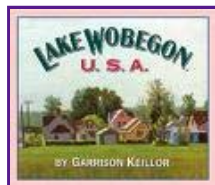


Executive Compensation, Where Everyone is Above Average

Posted on Friday, August 21st, 2009 at 7:00 am.



It seems like executive compensation consultants come from Lake Wobegon, where “all the women are strong, all the men are good looking, and all the children are above average.”

I think executives should be compensated for out-performing their peers. They shouldn't be punished for a negative performance due to external forces if they still out-performed their peers. Further, they shouldn't be rewarded for a positive performance, if they under-performed their peers.

The magic is in picking the peer group to compare. Ideally, a peer group should include companies that are similar along several characteristics (e.g., industry, size, diversification, and financial constraints). Of course matching all of those characteristics would lead to a very small group for comparison.

In an article in the Wall Street Journal, Cari Tuna points out that Tootsie Roll Industries used Kraft Foods as a peer for deciding how much to pay its executives. Tootsie had \$496 million in sales and Kraft had \$42.2 billion in sales.

A study by [Ana Albuquerque](#) of Boston University examined what needs to go into selecting the peer groups. She found that having the the same industry and size quartile shows the best evidence for creating a relative peer group for executive compensation. In a second study, she found that companies tend to choose peers that pay their CEOs more, which in turn translates into firms paying their CEOs more.

In their study, [Michael Faulkender](#) of the University of Maryland and [Jun Yang](#) of Indiana University came to the conclusion that “compensation committees seem to be endorsing compensation peer groups that include companies with higher CEO compensation, everything else equal, possibly because such peer companies enable justification of the high level of their CEO pay.”

You can also add into the mix that the company may not want to seen as having a CEO who is below average. If your CEO is below average, then your company may be below average.

If you're a CEO of a public company, it's getting harder and harder to be below average.

References:

- [Picking Big 'Peers' to Set Pay](#) by Cari Tuna for The Wall Street Journal
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- [Ethics in CEO Compensation](#) by Chris MacDonald on The Business Ethics Blog
- [CEO Pay and the Lake Wobegon Effect](#) – previous post
- [CEO Pay and the Lake Wobegon Effect](#) by [Rachel Hayes](#) and [Scott Schaefer](#) of the University of Utah in the Journal of Financial Economics.

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One Response to “Executive Compensation, Where Everyone is Above Average”

1.  [Jason Mark Anderman](#)
[August 21, 2009 at 11:36 pm \(Edit\)](#)

This issue bothers me because I feel that executive compensation consulting represents conflicts of interest on multiple levels. Compensation consulting is a relatively small project for a consultant. The consultant is much more interested in large scale projects, which his or her employer is much less likely to get if they don't recommend increasing compensation. Additionally, the board of directors often includes executives at other companies, who can gain in compensation by seeing their officer peers do the same. Also, the consultant wants to get these board of directors executives to give them business as well, so it all ends up being a vicious circle. It makes one wonder if we would be better off with the following approach: (1) filling a board with retired executives who agree not to serve on any other boards, and paying each a six figure salary to justify the sacrifice, and (2) ensuring that firms should not give consulting business to the same consultant that advises on compensation. Sadly, suggesting this course of action to Congress or the SEC would likely result in an enormous regulatory framework that would not be worth the compliance hassle. Perhaps major shareholders like CALPERS need to lead the way. What do you think?

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