Total return not the total view

Total Shareholder Return has a nice ring to it. And much to recommend it as a tool to guide CEO pay decisions. But boards that use it exclusively aren't getting a complete picture

By Ken Hugessen with Linda McNally

In recent years, Total Shareholder Return (TSR) has become the most frequently used metric in long-term incentive plans for assessing company relative performance and guiding the outcome of pay decisions. It is also used by proxy advisory firms to evaluate CEO pay in the context of performance. However, TSR has its limitations. An important starting point is to understand the fit of relative TSR for your organization; in particular, the ability to construct a peer group that aligns to its business and financial characteristics. But even then, if used exclusively, TSR can give an incomplete picture of long-term value creation and sustainable performance

The Investor Responsibility Research Center Institute (IRRCi) has published two reports that examine the relationship among metrics used to assess company performance, CEO pay and say-on-pay voting. The first, *The Alignment Gap Between Creating Value, Performance Measurement, and Long-Term Incentive Design*, postulates that while TSR provides a window into current value of a company, it may not always reflect the value of future economic profit which drives sustained long-term TSR performance. To fill this gap, the IRRCi proposes that boards, shareholders and proxy advisers also consider another measure: economic profit, or return on invested capital greater than its cost of capital.

IRRCi reached this conclusion by looking at company performance from 2003 through 2012. It found that 43% of the S&P 1500 had "negative five-year cumulative economic profit." Also, these companies "failed to provide a return on invested capital greater than their weighted average cost of capital over rolling five-year performance periods." Such results raise questions about these companies' viability and whether they can produce future economic profits. The conclusion of IRRCi's analysis is "value is created when return on invested capital is greater than the weighted average cost of capital."

IRRCi's analysis of cumulative economic profit compared to relative TSR over five-year rolling time periods produced some intriguing results. Only 35% of companies studied had both positive TSR and positive economic profit. At the other extreme, 30% generated negative TSR and negative economic profit. However, 35% had mixed results: 17% had positive TSR, but negative economic profit; 18% the opposite.

IRRCi's second study, *The Alignment Gap Between Say on Pay and Creating Value*, looked at say-on-pay support for the same subject group as the first study. Interestingly, it found little difference in support for low-performing companies and high-performing companies when performance was assessed using both economic profit and relative TSR. IRRCi also examined the key factors in setting CEO compensation and determined that 63% of pay values were influenced by industry, inflation, company size and previous pay policies of the company. Only 12% of CEO pay was attributable to economic profit or TSR.

In Hugessen's conversations with institutional investors, we continue to hear preference for performance share unit (PSU)-based compensation plans where payouts aren't determined by a single performance metric (typically relative TSR). When it comes to which metrics should be included, they are less prescriptive, except to say that 1) chosen metrics should align with the company's stated long-term strategic plan, and 2) management's decisions should be able to influence, but not manipulate, the final results. Having said that, return on invested capital (ROIC) or economic profit are often cited as strong measures of real value creation.

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Beyond TSR, ROIC and economic profit, directors may want to include future share-value creation when assessing performance and aligning CEO pay with performance. They can do this by:

- including metrics that evaluate share-value creation and/or future focused metrics such as innovation and capital efficiency;
- extending performance periods of long-term incentive plans to five years or more;
- enhancing disclosure to highlight investments into the future of the company and the company's commitment to seek returns over capital cost in order to produce sustainable share-value creation.

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