Relative Total Share Return

Myths and Realities — The Detail

June 2012

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Relative Total Shareholder Return: Myths and Realities The Detail

The main article identified seven myths and realities of Relative TSR. This supplement provides additional explanation of the realities.

In summary, the seven myths are:

1. RTSR plans provide **incentive** to beat the competition.
2. TSR is a good measure of executive performance.
3. Measuring TSR on a relative basis levels the playing field by removing overall market movements and industry economics from the evaluation of executive performance.
4. It is too hard to set valid multiyear financial goals.
5. RTSR plans are better than stock options.
6. All percentiles are created equally.
7. 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.

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

   Reality—To be an incentive, executives should have line-of-sight between the performance required and the potential dollars to be earned. Given current levels of volatility in the stock market, it is often difficult to relate financial performance achieved to their own company's TSR. By setting a goal of how your company's TSR relates to other companies, there is even less line-of-sight, and therefore, no incentive.

   RTSR plans provide **rewards** closely linked to shareholder value. While not an incentive from an executive's perspective, from a shareholder's perspective, RTSR rewards performance directly related to their returns while filtering out short- and mid-term movements in the stock market. It also rewards executives at those companies at the top of the sector.

   When coupled with stock options (which reward absolute share price increases), or replacing restricted stock (which addresses retention for more than pay for performance), RTSR plans enhance the link between executive compensation earned and the shareholder experience.

   LTI plans that measure financial performance do provide the line-of-sight necessary to meet the incentive test. Further, stock options and restricted stock also link executives and shareholders whether RTSR plans are used or not. Incentives should be determined based on the total reward strategy.

2. **Myth**—TSR is a good measure of executive performance.

   Reality—It is hard to argue against TSR over long periods of time as being important. It directly measures share price change plus dividends. ISS and others use one- and three-year TSR as evaluation criteria for Say-on-Pay voting. However, as a performance measure in a compensation program, TSR is not without flaws. The principle flaw when measuring distinct three-year periods is that it is a point-to-point measure. By point-to-point, we mean:

   - 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 for the evaluation of executive performance.

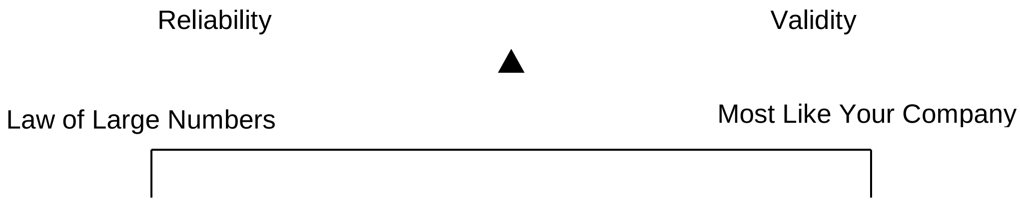
   Reality—Peer group matters. Therefore, the leveling of the playing field can only be reality when there is a proper set of peer companies. Peer group selection is a critical factor in assuring that RTSR incentive plans link executive rewards to relative returns as expected. Small peer groups (< 20) may include a company's most direct competitors—which is great. However, over a three-year time frame, two things can happen that lead to an unintended pay result:

   - Companies in the peer set may not exist by the end of the performance period due to merger, acquisition, or bankruptcy; and
   - A small number of companies may have unusually high or low TSR over the measurement period potentially biasing the percentile results.

   In either case, when the sample size starts small, it only takes a few companies to dramatically alter the pay results. Three companies are 20% of a 15-company peer group and 25% of a 12-company group. Given that RTSR pay-to-performance scales are typically based on percentiles, this could materially change the payouts in unintended ways.

   Large peer groups (> 60—i.e., S&P 500, Russell 3000) can be used to reflect how the company performs on TSR relative to the broad market. This is an example of "just because you can do something does not mean you should." It is our experience that executives perceive this type of plan more like the lottery than an incentive or even a reward program. Too often, in large peer groups, an industry sector may fall in or out of favor having more to do with future expectations than current performance.

   The best peer groups balance two considerations—validity and reliability. Validity refers to how much the peers resemble the company. Validity includes, but is not necessarily limited to, direct competitors. Valid peers are ones whose volatility correlates with the companies and have some face *validity (i.e., costs rely on using similar raw materials or products are sold to similar customers). The balance to validity is reliability. Reliability refers to having statistically reliable results over the measurement period that are not impacted by the performance or elimination of a few peer companies.*



*Validity leads to smaller groups of similar companies while reliability leads to larger groups of similar **enough** companies. Our experience is that peer groups which balance validity and reliability tend to include approximately 20–60 companies. When possible, we recommend using subsets of established indices such as the Russell 3000 that addressed specific industries. This avoids the potential criticism of "cherry-picking" companies.*

4. **Myth**—Companies should use RTSR as a measure because in today's uncertain economic environment it is too difficult to set multiple-year financial goals.

   Reality—There is value in using financial metrics in long-term performance plans as evidenced by the face that only 34% of long-term performance plans use Relative TSR[1]. Using financial metrics provides the line-of-sight, and therefore, the incentive that RTSR does not. An executive team can plan for and execute against long-term financial goals.

   Setting multiple-year financial goals can be challenging but is done regularly. Companies create long-term strategic plans and communicate goals to investors. Investors have expectations for financial performance by sector/industry/company that need to be met or exceeded for share price to increase.

   Several inputs can be brought to the goal-setting process to make the goals valid for incentive purposes such as:

   - Historical performance of the company and its competitors;
   - Analyst expectations; and
   - The company's strategic plans.

   In addition, the incentive design can be refined to address the greater levels of uncertainty. ***Note:** we will address metric selection, goal setting, and plan design in future performance standard articles.*

[1] Source: Aon Hewitt's "Executive Compensation Policies and Programs" September 2011.

One important factor in determining whether or not to use RTSR and/or financial measures is performance cyclicality or volatility[2]*. Certain industry/company characteristics lead to performance cyclicality/volatility. Examples include:*

- *Commodities are a material portion of raw materials input and/or product output;*
- *Natural cycles linked to industry capacity;*
- *Business in early stages of development; and*
- *Subject to rapid changes in demand (i.e., fashion or technology).*

The level of performance cyclicality or volatility can influence whether RTSR incentives may be used relative to incentives based on financial metrics.

- *High performance volatility—RTSR may be the sole measure of performance for LTI.*
- *Moderate performance volatility—RTSR, if used, combines with financial metrics either as a portion of the incentive or as a modifier of the financial metrics-based incentive.*

Low performance volatility—Financial metrics may be the sole measure(s) of performance for LTI.

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

Reality—RTSR plans are more effective when coupled with stock options. 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 equal.

Reality—Percentiles are numerical and so companies often set linear pay-performance relationships either through the entire payout curve or at least from Threshold to Target and Target to Superior performance. An example of a linear pay-performance relationship is:

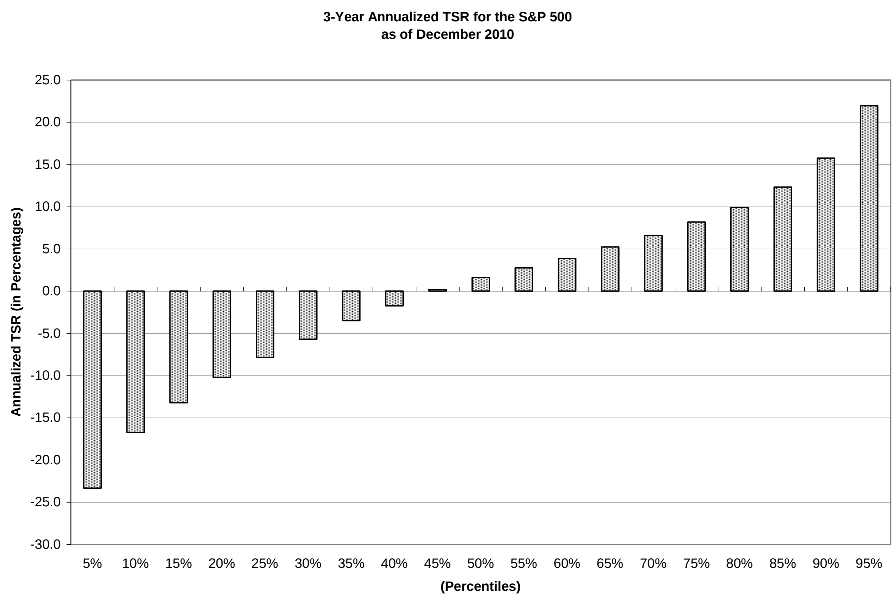
	Performance: Peer Percentile	**Actual Award: As a % of Target**
Below Threshold	< 35th	0
Threshold	35th	50%
Target	50th	100%
Superior	65th	150%
Maximum	80th	200%

[2] Cyclicality refers to ups and downs over a period of years. Volatility refers to fast changing market conditions.

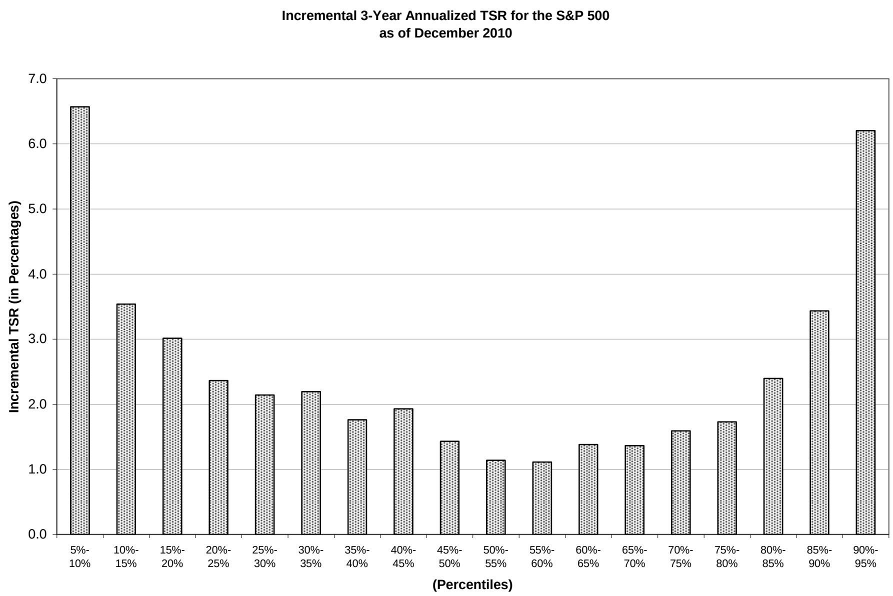
In this example, for each incremental 15 percentile improvement, there is a 50% (of target) incremental award.

However, each incremental percentile does not provide the same change in TSR. It is the change in TSR that provides incremental value to shareholders. The actual TSR associated with the median performance of any peer group changes from cycle to cycle as does the incremental TSR associated with any 5 or 10 percentile movement. Based on work with a number of different industry peer groups over long-time horizons, we have observed that the greater distance from median, the greater the incremental TSR for the same percentile change.

To illustrate this point, we reviewed TSR for the S&P 500 for the three-year period of 2008–2010. The first chart illustrates the actual TSR for every 5 percentile. As expected with such a large and diverse group (high on reliability, low on validity), there is a wide range of TSR.



The second chart illustrates incremental TSR for each 5 percentile change. The smallest changes in actual TSR occur near the median and grow as you move away from median in either direction.



The practical application of this is that RTSR pay-performance relationships should be curves rather than straight lines. While any one three-year cycle may not be fully representative, it is fairly easy to calculate three-year TSRs over the past 5–10 years for your selected peer group. This quantitative analysis will help establish a pay-performance relationship that better reflects the real incremental value to shareholders.

7. **Myth**—The accounting expense for a RTSR performance share will be less than (or at least mo more than) the face value of the share at grant since there is a discount for the performance contingency.

   Reality—We acknowledge that most executives **perceive** a value lower than face value. However, the accounting cost for RTSR plans is more often greater than face value. A Monte Carlo simulation is most commonly used to value RTSR plans. A Monte Carlo estimates thousands of potential share prices for a company and the peers. These simulations lead to a value which can be 120%–150% of face value. Explaining the details of a Monte Carlo simulation and how specific plan design features impact accounting expense can be an article by itself. (In fact, it takes three articles, Valuation 101–103 which can be found at www.relativetsr.com.)

   Suffice it to say that the accounting expense should be estimated during the design process so that it can be determined if the plan should be modified to reduce the expense. Be aware that different design changes have a different impact on the perceived value of the plan by executives.

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Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. We advise, design and execute a wide range of solutions that enable clients to cultivate talent to drive organizational and personal performance and growth, navigate retirement risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability and wellness. Aon Hewitt is the global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. For more information on Aon Hewitt, please visit www.aonhewitt.com.