

# Managerial Labor Market Competition and Incentive Contracts

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Job Market Talk at the University of Gothenburg

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# Introduction

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- Principle-agent problem matters to explain incentive pay.
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- **Firm Size Incentive Premium and Managerial Labor Market:**  
Incentive premium is higher in industries where the managerial labor market is more active.

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- **Firm Size Incentive Premium and Managerial Labor Market:**  
Incentive premium is higher in industries where the managerial labor market is more active.

## What I provide:

- An explanation based on the executive job ladder.

# Introduction — firm size incentive premium

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## Key variables:

- firm size by market capitalization
- performance-based incentives by PPS, *pay-for-performance sensitivity*

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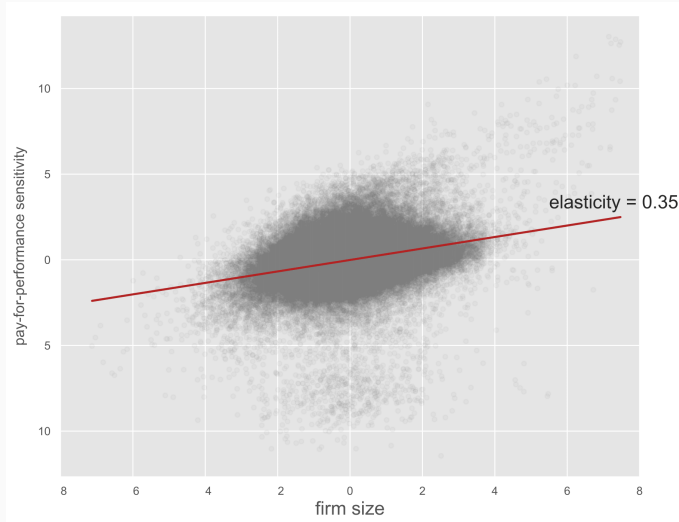
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## Size incentive premium:

- Controlling for **total compensation**, year  $\times$  industry dummies, etc.

$$\text{Corr}(\text{PPS}, \text{firm size}) > 0.$$





**Figure 1:** PPS increases in firm size (size incentive premium)

Scatter and linear fit of  $\log(\text{PPS})$  on  $\log(\text{Mktcap})$ , based on S&P 1500 firms from 1992 to 2016.

# Introduction — size incentive premium and labor market

	log( <i>PPS</i> )				
	(1)	(2)	(3)	(4)	(5)
<i>log(firm size)</i>	0.585*** (0.0141)	0.347*** (0.0247)	0.529*** (0.00499)	0.561*** (0.00310)	0.571*** (0.0139)
<i>log(firm size)</i> × <i>J-J rate</i>			0.415** (0.101)		
<i>log(firm size)</i> × <i>GAI</i>				0.0648*** (0.00156)	
<i>log(firm size)</i> × <i>inside CEO frac</i>					-0.0458* (0.0202)
<i>log(total pay)</i>		0.609*** (0.0350)	-0.251*** (0.00173)	-0.304*** (0.00267)	-0.253*** (0.00173)
<i>tenure, age, year</i>	X	X	X	X	X
<i>other controls</i>	X	X	X	X	X
<i>industry</i>	X	X			
<i>year</i> × <i>industry</i>	X	X			
Observations	146,747	128,006	125,858	75,747	125,858
adj. <i>R</i> <sup>2</sup>	0.442	0.514	0.521	0.531	0.521

# Introduction — model intuition

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- dynamic moral hazard + job ladder

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What are labor market incentives?

- on-the-job executives can be poached by outside firms
- labor market incentives: effort  $\leftarrow$  productivity  $\leftarrow$  poaching offer

## Introduction — model intuition, cont'd

Key assumption (Gabaix and Landier, 2008):

- $\text{cash flow} = \text{firm size} \times \text{executive productivity}$
- larger firms can always outbid smaller ones
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## Introduction — model intuition, cont'd

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Labor market incentives decrease in firm size

- **job ladder effect** — position on the ladder
- **wealth effect** — wealthier executives are harder to incentivize

This paper

1. documents the firm size incentive premium
2. develops a dynamic equilibrium framework to explain the premium
3. explains the significant increase in executive compensation since the mid 1970s (Frydman and Saks 2010)

## Related Literature

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- Assignment models:
  - Tervio (2008), Gabaix and Landier (2008), Edmans et al. (2009), etc.
  - This paper adds dynamics and search frictions.
- Moral hazard models
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  - moral hazard: Spear and Srivastava (1987), etc.
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- Labor search literature
  - sequential auction: Postel-Vinay and Robin (2002), etc.

# Road Map

1. Model
2. Data & evidence
3. Structural estimation
4. Explain the pattern since the mid 1970s

# The Model

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## Set Up: Moral Hazard

Discrete time and infinite periods

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Discrete time and infinite periods

Executives:

- risk averse,  $u(w) - c(e)$ ,  $e \in \{0, 1\}$ ,  $c(1) = c$ ,  $c(0) = 0$ ,

$$u(w) = \frac{w^{1-\sigma}}{1-\sigma}$$

- effort  $e$  stochastically increases executive productivity  $z \in \mathcal{Z}$
- $z$  is persistent, follows a discrete Markov Chain process

$$z_t = \rho_0(e) + \rho_z z_{t-1} + \epsilon_t$$

- die with  $\eta \in (0, 1)$ , the match breaks up, the job disappears

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Firms:

- firm size  $s \in \mathcal{S}$ , exogenous and permanent
- production (cash flow)  $y(s, z) = \alpha_0 s^{\alpha_1} z$ ,  $\alpha_0, \alpha_1 \in (0, 1]$ .

## Set Up: Managerial Labor Market

Managerial Labor Market:

- search frictional and allows on-the-job search
- with  $\lambda_1 \in (0, 1)$  sample an outside firm  $s'$  from  $F(s')$

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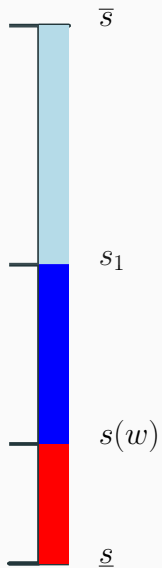
Bertrand Competition:

- current firm  $s$  versus outside firm  $s'$
- each has a bidding frontier,  $\overline{W}(z, s)$ , defined by

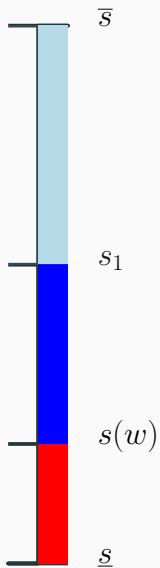
$$\Pi(z, s, \overline{W}(z, s)) = 0$$

- $\overline{W}(z, s)$  increases in  $z$  and  $s$

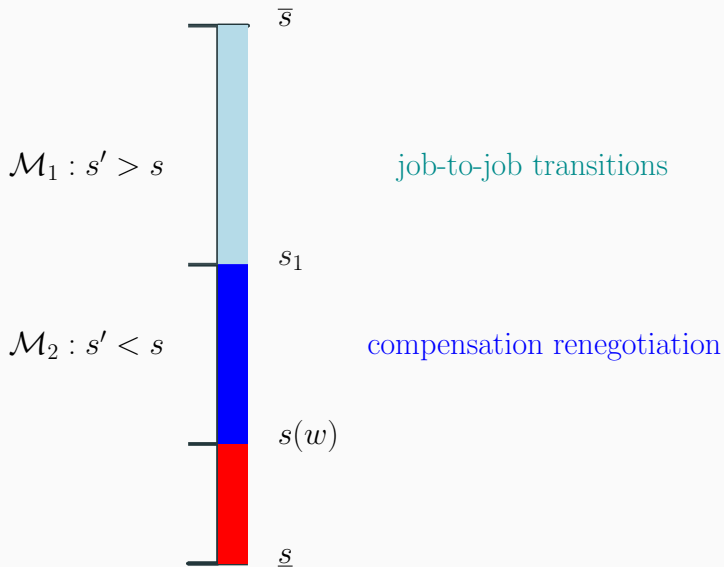


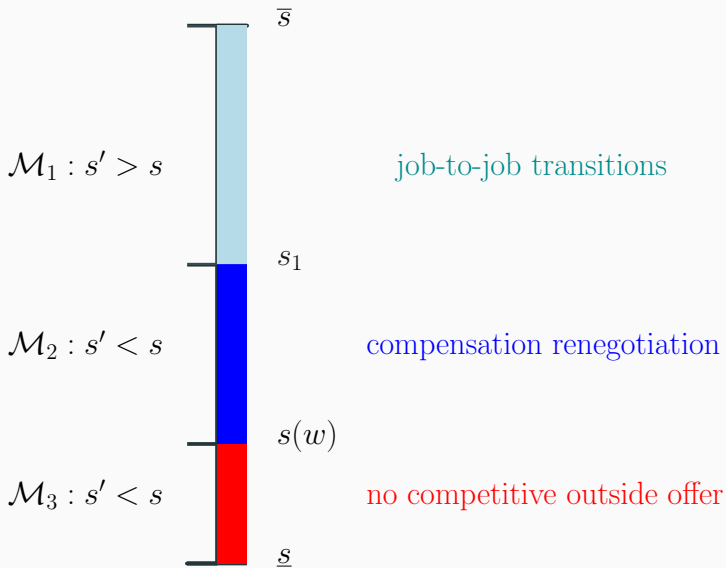


$\mathcal{M}_1 : s' > s$



job-to-job transitions





# Contracting Problem

Firms **maximize profits** by choosing

- current period compensation  **$w$**
- state-contingent continuation value  **$W(z', s')$**

subject to

*Promise-keeping Constraint,* (PKC)

*Incentive Compatibility Constraint,* (IC)

*Participation Constraint of executive,* (PC-Executive)

*Participation Constraint of firm,* (PC-Firm)

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Details

# The Equilibrium

A stationary equilibrium is defined by

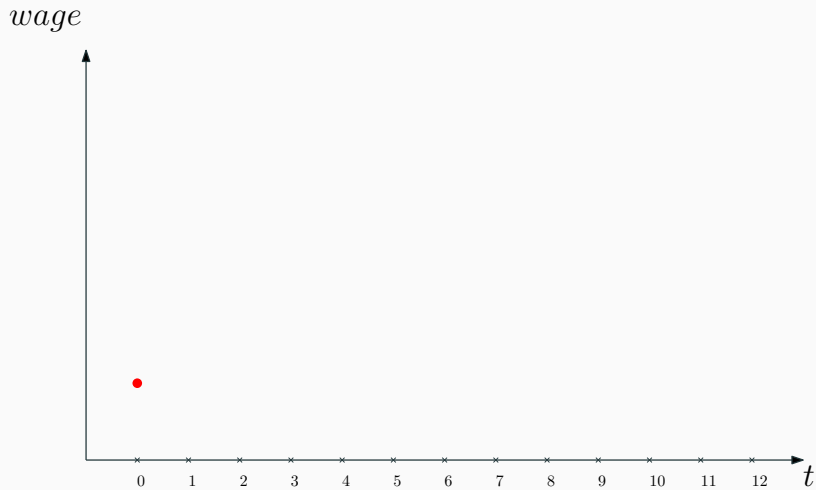
- value functions  $\{W^0, W, \Pi\}$ ;
- optimal contracts  $\sigma = \{w, W(z', s')\}$  for  $z' \in \mathbb{Z}$  and  $s' \in \mathbb{S}$ ;
- $\Gamma(z'|z)$  follows the optimal effort choice;
- a distribution of executives across employment states evolving according to flow equations.



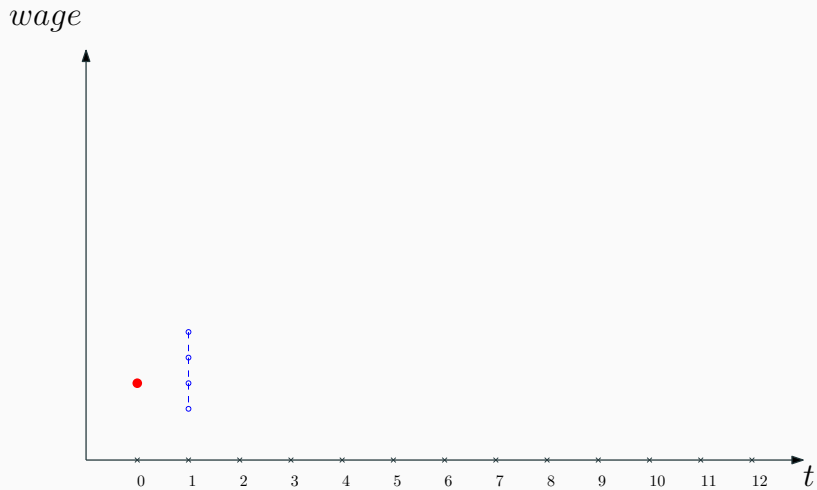
# The Optimal Contract

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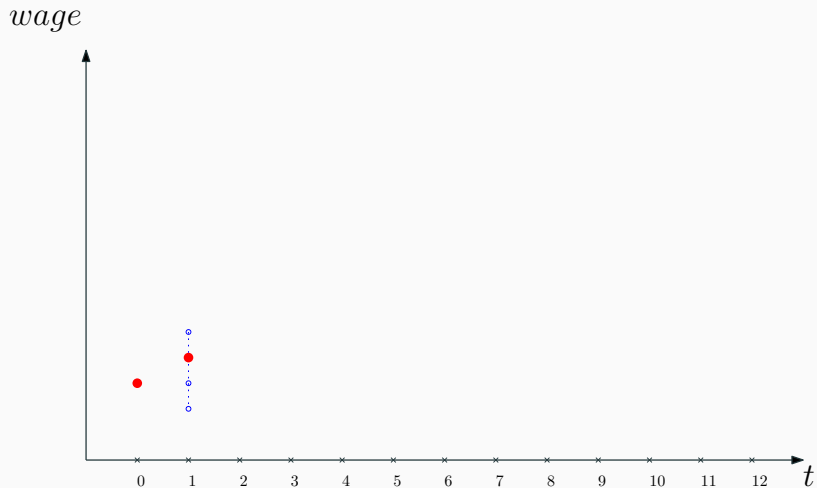
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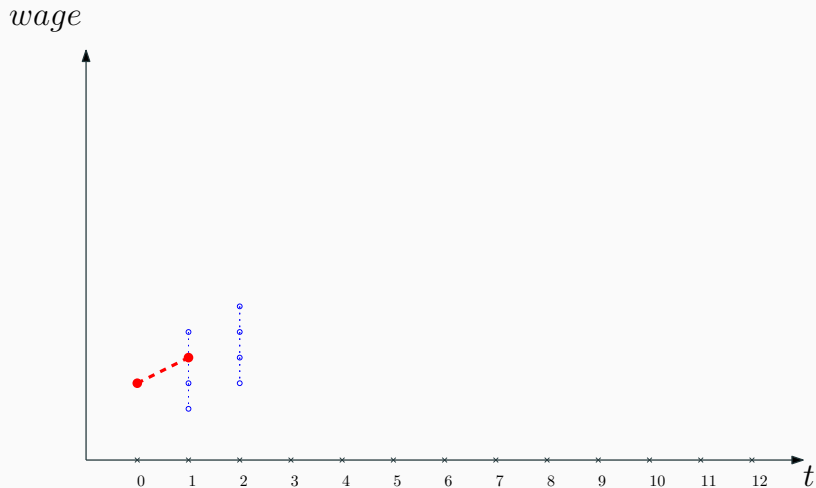
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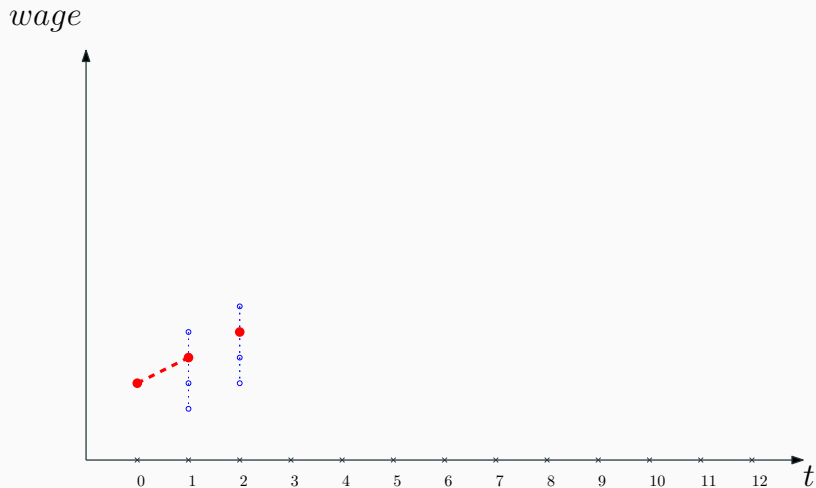
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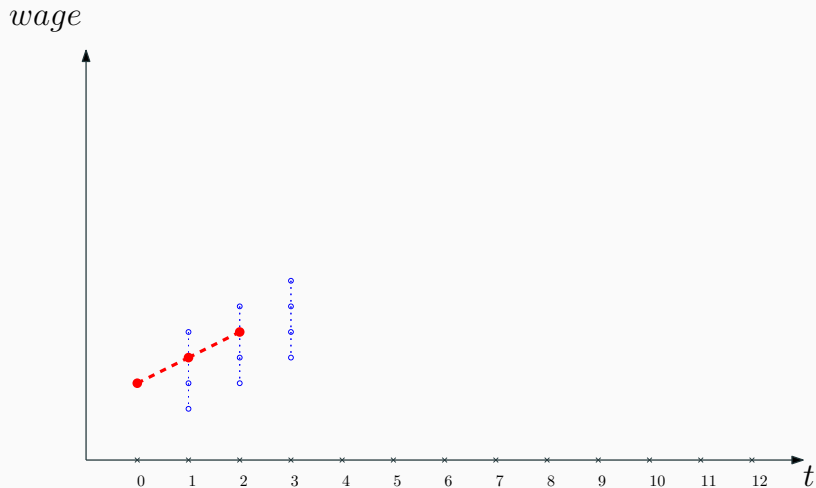
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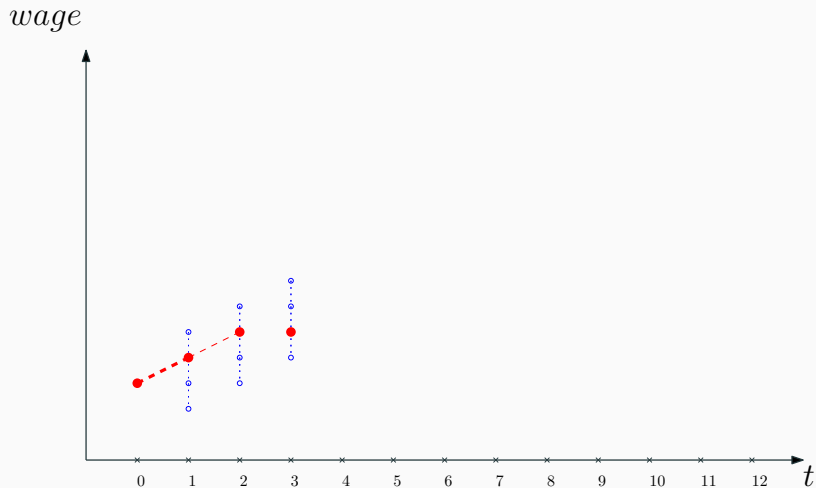
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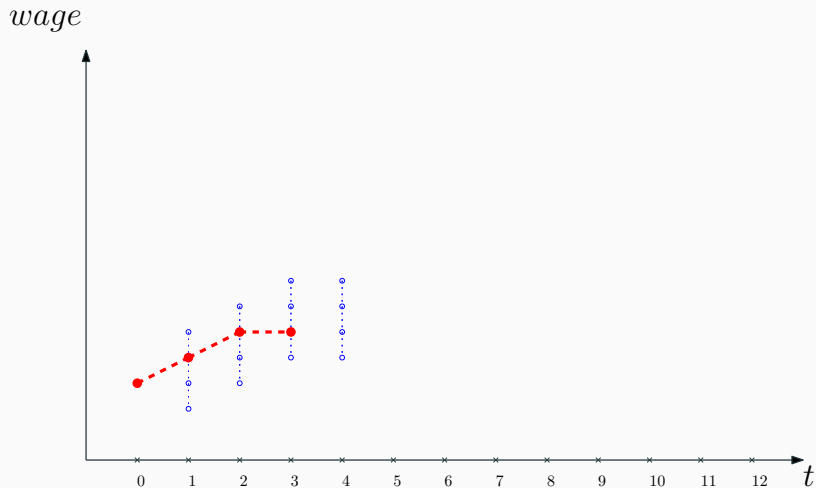


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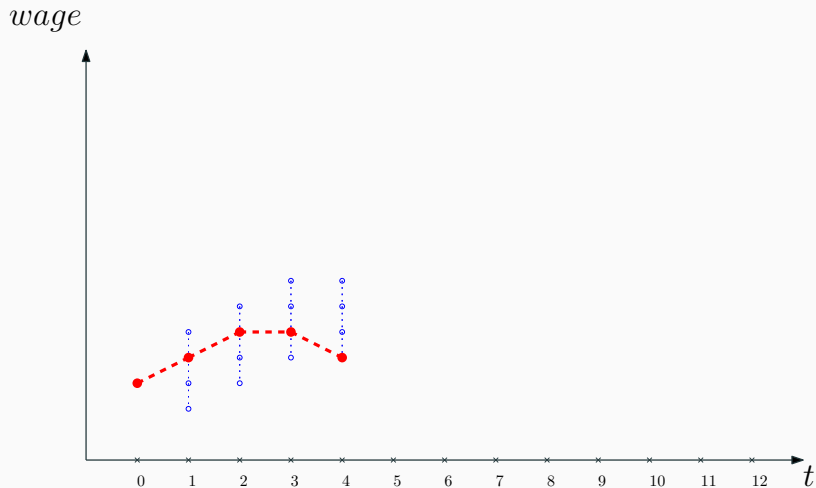




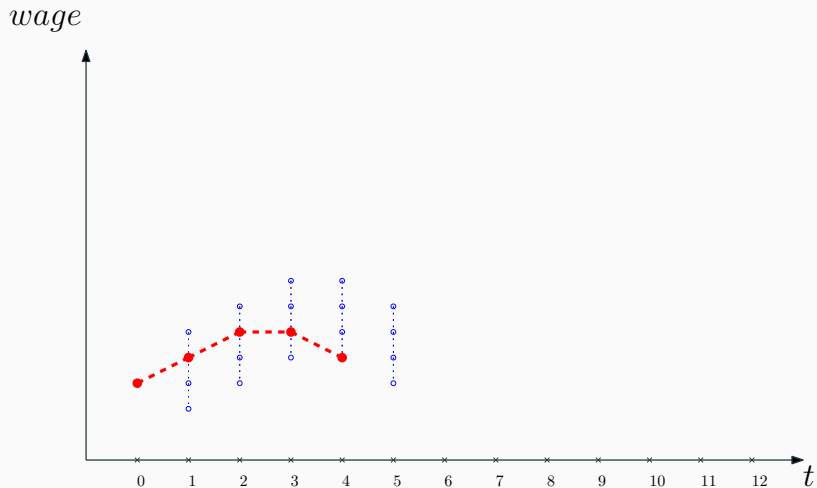
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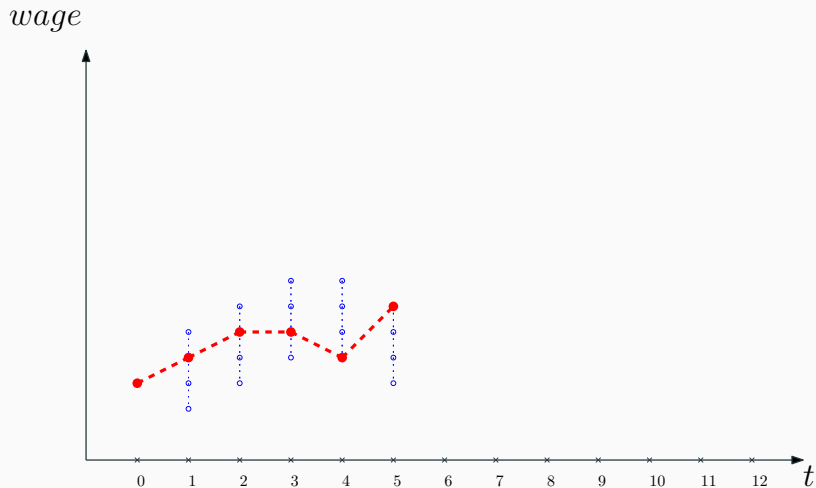
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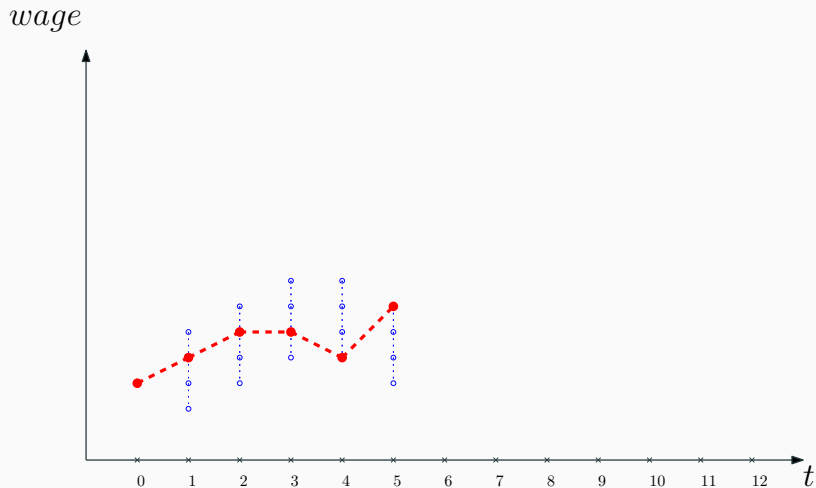
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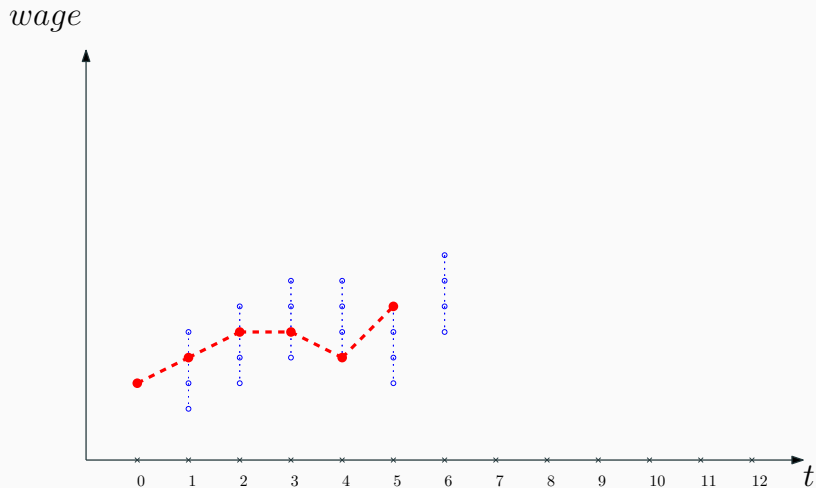
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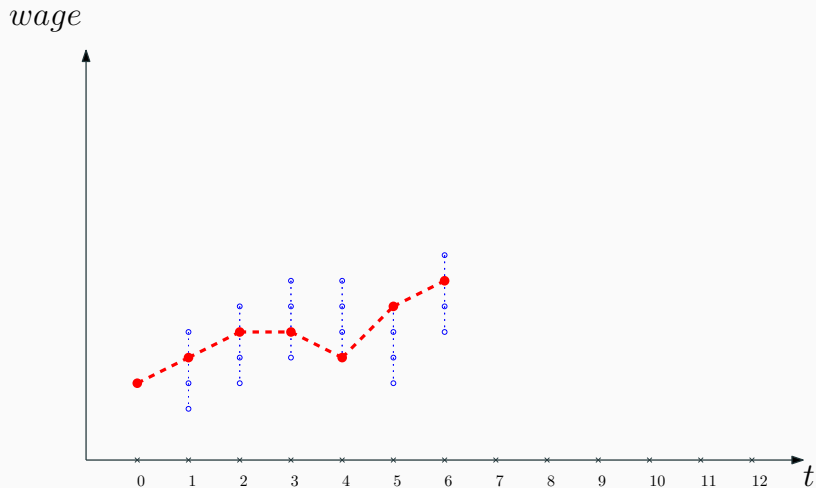
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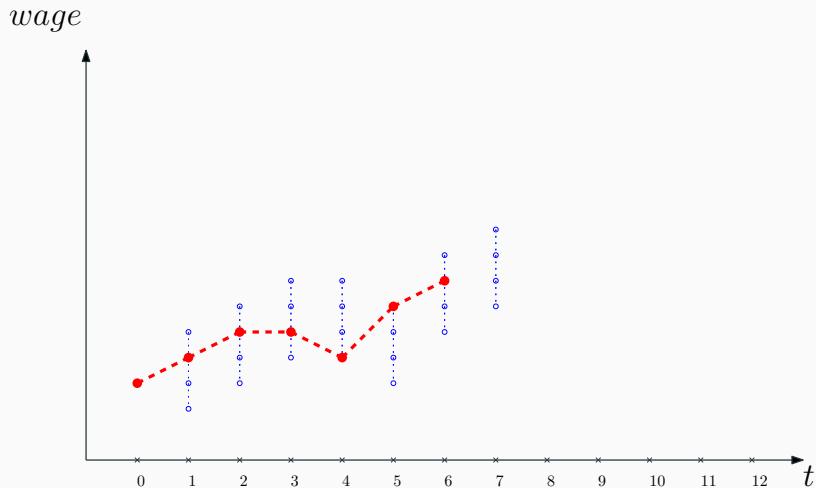
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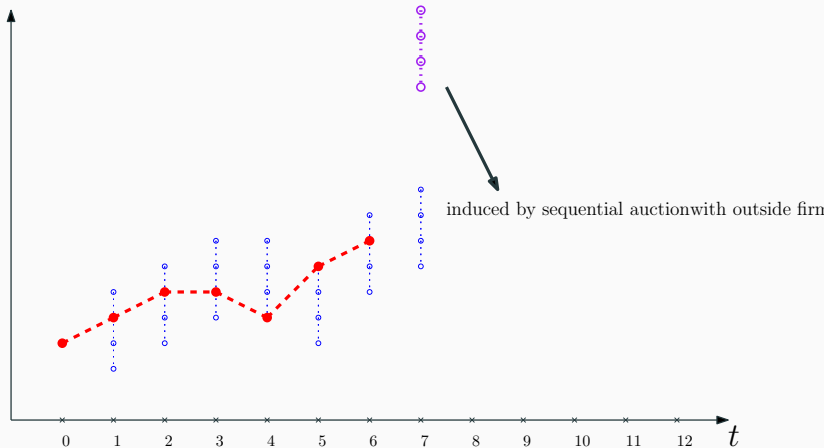
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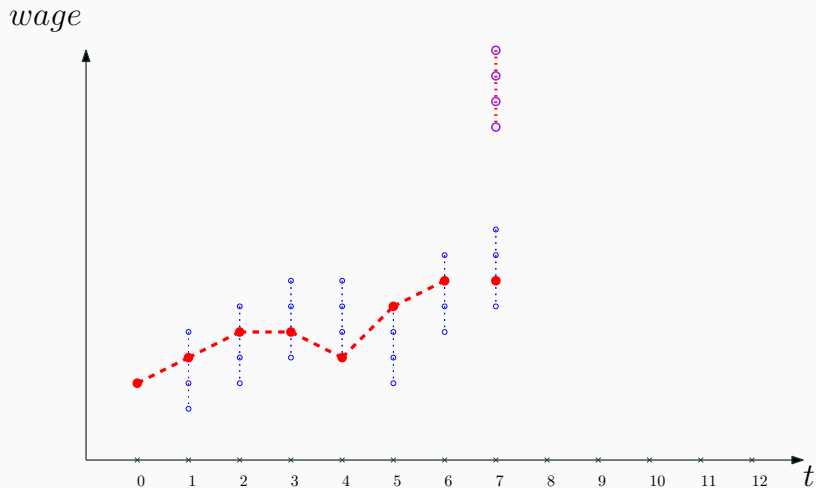


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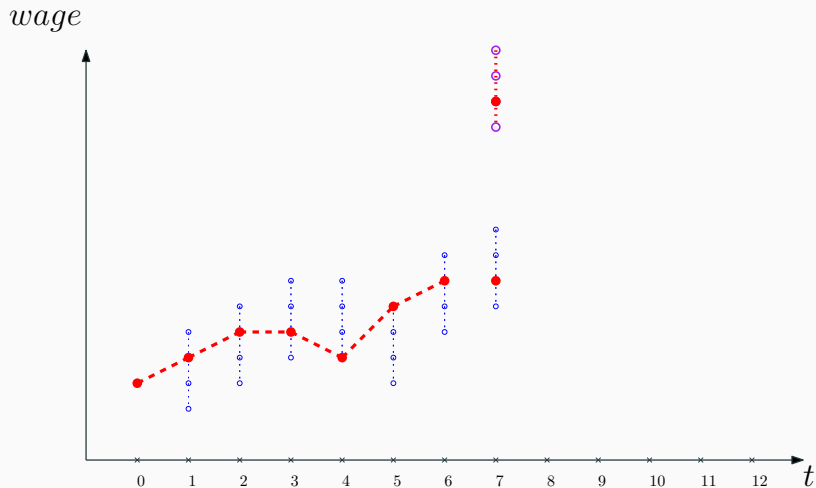
*wage*



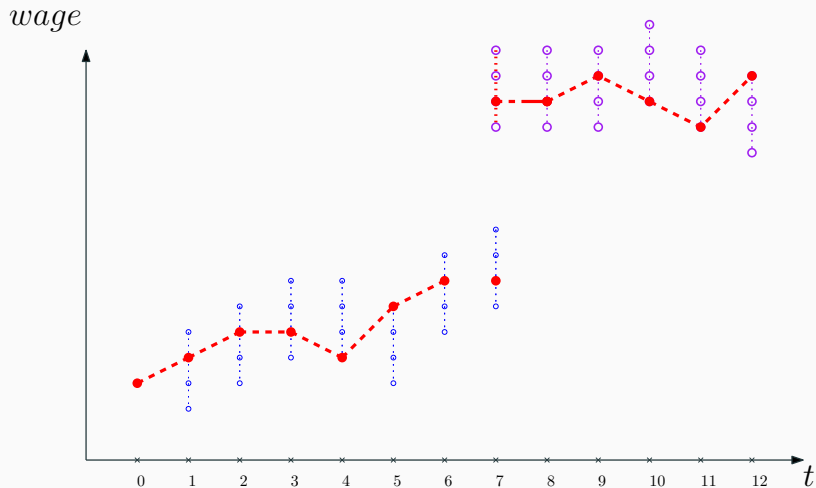
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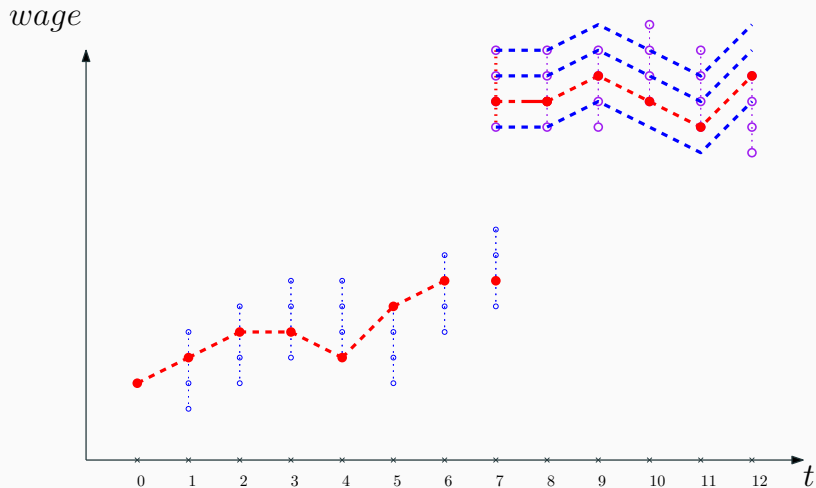
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## Size incentive premium

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## Labor market incentives

What is the incentive out of  $W(z')$ ?

$$\mathcal{I}[W(z')] \equiv \mathbb{E}_{z'} \left[ W(z') | e = 1 \right] - \mathbb{E}_{z'} \left[ W(z') | e = 0 \right].$$

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The incentive compatibility constraint is

$$\underbrace{\sum_{s' \in \mathcal{M}_1} F(s') \mathcal{I}[\overline{W}(z', s)] + \sum_{s' \in \mathcal{M}_2} \mathcal{I}[\overline{W}(z', s')] F(s')}_{\text{Labor Market Incentives}} + \underbrace{\sum_{s' \in \mathcal{M}_3} F(s') \mathcal{I}[W(z')]}_{\text{Performance-based Incentives}} \geq \tilde{c},$$

where

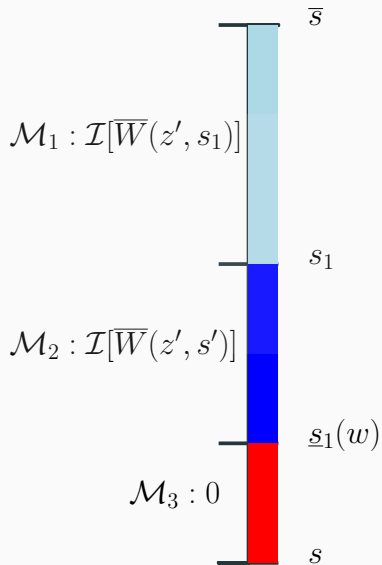
$\mathcal{M}_1 : s' \geq s$ , lead to job turnovers

$\mathcal{M}_2 : s' < s$ , improve compensation, no job turnovers

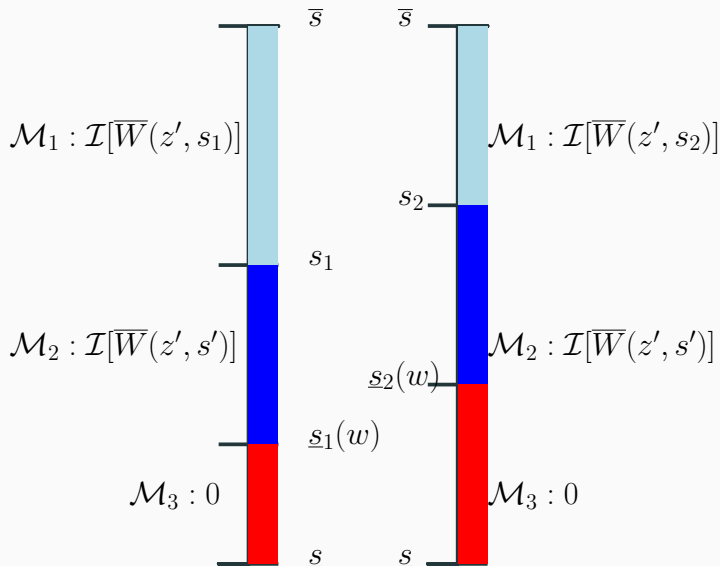
$\mathcal{M}_3$  : other or no outside firms



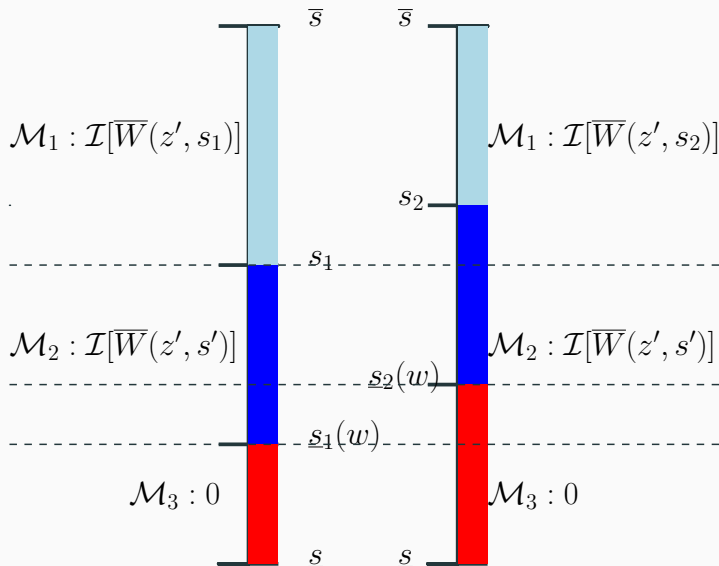
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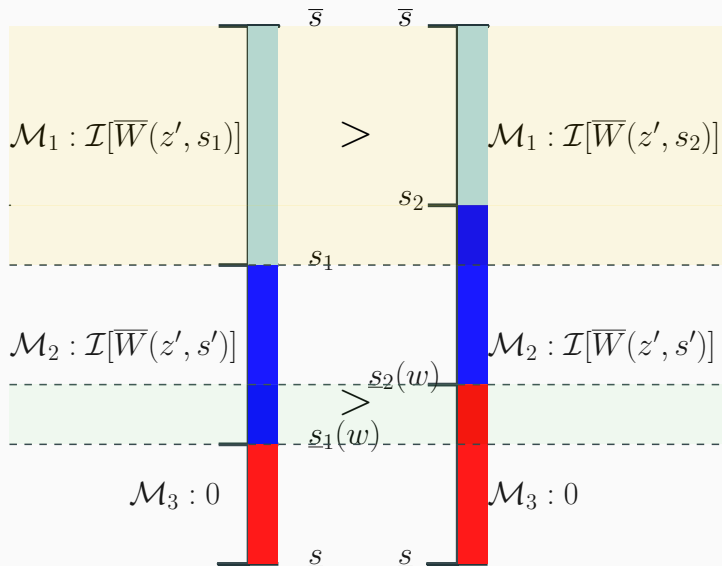
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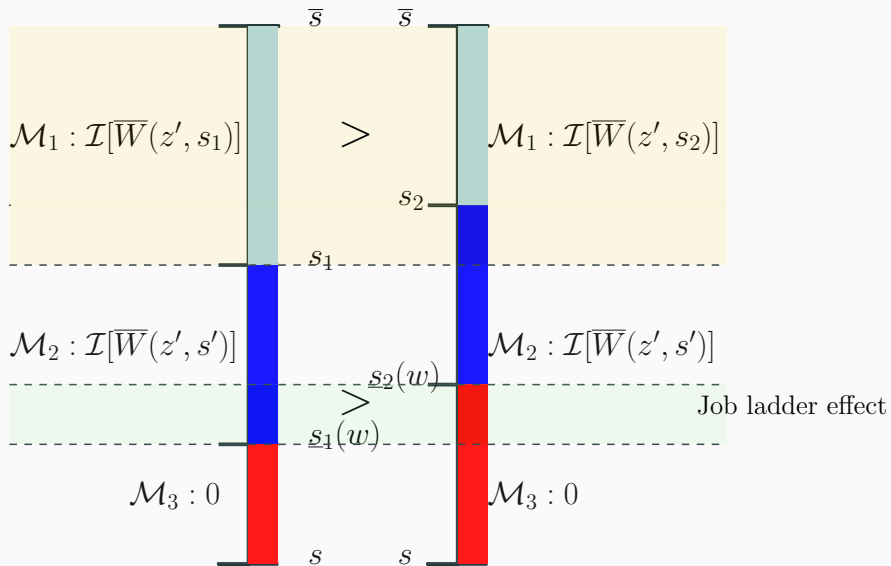
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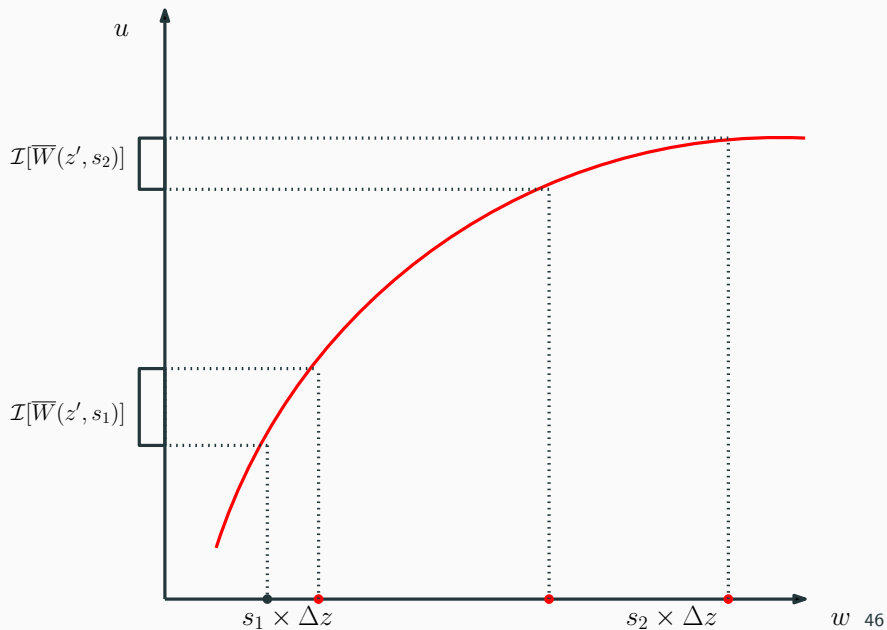
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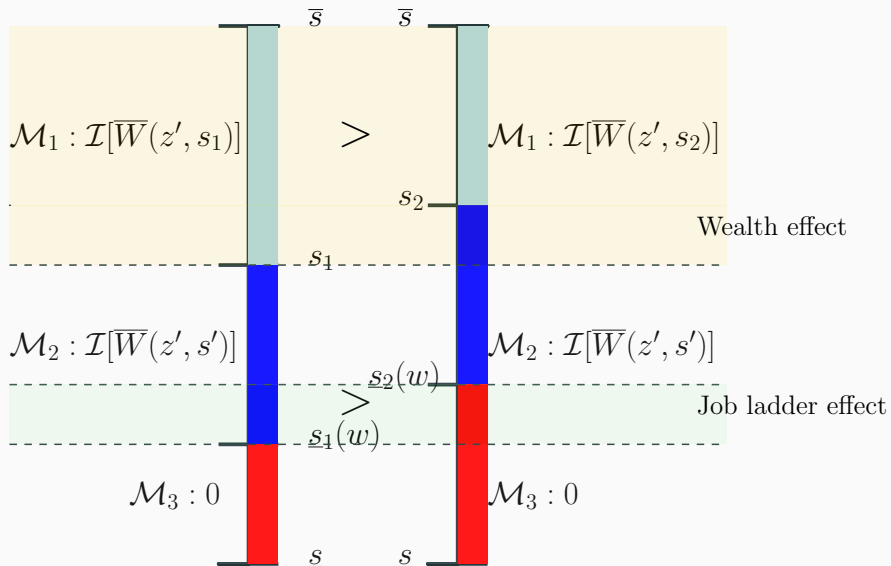
## Size incentive premium



## Incentives from $\overline{W}(z', s)$ decrease in $s$



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### Proposition

Suppose the executives' utility is of the CRRA form and the cost of effort  $c = \overline{c}(s)$ , then  $\mathcal{I}(\overline{W}(z', s))$  decreases in  $s$  if

$$\sigma > 1 + \frac{s^{1-\alpha_1}}{\alpha_1} \psi'(s), \quad (1)$$

where  $\psi(s)$  is a function of  $s$  that is positive and increasing in  $s$ .



# Summary

- Firms compete to retain/attract executives.
- Firm size matters.
- Labor market incentives decrease in firm size due to a job ladder effect and a wealth effect.

# Data and Evidence

---

## Assemble a new dataset

- ExecuComp & BoardEX + hand-collected from LinkedIn/Bloomberg
- ExecuComp: annual records on top executives' compensation
- BoardEX: detailed executive employment history
- Final sample: 35,088 executives, 218,168 executive-year obs., spanning the period 1992 to 2016.

## Define job turnovers

- Job-to-job transition: leaves the current firm, and starts to work in another firm within  $n?$  days.
- Exit: otherwise.

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## Define job turnovers

- Job-to-job transition: leaves the current firm, and starts to work in another firm within 180 days.
- Exit: otherwise.

## Reduced-form evidence

### 1. Managerial labor market is active. [Details](#)

- annual job-to-job transition rate 5%
- relatively stable over years and across industries

### 2. Executives climb job ladders towards larger firms. [Details](#)

- about 66% of job-to-job transitions are towards larger firms
- for the rest, 20% of them are promotions from non-CEO to CEO

## Reduced-form evidence

3. Executives in larger firms have less job-to-job transitions. [Details](#)
  - Cox model, 1% increase in firm size leads 8.3% lower hazard of job-to-job transitions.
4. Starting from the same level of compensation, the pay-growth is higher in larger firms. [Details](#)
  - 1% increase in firm size leads to 10% increase in pay-growth rate

5. Firm-size incentive premium is higher in industries where managerial labor market is more active. Incentive Premium

- job-to-job transition rate (industry-year level)
- general ability index (Custódio et al. 2013)
- fraction of outsider CEO (Martijn Cremers and Grinstein 2013)

# Estimation

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# Model Specifications

- utility function of **CRRA** form

$$u(w) = \frac{w^{1-\sigma}}{1-\sigma}$$

- production function of **multiplicative** form

$$y(s, z) = e^{\alpha_0} s^{\alpha_1} z$$

- productivity process by **AR(1)**, discretized by Tauchen (1989)

$$z_t = \rho_0(e) + \rho_z z_{t-1} + \epsilon_t$$

- poaching firm distribution by truncated **log-normal**  $F(s)$

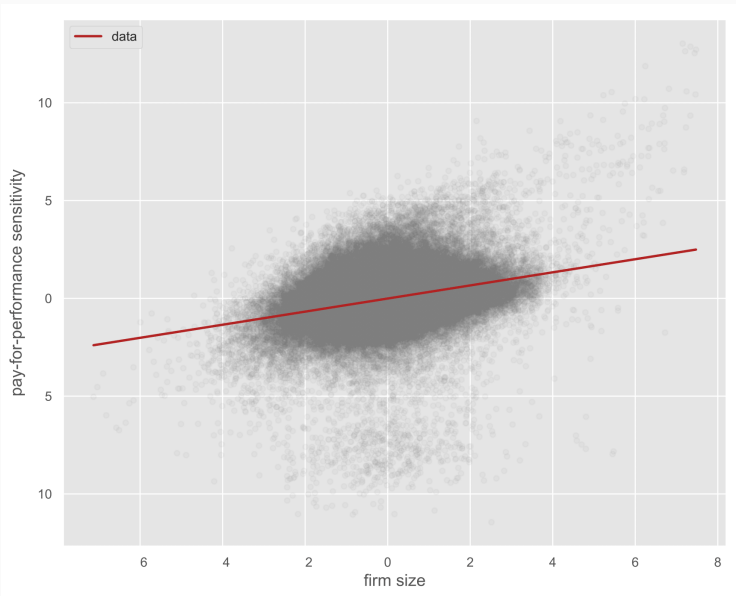
# Parameters

Parameters	Description
$\eta$	the death probability
$\lambda_1$	the offer arrival probability
-----	
$\rho_z$	the $AR(1)$ coefficient of productivity shocks
$\mu_z$	the mean of productivity shocks for $e = 1$
$\sigma_z$	the standard deviation of productivity shocks
-----	
$\mu_s$	the mean of $F(s)$
$\sigma_s$	the standard deviation of $F(s)$
-----	
$c$	cost of efforts
$\sigma$	relative risk aversion
$\alpha_0, \alpha_1$	production function parameters

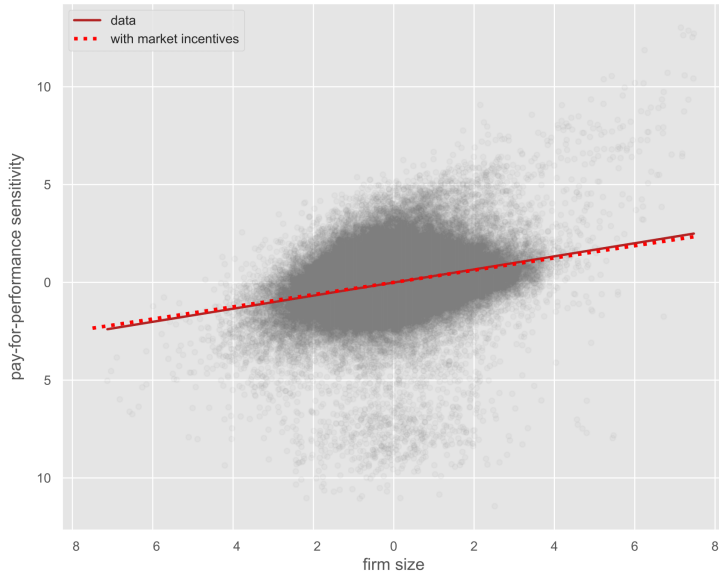
## Moments and Estimates

Moments	Data	Model	Estimates	Standard Error
Exit Rate	0.0691	0.0691	$\eta = 0.0695$	0.0127
J-J Transition Rate	0.0498	0.0473	$\lambda_1 = 0.3164$	0.0325
$\hat{\rho}_{\text{profit}}$	0.7683	0.6299	$\rho_z = 0.8004$	0.0366
<i>Mean</i> (profit)	0.1260	0.1144	$\mu_z = 0.0279$	0.0014
<i>Var</i> (profit)	0.0144	0.0160	$\sigma_z^2 = 0.1198$	0.0044
-----				
<i>Mean</i> (log(size))	7.4515	7.4806	$\mu_s = 1.2356$	0.0365
<i>Var</i> (log(size))	2.3060	2.1610	$\sigma_s = 2.5795$	0.1211
-----				
<i>Mean</i> (log(total pay))	7.2408	7.2665	$\alpha_0 = -1.5534$	0.0147
<i>Var</i> (log(total pay))	1.1846	0.8960	$\alpha_1 = 0.5270$	0.0217
$\beta_{\text{total pay} - \text{size}}$	0.3830	0.2822		
-----				
$\beta_{\text{PPS} - \text{total pay}}$	1.1063	1.1997	$\sigma = 1.1038$	0.0030
<i>Mean</i> (log(PPS))	8.4994	8.478	$c = 0.0814$	0.0259
<i>Var</i> (log(PPS))	3.4438	3.35872		

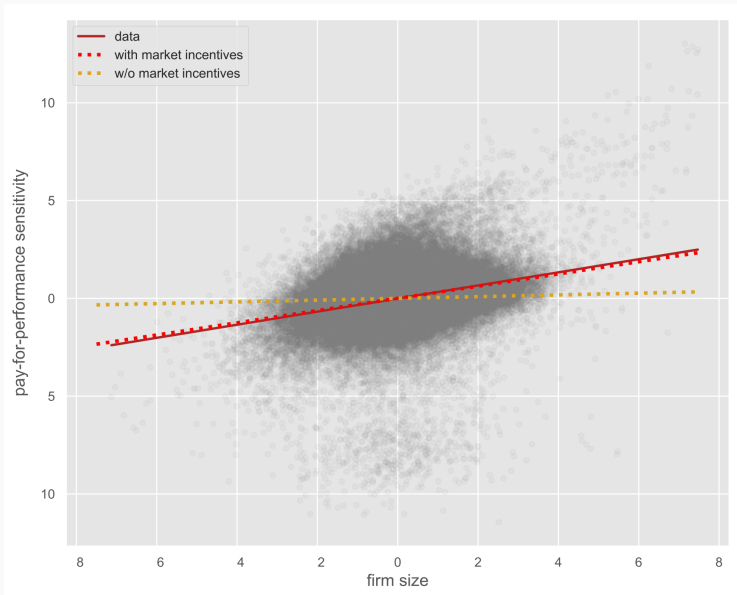
# Data



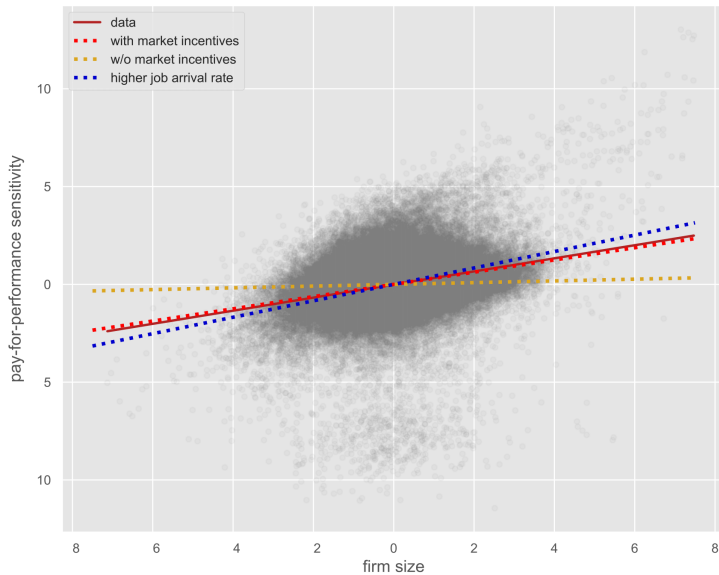
# Predictions — model



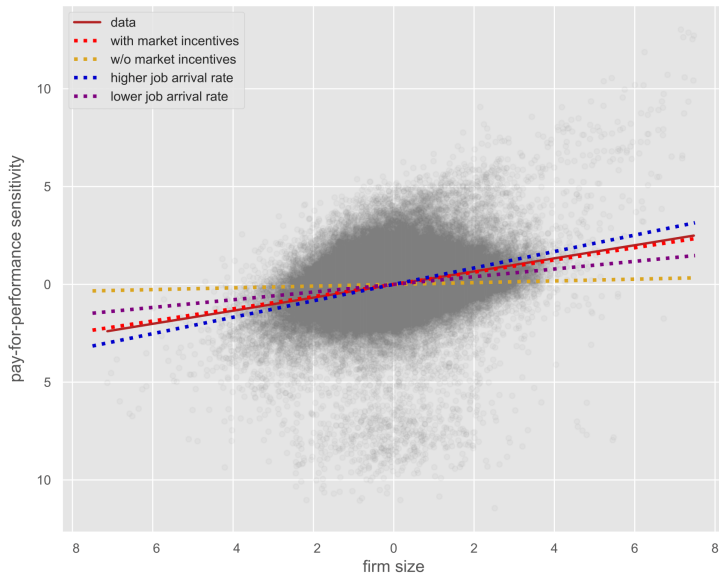
## Predictions — without labor market incentives



## Predictions — with higher job arrival rate

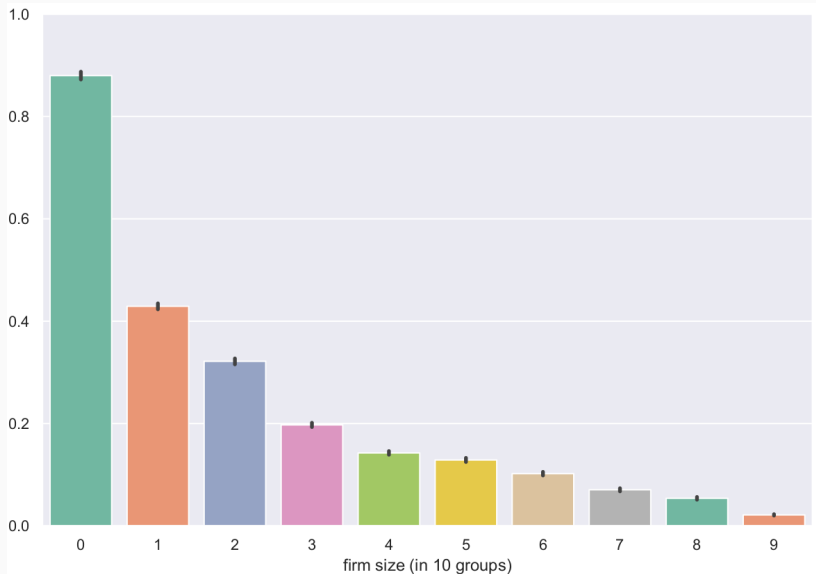


## Predictions — with lower job arrival rate





## Fraction of labor market incentives



## Long-run trends

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## Long-run trends in executive compensation

Frydman and Saks (2010) document that since the mid-1970s:

1. sharp increase in total and incentive pay.
2. more inequality among executives
3. higher correlation between compensation and firm size

## Long-run trends in executive compensation

Frydman and Saks (2010) document that since the mid-1970s:

1. sharp increase in total and incentive pay.
2. more inequality among executives
3. higher correlation between compensation and firm size

These facts can be quantitatively explained by an exogenous increase in higher job arrival rate  $\lambda_1$ .

- Huson et al. (2001), Murphy and Zabojnik (2007): An increasing number of CEO openings have been filled through external hires.
- Frydman (2005): Executive jobs have increasingly placed greater emphasis on general rather than firm-specific skills.

## Long-run trends in executive compensation

Moments (dollar value in year 2000)	Data		Model	
	1970s	1990s	$\lambda_1 = 0.05$	$\lambda_1 = 0.4$
Mean total pay (thousand)	1090	4350	985	4296
Mean size (million)	-	-	2426	5710
Mean PPS (thousand)	21.743	120.342	24.972	125.310
$\beta_{totalpay-size}$	0.199	0.264	0.175	0.240
Percentiles of total pay (thousand)				
25th percentile	640	1350	109	1217
50th percentile	930	2360	478	2957
75th percentile	1310	4430	1596	5860

## Conclusion

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## Takeaways

- Moral hazard problem is not necessarily more severe in larger firms.
- Managerial labor market competition explains firm size incentive premium.
- Small and medium firms take advantage of the labor market incentives.

**Thanks you for your attention.**

`http://bohuecon.github.io`



# Contracting Problem

Firms choose  $\{w, W(z', s')\}$  to maximize profits

$$\Pi(z, s, V) = \max_{w, W(z', s')} \sum_{z' \in \mathbb{Z}} \sum_{s' \in \mathbb{S}} \left[ y(s, z') - w + \tilde{\beta} \Pi(z', s, W(z', s')) \right] \tilde{F}(s') \Gamma(z'|z)$$

subject to

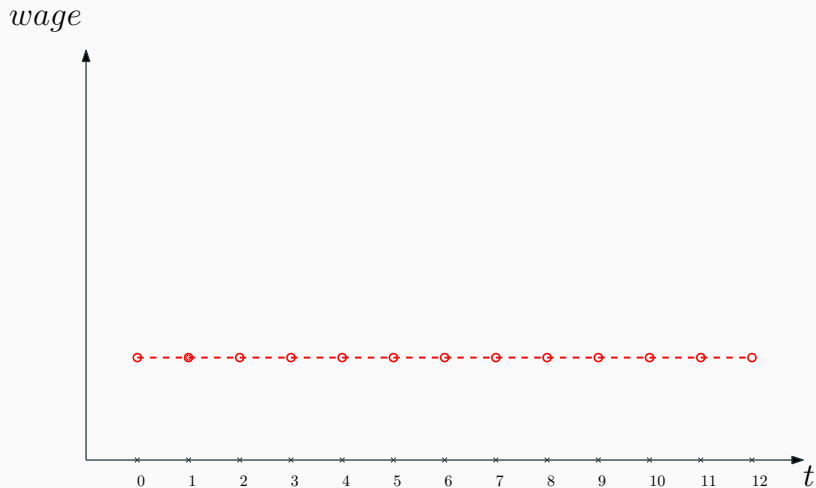
$$V = u(w) - c + \tilde{\beta} \sum_{z' \in \mathbb{Z}} \sum_{s' \in \mathbb{S}} W(z', s') \tilde{F}(s') \Gamma(z'|z), \quad (\text{PKC})$$

$$\tilde{\beta} \sum_{z' \in \mathbb{Z}} \sum_{s' \in \mathbb{S}} W(z', s') \tilde{F}(s') \left( \Gamma(z'|z) - \Gamma^s(z'|z) \right) \geq c, \quad (\text{IC})$$

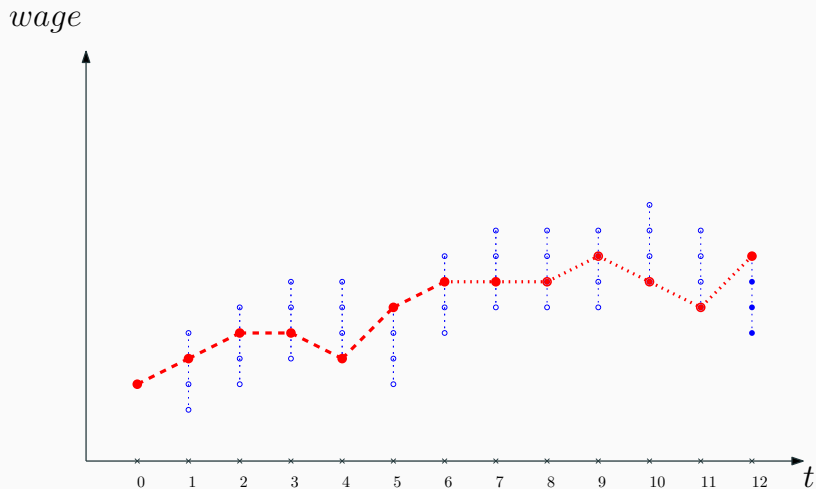
$$W(z', s') \geq \min\{\overline{W}(z', s'), \overline{W}(z', s)\}, \quad (\text{PC-Executive})$$

$$W(z', s') \leq \overline{W}(z', s). \quad (\text{PC-Firm})$$

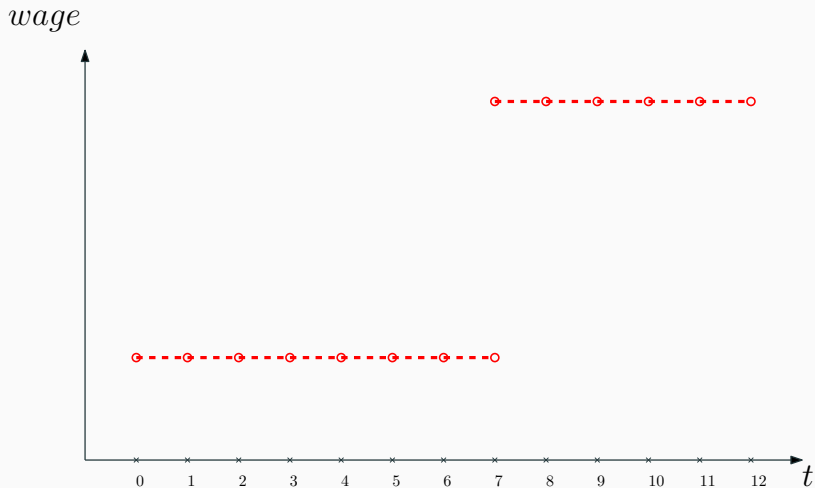
## No Moral Hazard, Full Commitment



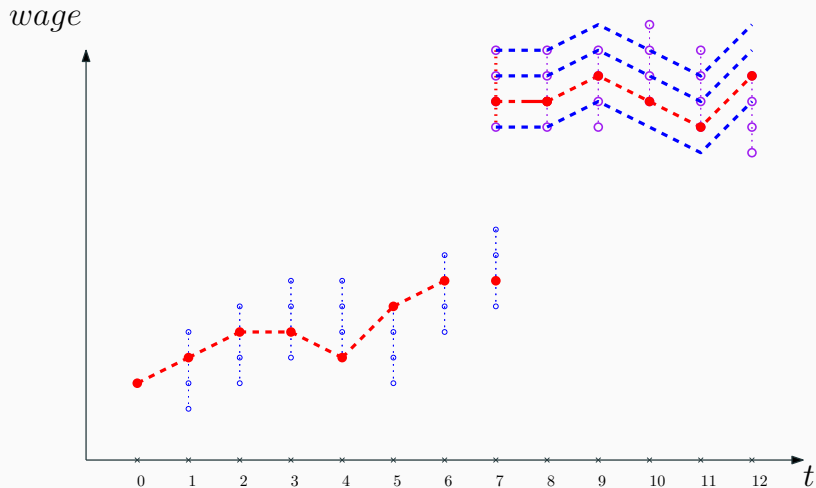
# Only Moral Hazard



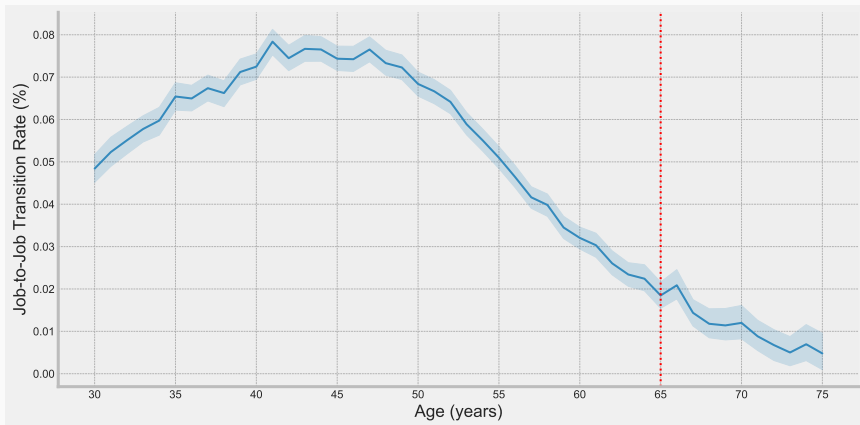
# Only Limited Commitment



# Optimal Contract

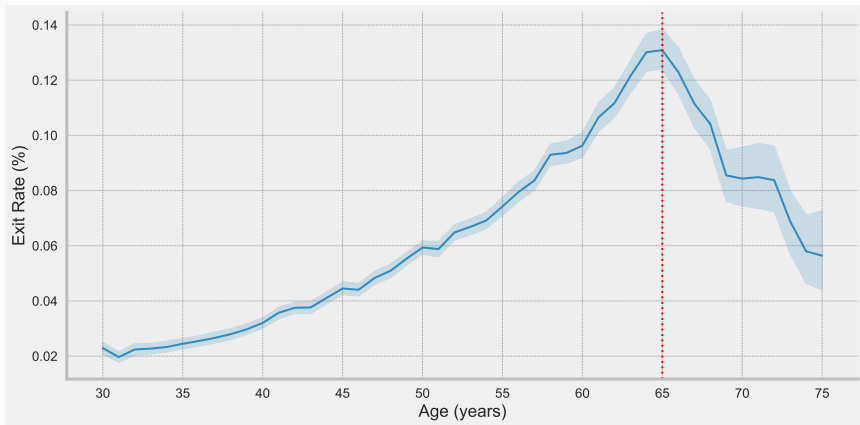


# Job-to-job transition rate over age



[Back](#)

# Exit rate over age



[Back](#)

# Climb the Job Ladder

Table 3: Change of firm size upon job-to-job transitions

<i>Panel A: All executives</i>			
Firm size proxy	Total obs.	Firm size decrease obs. (%)	Firm size increase obs. (%)
Market Cap	2567	985 (39%)	1582 (61%)
Sales	2617	1051 (40%)	1566 (60%)
Book Assets	2616	1038 (40%)	1578 (60%)
<i>Panel B: Across age groups</i>			
Age groups	Total obs.	Firm size decrease obs. (%)	Firm size increase obs. (%)
≤ 40	100	34 (34%)	66 (66%)
[40, 45)	381	135 (35%)	246 (65%)
[45, 50)	701	262 (37%)	439 (63%)
[50, 55)	766	304 (40%)	462 (60%)
[55, 60)	261	179 (43%)	82 (67%)
[60, 65)	73	52 (39%)	21 (61%)
[65, 70)	30	7 (25%)	23 (75%)
≥ 70	6	1 (16%)	5 (84%)



Table 4: Job-to-Job Transitions and Firm Size

	Job-to-Job Transition	
	(1)	(2)
log(Firm Size)	0.917**** (0.0109)	0.972* (0.0139)
Age	0.985**** (0.00273)	0.967*** (0.0112)
log(tdc1)		0.830**** (0.0150)
Market-Book Ratio	0.942**** (0.0150)	0.939**** (0.0157)
Market Value Leverage	1.033** (0.0139)	1.035** (0.0142)
Profitability	0.913**** (0.0197)	0.905**** (0.0199)
Year FE	Yes	Yes
Industry FE	Yes	Yes
N	154635	118119
chi2	496.1	491.4

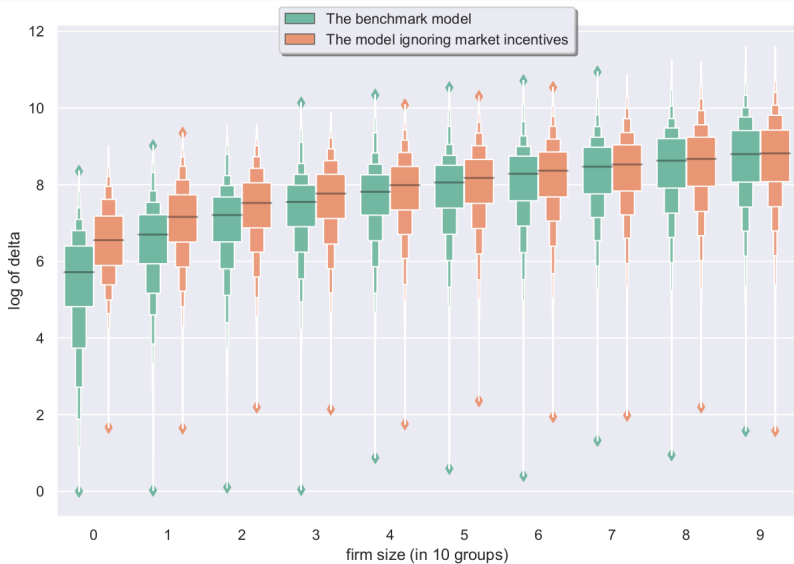
Table 1: Compensation growth increases with firm size

	$\Delta \log(tdc1)$					
	(1)	(2)	(3)	(4)	(5)	(6)
$\log(firm\ size)_{-1}$	0.112*** (0.00903)	0.154*** (0.0129)	0.108*** (0.00183)	0.107*** (0.00189)	0.141*** (0.00177)	0.127*** (0.00489)
$\log(firm\ size)_{-1}$ $\times EE90$			0.0711* (0.0403)			
$\log(firm\ size)_{-1}$ $\times EE190$				0.0759** (0.0353)		
$\log(firm\ size)_{-1}$ $\times gai$					0.0233*** (0.00546)	
$\log(firm\ size)_{-1}$ $\times inside\ CEO$						-0.000232*** (0.0000696)
$\log(tdc1)_{-1}$	-0.290*** (0.0200)	-0.390*** (0.0262)	-0.251*** (0.00173)	-0.251*** (0.00173)	-0.304*** (0.00267)	-0.253*** (0.00173)
Dummies	X	X	X	X	X	X
Other controls		X	X	X	X	X
Observations	129068	106819	106820	106820	58188	106820
adj. $R^2$	0.157	0.216	0.260	0.260	0.233	0.262

Table 2: Performance-based incentives increases with firm size

	log( $\delta$ )					
	(1)	(2)	(3)	(4)	(5)	(6)
$\log(\text{firm size})$	0.604*** (0.0141)	0.347*** (0.0247)	0.525*** (0.00512)	0.529*** (0.00499)	0.561*** (0.00310)	0.571*** (0.0139)
$\log(\text{firm size})$ $\times \text{EE90}$			0.359* (0.118)			
$\log(\text{firm size})$ $\times \text{EE190}$				0.415** (0.101)		
$\log(\text{firm size})$ $\times \text{gai}$					0.0648*** (0.00156)	
$\log(\text{firm size})$ $\times \text{inside CEO}$						-0.000458* (0.000202)
$\log(\text{tdc1})$		0.609*** (0.0350)	-0.251*** (0.00173)	-0.251*** (0.00173)	-0.304*** (0.00267)	-0.253*** (0.00173)
Dummies	X	X	X	X	X	X
Other controls		X	X	X	X	X
Observations	146747	128006	125858	125858	75747	125858
adj. $R^2$	0.442	0.514	0.521	0.521	0.531	0.521

# If labor market incentives are ignored ...



CEO's of "Small Firms" in S&P 500

tdc1: total compensation

delta: dollar-percentage incentive

	Company	Market Cap millions	tdc1 000's	delta 000's/%
	INCYTE CORP	446.408	2432.9734	60.939838
	WESTROCK CO	547.828	2800.668	130.96215
	ENVISION HEALTHCARE CORP	678.6906	1777.991	217.729
	PRICELINE GROUP INC	886.0817	1775.531	165.73476
	LKQ CORP	889.9763	2602.093	473.70974
	REGENERON PHARMACEUTICALS	897.3801	3094.134	566.14187
	SKYWORKS SOLUTIONS INC	1113.547	2638.243	128.10688
	CENTENE CORP	1130.155	4584.605	344.02299
	ALASKA AIR GROUP INC	1194.977	950.098	99.525198
	HOLOGIC INC	1276.448	2709.708	428.10996
	ACUITY BRANDS INC	1328.171	1102.528	133.42285
	ANSYS INC	1368.129	3738.803	431.01562
	GARTNER INC	1474.909	8945.338	158.65569

CEO's of "Large Firms" in S&P 500

tdc1: total compensation

delta: dollar-percentage incentives

	Company	Market Cap millions	tdc1 000's	delta 000's/%
	TIME WARNER INC	79965.89	18545.215	1212.9513
	CONOCOPHILLIPS	80163.26	35442.729	4520.5571
	UNITED PARCEL SERVICE INC	82439.55	3120.042	340.01132
	VERIZON COMMUNICATIONS INC	83233.88	19425	861.09722
	HOME DEPOT INC	86128.2	35750.103	2014.3633
	AT&T INC	94944.89	17283.529	1666.3201
	COCA-COLA CO	95494.39	12781.61	425.62199
	PEPSICO INC	97836.48	15268.415	2919.7995
	CISCO SYSTEMS INC	121238.6	16269.85	5981.3853
	CHEVRON CORP	126749.6	13125.882	1106.8351
	INTL BUSINESS MACHINES CORP	129381.2	21693.615	1298.8777
	INTEL CORP	147738.2	6101.835	1874.5755
	WAL-MART STORES INC	192048.2	16652.894	1465.7708
	EXXON MOBIL CORP	344490.6	48922.808	3843.027

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