Relative Total Share Return

Myths and Realities

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Aligning the interests of executives and shareholders is a fundamental goal for executive compensation governance. Compensation Committees have at their disposal many forms of compensation to meet this goal. None of these tools alone perfectly achieves this or the other key goals for executive compensation programs. Understanding the realities of what each form of compensation does -- or does not do-- becomes critical to drafting the combination of plans that will best align executive and shareholder interests.

Too often decisions are made for reasons other than sound analytical evaluations. What peers do or how IISS/Glass Lewis do things takes a lead rather than an secondary role in determining the plan design. At Aon Hewitt, we believe concepts that sound logical “at 30,000 feet” need to be examined to ensure they are effective “on the ground.”

This paper addresses the myths and reveals the realities of Relative Total Shareholder Return (RTSR) -- one incentive form that is getting substantial attention in part because it is the only measure of performance used by ISS and Glass Lewis in their pay-for-performance evaluations.

We are not suggesting that RSTR is either good or bad, only that it is not a panacea for rewarding executive performance. Understanding the seven myths and realities of RTSR compensation plans will help both senior managers charged with developing executive compensation plans and Compensation Committees members charged with evaluating the merits of those plans determine whether Relative Total Shareholder Return is, (1) the replacement for stock options, (2) a valued component of a total executive compensation approach, or (3) just not the right fit for your company.

The Myths and Realities of Relative Shareholder Return

The following realities are what determine the role, if any of an RTSR plan for your company.

1. **Myth**—RTSR plans provide incentive to beat the competition.

   **Reality**—RTSR plans are not incentive plans, they are reward plans. To be an incentive plan, the executive must have line-of-sight to the performance goal. The executive’s line-of-sight is weaker to TSR than financial or operational performance measures. There is virtually no line-of-sight to Relative TSR since the executive does not know what actions to take to create shareholder value at a rate that will beat the competition over the next few years. Relative TSR changes through the performance period and is not finalized until the last day of the measurement period. Reward plans are not “bad”, they can help ensure that executive pay is aligned with performance. Stock options are reward plans. It is just that they are limited in directing and motivating executives.

2. **Myth**—TSR is the best measure of executive performance.

   **Reality**—TSR, over the long term (infinity and beyond), measures executive performance well. It works less well in short and mid-term time horizons because it is a point-to-point measure. Being a point-to-point measure means:
- The starting point matters; companies with poor performance (and relatively low share price) have potential advantage over companies going into the period with stronger performance.
- The ending point matters; the market's future expectations for a company can have a larger role than its current performance.
- The middle of the performance period doesn't matter; great performance (including high share prices) throughout the middle of the period has no impact on the TSR calculation.

TSR could end up the same for two companies with very different average share prices over the period. We question whether that leads to the “best” way to measure executive performance.

3. **Myth**—Measuring TSR on a relative basis levels the playing field by removing overall market movements and industry economics from the evaluation of executive performance.

**Reality**—Peer group matters. This myth can be reality only when the peer group is both valid and reliable. Validity means that the peers are in the same businesses or at least are impacted by similar economic conditions. Reliability means that the set of peer companies is large enough to provide a consistent comparison over time. A group that is too small (< 20) can lead to some odd results. The common fallback to a large enough group of reliable peers is to “go big” such as the S&P 500, Russell 3000, or the ISS selected Global Industries Classification System (GICS) list. Using a very large peer group eliminates any hint of incentive (line-of-sight) and causes the compensation plan becomes more of a lottery than an executive reward plan.

4. **Myth**—It is hard in an uncertain economy to set multiyear, forward-looking financial goals so companies should default to RTSR which requires no goal setting.

**Reality**—While no one has an accurate crystal ball, the executive team needs to run the business for the long term. The vast majority of companies develop business plans with absolute long-term financial goals. The Board and shareholders have long-term expectations. There are a number of techniques that can help establish long-term financial goals that will, from a pay perspective, stand up to all but severe changes in economic conditions. Having absolute financial goals brings incentive into the compensation structure by providing direct line-of-sight.

5. **Myth**—RTSR compensation plans are better than stock options.

**Reality**—RTSR plans are more effective when coupled with stock options than when used to completely replace them. Like RTSR plans, the realized value of stock options is also highly dependent on starting and ending points. However, they reward for the absolute gains that shareholders receive and punish drops in share price. While this will mean that at times executives win or lose with broad market movement more than the company’s performance, so do shareholders. With RTSR plans, there may be payments to executives when shareholders lose money. Balance between paying for absolute and relative performance best aligns long-term executive and shareholder interests.

6. **Myth**—All percentiles are created equally.

**Reality**—We believe that a company’s performance more than the executive compensation plan’s design should determine executive compensation payouts. Most RTSR plans pay based on the percentile achievement amount the selected peers. However, the absolute TSR change tends to be far greater in the tails (<35th, >65th) than in the middle. Therefore, each 10 percentile increase in performance should not lead to a common increase in the award earned—as is the case with many
RTSR plans. The pay-for-performance formula should take into account the historical distribution of TSR for your peers to better align the executive’s payouts to the level of TSR.

7. **Myth**—The accounting expense will be no more than the value of the share at grant, and may be less reflecting the uncertainty of achieving the performance hurdles.

**Reality**—Due to the workings of the Monte Carlo model (the most common approach to valuing RTSR plans) a company can expect to expense more than 100% of the grant date value unless certain design parameters are adjusted to lower the per share value. Without planning for these design adjustments an RTSR performance based share would likely have a higher accounting expense than a time based restricted share. Given that the accounting expense for RTSR plans is fixed at grant regardless of the ultimate performance (similar to stock options) the accounting expense is an important consideration.

For those that want more of what is behind the RTSR myths and realities, the Addendum illustrates the issues in greater detail to provide additional clarity.

**Five Rules for RTSR Plans**

RTSR plans do reward executives for outperforming some peer group, have become an important measurement of performance by shareholder advisors (such as ISS) and when designed well add the dimension of relative performance to the measurement of executive performance. However, we hope the issues we have raised will lead to an examination of existing plans and careful consideration before implementing a new one. We are recommending five simple rules.

**Rule One**—Never use an RTSR plan as the sole long-term incentive element. Relative assessment of performance based on a point to point measure that is subject to vagaries at either end does not provide a sufficient evaluation of executive performance does not provide an incentive and has little retention value.

**Rule Two**—Invest the time to select the right set of peer companies. If there is not a set that provides a good balance of validity and reliability seriously consider whether or not an RTSR plan is better choice than other long-term compensation alternatives.

**Rule Three**—Make sure that there is incentive in the total compensation structure. Absolute goals provide more incentive than relative goals and financial metrics provide greater line of sight than TSR.

**Rule Four**—Calibrate the RTSR plan. Both the pay to performance formula and the accounting expense can be vastly better with some analysis. This is one area where benchmarking the features of other company’s RTSR plans may not be useful.

**Rule Five**—Get below 30,000 feet. Executive compensation plans provide a unique challenge because while they need to be theoretically pure, the devil is usually in the details.

Follow these rules and you can be assured of determining the best role for RTSR plans within your company’s total executive compensation program.
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