were excluded from this analysis.

For our regression analysis, we included the 458 companies currently in the S&P 500, for which we have complete share price data back to January of 2006. Our ordinary least-squares regression analysis included six additional independent variables: Market\_Capitalization, the January 1, 2007 market capitalization of each current member of the S&P500, Market\_to\_Book, the ratio of the January 1, 2007 market capitalization to the January 1, 2007 (or closest available date) book value for each company, Momentum\_(2006) the change in the share price over the calendar year 2006, EPS\_Growth\_% the change in earnings per share over the 2006 calendar year, Debt/TCE the ratio of total debt to total common equity, and PE\_Ratio the ratio of the Janauary 2007 share price to earnings per share over the prior 12 months. The regression model took the form of  $\text{Excess\_Return} = \alpha + \beta\text{CEO\_Pay\_Ratio} + \gamma\text{Market\_Capitalization} + \delta\text{Market\_to\_Book} + \phi\text{Momentum\_}(2006) + \eta\text{EPS\_Growth\_ \%} + \iota\text{Debt/TCE} + \varphi\text{PE\_Ratio} + \varepsilon$ .

### Appendix III: Regression Results

Model with segment adjusted performance:

<i>Regression Statistics</i>	
Multiple R	0.237112053
R Square	0.056222125
Adjusted R Square	0.041573688
Standard Error	1.133340764
Observations	459

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	0.31689	0.09423	3.36301	0.00084	0.13171	0.50207
2007 CEO Pay Ratio	-0.00091	0.00038	-2.42586	0.01566	-0.00165	-0.00017
Market Cap	0.00000	0.00000	-1.88422	0.06018	0.00000	0.00000
Market to Book	-0.00008	0.00008	-0.96471	0.33521	-0.00024	0.00008
Momentum (2006)	0.73028	0.22096	3.30504	0.00103	0.29604	1.16451
2006 EPS % Growth	-0.00819	0.02100	-0.38975	0.69690	-0.04946	0.03309
Debt/TCE	0.00001	0.00001	0.80847	0.41925	-0.00001	0.00003
PE Ratio	0.00112	0.00111	1.00616	0.31488	-0.00107	0.00330

Model with segment fixed effects:

<i>Regression Statistics</i>	
Multiple R	0.359852042
R Square	0.129493492
Adjusted R Square	0.097760766
Standard Error	1.12487117
Observations	459

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	0.15461	0.46713	0.33098	0.74081	-0.76346	1.07269
2007 CEO Pay Ratio	-0.00108	0.00039	-2.78676	0.00555	-0.00184	-0.00032
Market Cap	0.00000	0.00000	-1.60981	0.10815	0.00000	0.00000
Market to Book	-0.00009	0.00008	-1.13195	0.25827	-0.00025	0.00007
Momentum (2006)	0.75884	0.22478	3.37586	0.00080	0.31706	1.20061
2006 EPS % Growth	-0.00788	0.02105	-0.37459	0.70815	-0.04925	0.03348
Debt/TCE	0.00001	0.00001	0.83507	0.40413	-0.00001	0.00003
Consumer Discretionary	0.56071	0.48072	1.16638	0.24409	-0.38407	1.50549
Consumer Staples	0.43263	0.49793	0.86885	0.38540	-0.54597	1.41123
Energy	0.25504	0.49596	0.51424	0.60734	-0.71968	1.22977
Financials	-0.39400	0.47718	-0.82568	0.40943	-1.33181	0.54382
Healthcare	0.71360	0.48796	1.46243	0.14433	-0.24540	1.67260
Industrials	0.25179	0.48309	0.52120	0.60249	-0.69764	1.20121
Information Technology	0.11874	0.48266	0.24601	0.80579	-0.82985	1.06733
Materials	0.43198	0.50602	0.85369	0.39374	-0.56252	1.42649
Telecommunication Services	0.00000	0.00000	65535.00000		0.00000	0.00000
Utilities	-0.10375	0.50354	-0.20603	0.83686	-1.09337	0.88588