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Total Shareholder Return Misses Mark on Performance

In theory,
theory and practice
are the same.
In practice,
they're not.

This saying and various iterations of it have been attributed to several different people, Yogi Berra among them. Regardless of who actually said this first or best, it aptly fits the world of top executive compensation. In theory, paying CEOs more to reward and incent improved firm performance may seem like a simple and direct way to align their incentives with those of shareholders. In practice, research suggests that this might not be so easy to achieve.

Getting Everyone on the Same Page — At Least In Theory

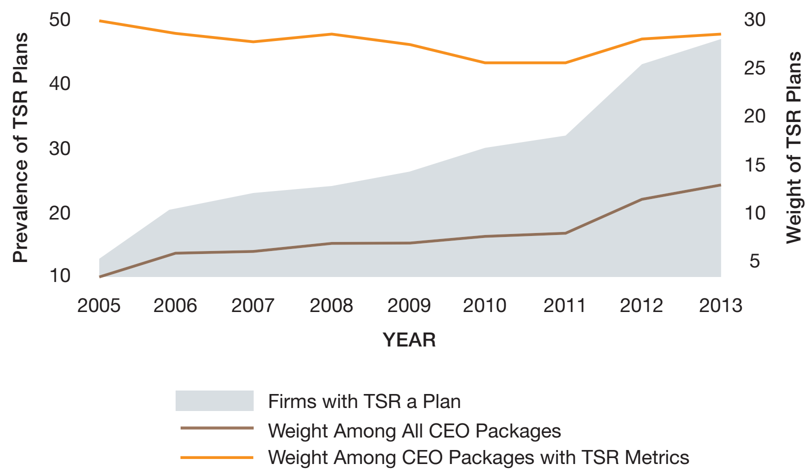
In their classic 1976 article, Jensen and Meckling described the principal-agent problem. As an example, consider a landowner who makes the farm manager's compensation a function of the farm profits to make sure that business decisions align with the owner's interests. In fact, economists as far back as the pioneer of the field, Adam Smith, have discussed the alignment of incentives and outcomes. In "The Wealth of Nations," Smith argued that directors of public corporations are likely to watch over shareholders' money less attentively than the partners of a private firm watch over their own money.

Theory suggests that including an incentive pay metric based on total shareholder return (TSR), i.e., the performance measure that expresses share price appreciation and dividends paid as an annualized percentage, in a CEO's compensation plan would lead to higher TSR for the firm. But does it? My colleagues and I at the Institute for

Hassan Enayati, Ph.D.
Institute for Compensation Studies
ILR School at Cornell University

Compensation Studies, in collaboration with executive compensation consulting firm Pearl Meyer, recently analyzed the role of TSR awards on firm performance to see if the results in practice are what theory predicts.

Figure 1 | Prevalence and Weight of TSR Metrics in CEO Compensation Packages



Source: TSR, Executive Compensation, and Firm Performance: A Brief. www.ilr.cornell.edu/ics

Relationship Among Prevalence, Importance and Results Disconnected

Using 10 years of historical data derived from Equilar's executive compensation database for the 2013 S&P 500 firms, we examined whether the inclusion of TSR measures in long-term incentive plans improved company performance (TSR, Executive Compensation, and Firm Performance: A Brief. www.ilr.cornell.edu/ics). Our first step was to understand how common TSR metrics were, and their size relative to total direct compensation. Not surprisingly, we find that TSR awards have become more common, but the size of the increase was bigger than expected. Figure 1 shows that the share of firms offering TSR awards to their CEOs more than tripled between 2005 and 2013, from 13 percent to 47 percent.

Looking at how the weight of the TSR metric relative to total direct compensation changed over time for those CEOs who had a TSR metric in their compensation plans, however, reveals a different story. Among CEOs with TSR metrics in their long-term incentive pay, the relative weight of these plans fell from 30 percent of total direct compensation in 2005 to under 26 percent in 2011, and then crept back up to just under 29 percent in 2013. Collectively, these trends suggest that more CEOs have TSR metrics and other performance-based measures but the relative importance of the TSR-based award has diminished. Maybe companies are uniformly deemphasizing TSR metrics, or maybe the average is being slightly deflated by new adopters of TSR-based compensation plans "trying it out" in a gentler way — sticking their toe in the water instead of jumping into the pool, so to speak.

Our research went on to use statistical models to assess the role that TSR metrics had on firm performance. We considered six measures of firm performance: one, three and five-year TSR, return on equity, earnings per share growth, and total revenue growth. While theory might tell you that making shareholder return part of a CEO's compensation plan would lead to higher shareholder return in the future, our research finds, in practice, no strong evidence of a positive impact of TSR plans on firm performance. Two potential reasons that the TSR metrics fail to align interests are (i) too many aspects outside of the control of the CEO determine firm performance or (ii) CEOs are unsure of the specific action needed to take to increase performance.

Where Do We Go From Here?

Although using TSR-based compensation plans may seem like a simple and direct way to align the interests of executives and shareholders, our work says that it may not be that easy. To be clear, our analysis isn't suggesting that companies don't try to link the financial interests of owners to their executives. We still believe the theory. Rather, our analysis to date suggests that it is the TSR pay metric as currently deployed that seems to miss its mark with regard to firm performance. Employers, compensation committees, and compensation professionals will need to continue working together to find strategies to pay executives in a way that leads to sustainable financial success, linking up theory and practice. ws

Got a Question? Send them to the Institute for Compensation Studies (ICS) at Cornell University, at ics-ilr@cornell.edu | www.ilr.cornell.edu/ics | facebook.com/ICSCornell