5 | 2012
workspan
The Magazine of WorldatWork©

The Problem With Relative Total SHAREHOLDER RETURNS

By Todd Sirras
and Barry Sullivan,
Semler Brossy
Consulting Group

Seductive theory aside, relative TSR in practice can be challenging.

The theory behind relative shareholder return as an incentive metric is sound: Executives earn rewards only when shareholders experience above-market returns. It's hard to argue with this, and many companies have adopted relative shareholder returns. Roughly half of the S&P 500 measure relative performance in their long-term incentive programs, and a majority of these companies measure relative total shareholder return (TSR). Most commonly, relative TSR is used as the basis for performance share programs, where awards rise or fall from target based on relative shareholder returns over set time periods, typically rolling three-year cycles. Outperform the benchmark and earn above-target rewards; underperform and earn less or none. A host of design questions arise when designing these programs:

- What portion of the total long-term incentive opportunity will be contingent with performance?
- Will relative TSR be used alone or in combination with financial or strategic metrics?
- Against whom do we compare shareholder returns — a tailored set of peer companies or some broader market index (e.g., S&P 500)?
- How will pay calibrate with performance? What is target performance? Any payout for performance below market median? What if TSR is negative, but still strong relatively?

Each of these questions and many more will require careful consideration, and the best answers and ultimate program design should reflect each company's unique context. However, there are two fundamental, but little discussed, issues with all relative total shareholder return metrics that will need to be taken into consideration before you can address these more detailed design concerns:

1 | Financial performance and shareholder returns can become disconnected in finite periods of time.

2 | Consistent outperformance on shareholder returns is difficult to achieve.

The impact of these issues becomes particularly acute where relative TSR is used as a sole metric, which is why the authors often advocate that relative TSR, where used as an incentive metric, should be used in combination with other performance metrics to help balance performance and pay outcomes over time. And, this point can be extended beyond relative TSR — any performance metric in isolation can carry unintended consequences.

The remainder of this article looks at these two issues in turn and discusses the implications for compensation design.

ISSUE 1 | Financial Performance and Shareholder Returns Can Become Disconnected

Over long periods of time, strong financial performance is highly correlated with strong shareholder returns. Companies that consistently grow their top line and generate positive returns on their invested capital over time are able to create sustainable shareholder value. Figure 1 maps the companies in the S&P 500 for the 10 years ending 2010. The relationship between strong financial performance and strong TSR is clear — those companies in the top-third on revenue growth and return on investment generate the highest TSR (16 percent on average).

However, disconnects can arise over shorter periods of time. In any finite period, strong financial performance does not translate to strong shareholder returns — in some cases due to exogenous factors, and in others due to increasing investor expectations. These disconnects can become compounded when measuring relative market performance, because the factors and variables for one company extend to all companies within the comparator set.

Figure 2 on page 50 shows the relationship between financial performance and TSR over shorter time periods, again referencing the S&P 500 companies. The authors' company tested the eight rolling three-year periods from 2001 through 2010, beginning with 2001 through 2003, continuing to 2002 through 2004, 2003 through 2005 and so on, and ending with 2008 through 2010. In roughly 50 percent of cases, financial performance — again measured using growth and returns — and TSR are generally well aligned: relative rankings on each are within ± 20 percentile points of each other.

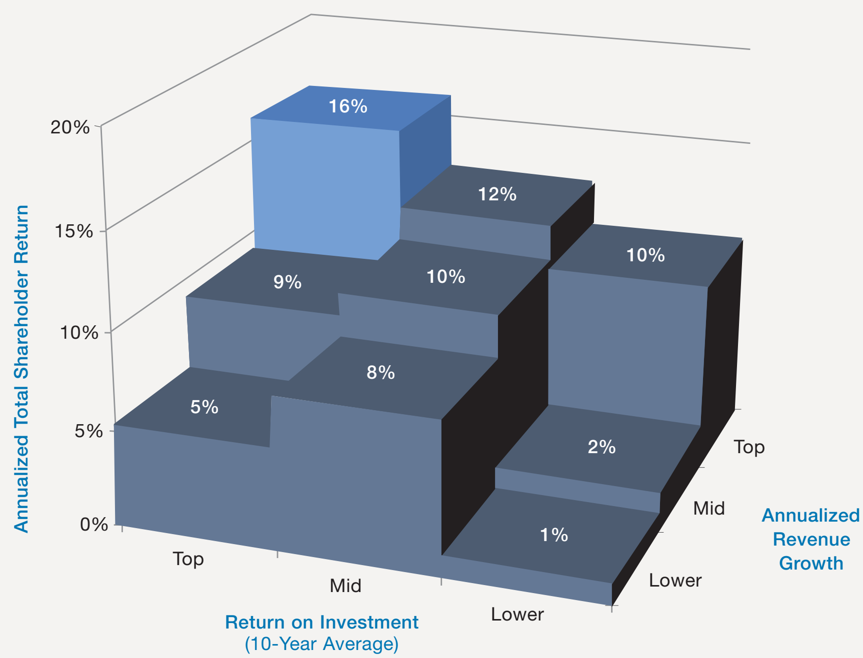
For the other 50 percent, relative financial and TSR performance are not very well aligned (i.e., differences between the two are more than ± 20 percentile points). Said another way, over these three-year periods, outperformance or underperformance on relative TSR is not driven by relative financial performance five times out of 10. Furthermore, in 20 percent of cases — the far right and left tails of the distribution in Figure 2 — relative financial performance is very poorly aligned with relative TSR (i.e., the differences between the two are more than ± 40 percentile points).

A three-year cycle is the most common measurement period used in long-term incentive plans. It is clear then that relative TSR-based incentives can become divorced during the measurement period from the core financial and operational performance that executives manage directly. For this reason, relative TSR-based incentives are often perceived as something outside of the executive team's control — "manna from heaven" when they actually do pay off — rather than a reward earned for specific achievements. In good years from a TSR standpoint, management can be rewarded even if the underlying financial performance or strategic achievements are not as strong, and similarly management can receive little or no reward if stock prices are down sharply — or even just down relative to their peers — despite above average financial performance.

As a result, relative TSR is usually less about driving specific behaviors and more about an after-the-fact affirmation of an incentive outcome. It's a simple thing for the board of directors to assess relative shareholder

Figure 1 | S&P 500 Less Financial Services

Ten-year period ending December 2010



Source: Semler Brossy Consulting Group Analysis. Financial services is excluded here, since the key financial drivers in that industry are generally different from other industries.

returns at the end of a performance period, and thereby qualify an above- or below-target payout, both internally to executives and externally to shareholders.

ISSUE 2 | Consistent Outperformance on Shareholder Returns is Difficult

On any given day, a company's share price is a not-so-simple distillation of available facts and predictions regarding the company's future performance, all wrapped into a single figure and then discounted to today's dollars. Executives and investors alike know that strong performance does not necessarily translate to higher share prices and shareholder returns. Rather, increases in share price and shareholder returns are often more dependent on beating investor expectations — company performance must outpace current expectations since these expectations are already built in at today's price.

Therefore, to deliver superior returns on a relative basis, a company must not only outperform peers financially, but also consistently beat shareholder expectations, and do so by a larger margin than other companies. Over time, even top-performing companies will find this difficult, because as their performance increases, so too will investor expectations. It is difficult to consistently deliver above-market performance.

Figure 3 on page 52 maps the S&P 500 companies, zeroing in on the five companies per industry that delivered the strongest TSR over the full 10-year period from 2001 through 2010. Each of these longer-term top performers were tested to understand their relative TSR performance in each of the eight rolling three-year periods within the full 10-year period. Even the best performing companies will lag the market sometimes. For example, the top-performing company in consumer discretionary scored as low as 8th percentile against its industry comparators in one of the eight rolling three-year periods. Also, consider consumer staples, where the long-term top performer scored lowest among industry comparators for one three-year period.

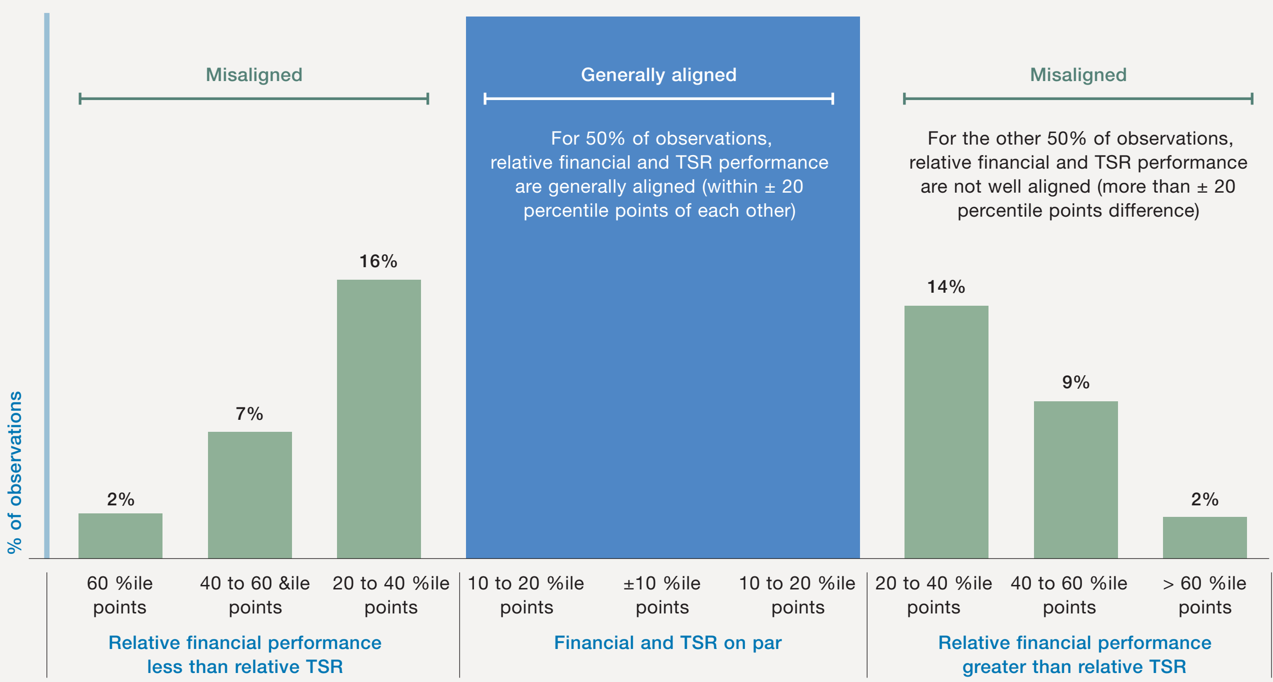
As a result, even top-performing companies over the long term will have occasional performance periods with relatively low payouts using relative TSR. It is nearly impossible to consistently defy the laws of gravity, due in part to ever-increasing shareholder expectations for high performers.

Conclusion

Relative shareholder returns are an essential element of a robust assessment of company performance. Whether relative shareholder returns should have a role in determining incentive outcomes is a company-by-company decision. This decision should be carefully considered, and companies should not feel obliged by what others do or general notions of best practice. There are sound arguments for and against relative TSR-based programs.

Figure 2 | S&P 500 Less Financial Services

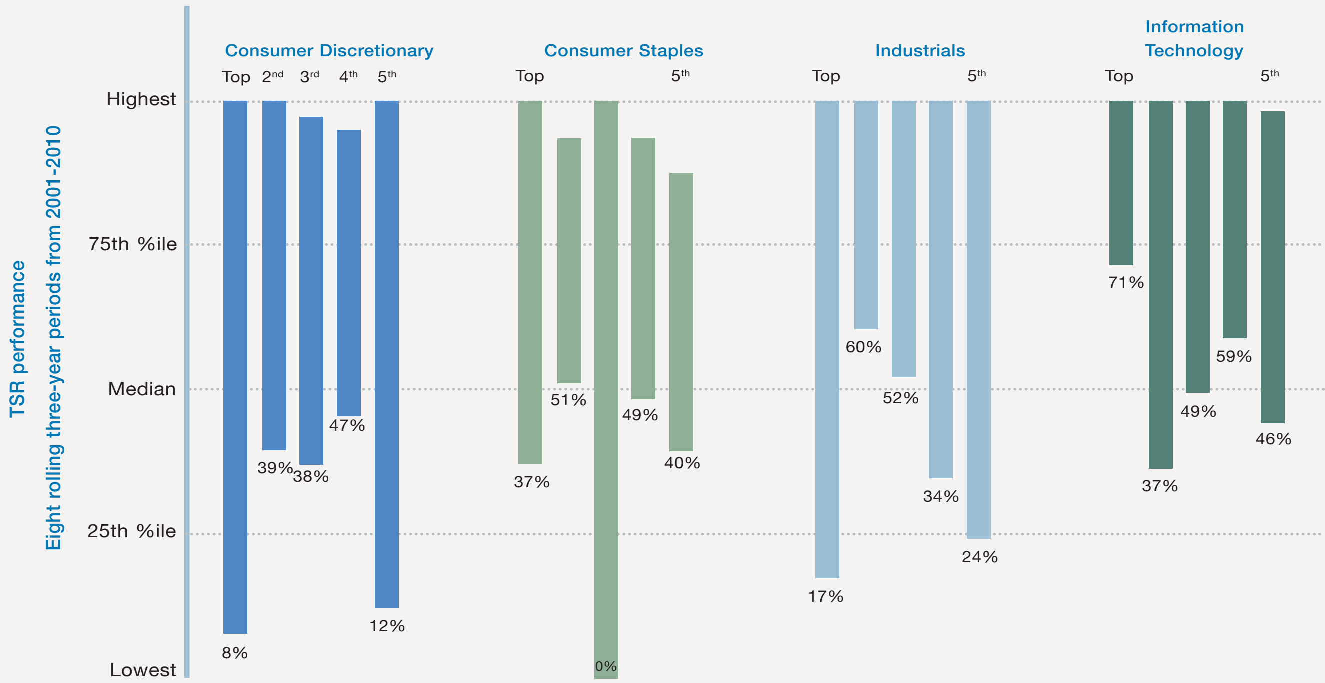
Eight rolling three-year periods from 2001 through 2010



Source: Semler Brossy Consulting Group Analysis.

Figure 3 | **S&P 500 — Select Industries**

Top five TSR performers by industry from 2001 through 2010



Source: Semler Brossy Consulting Group Analysis.

Argument for: Executives earn rewards only when shareholders experience above-market returns.

Argument against: Relative shareholder returns are already inherent to any equity-based incentive, and, therefore, relative TSR is unneeded as an explicit incentive metric.

The decision for each company comes back to intent. If the intent is to engage executives around a specific performance imperative, then relative TSR is a poor choice. But, if the intent is to help qualify incentive outcomes after the fact and demonstrate a commitment to aligning realized pay with performance, relative TSR can be very effective. Nonetheless, participants' perceptions of unfair and arbitrary pay outcomes should be expected.

Of course, there is broad space between these two intentions, and it is often best to use relative TSR within a multiple-measure framework. In the authors' experience, the most effective pay-for-performance frameworks are holistic in approach and structure, generally balanced across three key dimensions:

1 | Annual and longer-term performance
2 | Financial and strategic performance
3 | Performance against internally derived goals and relative to competitors and/or the broader market.

These balanced frameworks provide a fuller context for incentive outcomes, and they can help to avoid the unintended consequences that can come with more one-dimensional approaches. ws

Todd Sirras is a managing principal at Semler Brossy Consulting Group in Los Angeles. He can be reached at tsirras@semlerbrossy.com.

Barry Sullivan is a principal at Semler Brossy Consulting Group. He can be reached at bsullivan@semlerbrossy.com.

resources plus

For more information, books and education related to this topic, log on to **www.worldatwork.org** and use any or all of these keywords:

- Shareholder return
- Financial performance
- Strategic performance.