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A Holistic Approach to Rewarding the Method of Stock Appreciation

The fact that shareholders care about risk is self-evident.

Recent years have brought significant growth in the use of relative total shareholder return (TSR) as a performance metric in long-term incentive plans. While the measure is generally favored by shareholders and proxy advisers for being relatively transparent, easy to track and closely aligned with shareholder interests, is it ideal? Do TSR outcomes in a performance plan ensure strong alignment between pay and performance? Or do they largely reward volatility? This article will highlight some drawbacks with relative TSR plans and suggest ways to enhance their effectiveness in aligning pay and performance.

No Silver Bullet

While the merits of relative TSR are often cited, the authors' experience designing and monitoring such plans also reveals some noteworthy drawbacks, including:

- TSR results can be heavily influenced by short-lived share price swings at the beginning or end of the performance period, with the resulting payouts misaligned from the average return experienced by the average shareholder.
- A point-to-point measurement ignores what happens to the stock price between the beginning and end of the performance period (i.e., the shareholder experience), and a mechanism for adjusting payouts for the risk experienced by shareholders is absent.
- The probability of achieving higher levels of TSR in any one period is influenced by your starting point trading multiple (i.e., companies trading at a relative low at the start of the period are more likely to outperform in a cycle than those trading at a high at the start).
- Thinking about TSR plans broadly, the authors are skeptical that a single metric, no matter how closely aligned with investors, can capture the totality of long-term corporate performance.

As a hypothetical example to illustrate some of these drawbacks, consider the share price trajectories of the two companies shown in Figure 1. The authors deliberately picked a four-year period

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allowing the results of two overlapping three-year TSR cycles to be illustrated. Two key questions:

1 | As an investor, would you prefer the stock of Company A or Company B over the time period shown?

2 | As an executive, would you rather participate in the plan for Company A or Company B?

Investor experience: Both companies ultimately delivered the same return at the end of the three- and four-year periods. However, while Company A delivered consistent returns, Company B took its shareholders on a roller coaster ride.

Payouts to executives: Assuming a typical plan structure of three-year performance cycles, with a new cycle starting every year, the payouts to executives would likely unfold as follows:

- In the first cycle (at the end of the first three years), executives of Company A and Company B would receive the same payout given that they ended with the same returns at the end of the period.
- In the second cycle (covering years two through four), however, all other things being equal, the executives of Company B would realize a significantly higher payout than those at Company A. This is due to the fact that Company B's stock plunge during year one left it with a much lower starting point than Company A at the beginning of the second three-year cycle.
- Over the two performance cycles illustrated, while the shareholder experience was clearly superior at Company A, executives of Company B would likely get significantly higher payouts under a relative TSR plan.

As the example illustrates, the current TSR plan designs common in the market carry the inherent potential to produce payouts that are misaligned with the shareholder experience, the very dynamic these plans are intended to address. Furthermore, when combined with stock price volatility, the typical plan structure of multiple overlapping TSR cycles may amplify the disconnect between shareholder experience and executive payouts.

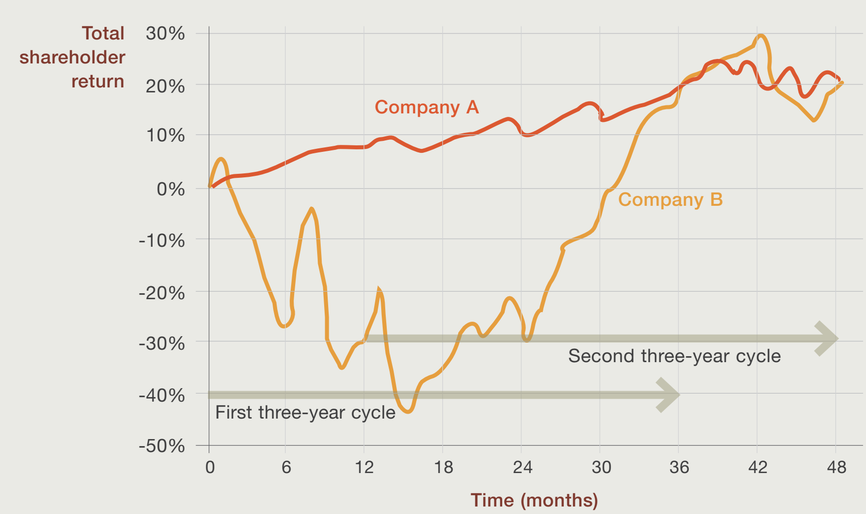
Shareholder Returns and Volatility

Given that stock beta, which is a measure of stock volatility in comparison to a broader stock market index, is a key concern to investors, companies should consider reflecting beta's importance in the design of their relative TSR plans. Shareholders' focus on beta, or relative volatility, is a reflection of a number of dynamics, including:

- Stock price volatility is one of the factors used to determine the suitability of a particular stock for various investment styles, risk and return objectives, and investment horizons.
- High downside volatility tends to induce shareholders to sell as capital preservation concerns come to the forefront.

While typical TSR plans artificially constrain the measurement period to the company's three fiscal years, shareholders don't have these arbitrary restrictions. Thus, while the company's executives may realize a robust payout following a stock price plunge and rebound, shareholders may exit during

Figure 1 | Stock Price Comparison



the decline and so may not participate in the recovery. One way to realign relative TSR plans with the shareholder experience is to go beyond merely rewarding point-to-point stock price appreciation and incorporate a volatility measurement into the plan.

Since the underlying rationale for using a TSR plan is to ensure alignment, adding a volatility metric would send a message that the plan pays for quantity and quality of results. Current TSR plan designs are too simplistic to effectively encourage executives to pursue both of these goals. The concept of risk-adjusted performance is now much more central to compensation programs and it's time for TSR plans to reflect this new reality.

Is Thoughtful Peer Group Selection Enough?

In designing relative TSR plans, careful peer group selection that focuses on companies in the same or closely related industries, subject to similar macro-economic forces, is often an important step. However, picking the right peer group is fundamentally a backward-looking exercise and, as Figure 2 illustrates, one that cannot ensure that the company and its peers will exhibit similar volatility characteristics in the future. Beta differences (and, thus, comparative share price movements) may vary significantly among peers. Figure 2 lists pairs of companies that one may reasonably expect to be peers for relative TSR purposes, along with their recent stock beta values.

These examples highlight the fact that selecting a focused peer group closely resembling a company may be inadequate to ensure similar risk characteristics in the future.

Figure 2 | **Recent Stock Beta Values for Possible Industry Peers**

Likely Peers For TSR Purposes	Beta Values
Lockheed Martin Corp.	0.62
General Dynamics Corp.	1.29
Merck & Co. Inc.	0.41
Sanofi	1.04
McDonald's Corp.	0.30
Yum! Brands Inc.	0.69
Edwards Lifesciences Corp.	0.63
St. Jude Medical Inc.	1.21

Possible Approaches for Incorporating Volatility Measurement

There are two main methods for introducing volatility measurements into relative TSR plans. Under both approaches, volatility would be measured on a relative basis against the same group of companies used for the TSR comparison. Relative benchmarking eliminates the need to set long-term volatility goals but accounts for the fact that this measure of performance is — at least partially — influenced by management.

Both approaches are structured such that relative volatility and plan payouts have an inverse relationship (high relative volatility lowers the payouts, while low relative volatility increases payouts).

- **Alternative 1** Relative volatility performance would be a multiplier to adjust payouts based on relative TSR performance. For example, the TSR component could be multiplied by 0.7 to 1.3 based on the volatility percentile ranking within the peer group, varying the TSR-based payouts by +/-30 percent.
- **Alternative 2** Payouts under the relative TSR and volatility components would be additive, with a TSR gate (threshold) used to zero out payouts in cases of strongly negative or significantly lagging TSR. For calculating payouts, relative TSR performance could be weighted at 65 percent, with relative volatility weighted at 35 percent. Payouts for the two metrics would be calculated separately and then added together. And the gate would ensure that TSR met at least some absolute standard (e.g., at least 5 percent).

The rationale for looking beyond TSR in long-term performance plans is not limited to shareholder alignment considerations. Companies choosing to pursue this design would also likely realize the following benefits:

- Coupling volatility with TSR measurement is a risk-mitigating tool within the relative TSR plan and the broader long-term incentives (LTI) portfolio.
  - This approach reduces the emphasis on stock price appreciation at all costs by incorporating a more holistic view of the path the company took to get there.
  - When stock options are used as part of the LTI mix, including a volatility measure in the performance plan, helps mitigate the perception that options are essentially a "pay for volatility" vehicle. As stock price volatility increases the probability of a high payout on the options, it also decreases the payout under the long-term performance plan.
- The proposed approaches reward steady, predictable management, while recognizing that extreme boom-and-bust stock price cycles are generally not preferred.

Another advantage of this approach is that companies that previously may have shied away from relative TSR plans because they viewed themselves as steady (but not star) performers can now start thinking about implementing these shareholder-favored types of plans. With this type of plan, executives at steady-performing companies have a higher probability of realizing a payout at target or higher because they will be rewarded for stock appreciation and consistency of returns.

One Size Does Not Fit All

Of course the introduction of volatility measures into relative TSR plans may not be right for every company. A key determining factor, for example, It's time to start thinking about rewarding executives not only for returns, but also for their consistency and predictability.

is how the company's shareholder base feels about volatility. If a significant percentage of a company's shares are owned by speculative investors (e.g., high-risk/high-return funds, hedge funds, activist investors), measuring volatility may not get much traction.

Another important consideration with the volatility metric is the company's maturity. Companies in early stages of development are probably not suitable candidates for this approach. Volatility is generally expected with the risk/reward profile associated with early-stage growth companies.

On Control, Complexity and Communication

There are potential objections to incorporating a volatility metric into TSR plans:

- Volatility is outside of management's control.
- The additional measure introduces more complexity into an already complex plan design.
- This design poses additional challenges in effectively communicating plan mechanics to participants.

We'll deal with these objections one by one:

- At first glance, the argument that stock price volatility is outside of management's control seems to hold some sway. However, what's proposed is to measure relative — not absolute — volatility. This is the same concept that underlies measuring relative TSR. If the company has accepted the notion that management influences stock price performance relative to a group of similar companies, the relative volatility concept is essentially identical.
- The complexity argument is valid, but in reality applies to relative TSR plans broadly, as opposed to the volatility metric specifically. Measuring relative volatility is really no more or less complex than measuring relative TSR. If a company already has a relative TSR plan in place, the additional complexity posed by the volatility metric is minimal.
- Communication challenges posed by this type of plan are real. However, participation in these plans is generally limited to top executives who are tasked with running complex organizations and are used to dealing with challenging concepts. With a well-designed communication strategy, this type of plan design can be clearly explained to this select group. Moreover, relative TSR plans are effectively geared to ensure pay alignment on a retrospective basis as opposed to serving as a forward-looking "incentive." The volatility measure provides another lens to fine-tune and get the pay-for-performance equation right.

Times Are Changing — TSR Plans Should Too

Since the early 2000s, stock market participants went from being primarily concerned with the return on their capital to losing sleep over the return of their capital. Relative TSR plans have been around for some time, but have not yet reflected the growing emphasis on risk and stability of returns. The authors believe it's time to start thinking about rewarding executives not only for returns, but also for their consistency and predictability.

While TSR plans can and should be improved through the introduction of a volatility measurement, the authors also recognize how relatively myopic the TSR metric is when used as the sole benchmark of long-term corporate performance. In the authors' opinion, it's very difficult, if not impossible, to accurately assess a company's performance without considering other financial and nonfinancial performance metrics. To focus compensation largely on point-to-point measures of TSR, even when adjusted for relative volatility, would be to ignore the very painful lessons of our recent past. ws

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