Executive Compensation

The Demise of TSR as the Primary Executive Pay Performance Measure

By Bob Romanchek and Tony Meyer

During the past decade, the use of total shareholder return (TSR) has risen rapidly in prevalence as a performance metric in executive long-term incentive plans. Many compensation committees believed this was a direct way to align executive pay and performance. But is it? A notable number of large-cap companies are now not so sure.

Meridian tracked the use of TSR since 2011 via an annual survey and recently published this year's findings in *2018 Trends and Developments in Executive Compensation*. The prevalence of TSR increased annually from 39 percent in 2011 to 63 percent in 2017. Then, in 2018, there was a reversal: only 53 percent of survey participants used TSR. Moreover, there was a decline in using TSR as the sole performance metric (39%, down from 48%), an increase in coupling TSR with an earnings or return measure, and an uptick in those now using TSR just as a modifier and not a baseline measure.

Were these changes an anomaly? Likely not. Compensation committees are realizing there are potential concerns with TSR, including:

- **Line of sight and external influences**. Share price movement can be influenced by many external factors over which executives have no control, including industry cycles, competitor activity, potential buyouts, economic factors, politics, tax and other statutory changes, and the weather. The resultant stock market volatility shows that positive action taken by management does not always directly result in positively correlated TSR.

- **Selecting comparator companies**. A vast majority of companies use TSR on a relative basis, where a company's stock price performance is compared to that of other companies. Which companies should be chosen as comparators? Some believe TSR should be compared to that of direct business peers. This could create misalignment because an executive has no direct influence over peer companies and their performance and the list of comparator companies may be too small for a fair, relative comparison. Consequently, some argue that TSR should be compared to a broader market index such as the S&P 500. Beating a small number of clear competitors versus beating the broad stock market as a whole are two different incentives with potentially different behavioral and payout implications—even if company TSR performance is the same.

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- **Performance period length and timing**. The start and end dates of the performance period will significantly impact the final payout. Most cycles are three years in length, and starting a three-year performance cycle at a high stock price (due to strong recent performance), in comparison to peers that may be starting at a low price due to poor prior performance, can result in an unfair performance comparison.

- **TSR is not the only favored metric**. A common misconception is that TSR is the one metric that institutional shareholders and proxy advisory firms endorse. This is not true. Proxy advisory firms are open to other financial metrics, even though their performance tests are based on TSR. Investors are also interested in how the business is running, as measured by earnings, cash flow, and/or return measures.

These considerations have led a number of companies to de-emphasize the use of TSR. Many still see the value in the pay-for-performance alignment of a TSR metric, but have more recently coupled TSR with a more traditional financial measure or have used TSR only as a modifier that can alter the payout.

Given that the market is showing signs of rethinking the use of TSR as the primary long-term incentive performance metric, we predict that the decline in usage will continue, with many companies using a TSR metric in a more limited capacity. In summary, the meteoric rise in the use of relative TSR has come to end.

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