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Relative TSR Practices & Proxy Advisors

A majority of the S&P 500 (~55%) use relative TSR as either a weighted metric or as a modifier for some portion of their LTI.

There are a variety of design provisions incorporated in any relative TSR arrangement, but two tend to receive the most commentary from the proxy advisors, specifically:

- Performance required for target payout; and
- Negative TSR payout caps.

Target Payout

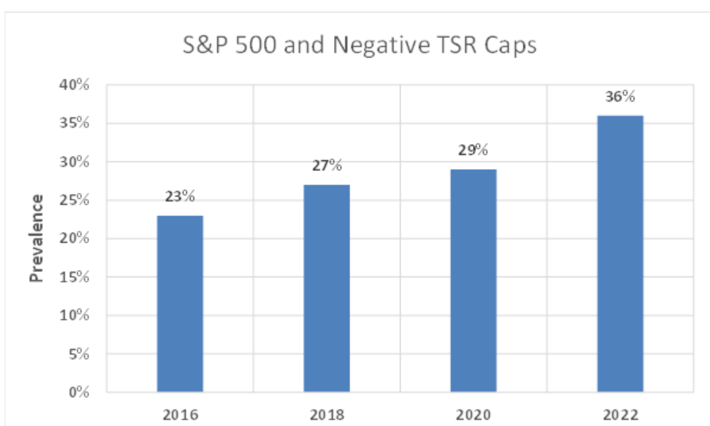
To earn a target payout, the dominant practice requires relative TSR be at the 50th percentile of the comparator group (i.e., peer group, or index). Among the S&P 500, ~80% use 50th percentile performance to earn the target award.

Many companies with a 50th percentile pay philosophy view it to be both sensible and a sound alignment of pay and performance for 50th percentile performance to yield a target award.

Nevertheless, proxy advisors prefer above median performance to achieve a target payout. It is quite common for both ISS and Glass Lewis to make comments in their reports such as “only median performance is required for attaining target performance;” or “concerns are raised regarding the rigor of the LTI plan's performance shares, as relative TSR targets median performance.” While both proxy advisors regularly make these comments, TSR goal setting is seldom the primary concern driving their final vote recommendations.

Negative TSR Payout Caps

Notwithstanding high relative performance, it is possible for *absolute* TSR to be negative. Among the S&P 500, 36% of companies include a negative TSR cap provision and this practice has been growing over time. When used, the most common (>90%) negative TSR cap limits any earned award to target.



Philosophical Question

Negative TSR caps are a more nuanced subject. Some argue that a superior relative ranking is indicative of the market's sentiment of superior management and operational outcomes notwithstanding a challenging market environment, and management should be rewarded accordingly. Alternatively, others argue that notwithstanding a superior ranking that above target outcomes are inconsistent with the shareholder experience which was an absolute decline in value.

One can easily see the strengths and limitations of both arguments. There is no "right" or "wrong" answer to this as each company needs to settle the philosophical debate to their satisfaction.

Both proxy advisors strongly support negative TSR caps, usually citing the negative *absolute* share price and the consequent misalignment of management with shareholders. However, there is some contradiction in this position, since in other contexts neither proxy advisor views absolute stock price changes as indicative of performance. For example, both proxy advisors have strong policy positions that stock options—which are predicated on absolute changes in stock price—are *not* performance based since, (they say) *absolute* stock prices are impacted by many external variables and not reflective of management's performance. Why then the strong position on negative TSR caps? The contradiction has never been explained.

Summary

Two key decision points in designing a relative TSR-based incentive plan are the performance scale, and whether or not to have negative TSR caps. The proxy advisors weigh in on these two areas of relative TSR arrangements more than any other. Importantly, while they have a point of view for both topics, their position on these provisions is typically *not* determinative of either Say on Pay or director voting outcomes. Both topics are ultimately areas of Committee judgment. The approach on both should follow the design and philosophical preferences of each company.

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