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Video Transcript: Balancing TSR as a Long-Term Incentive

Peter Lupo: The question that we speak about often at compensation committee meetings is whether or not TSR is an appropriate or a good measure to use in incentive programs. There are a few issues they have to think about. Proxy advisory firms have been using TSR to understand the performance of the company. More recently, the SEC has issued regulations on the pay-for-performance under Dodd-Frank. In those regulations, the SEC is saying companies have to use TSR as the measure.

You might, as a compensation committee chair, say automatically, "Well then, I should include TSR in my programs," but it's not an automatic decision. Two or three considerations. First of all, there is generally a lag or a lead between TSR and operational performance. If a company's operational performance has been very strong over a couple of years, it is likely that the total shareholder return may not immediately reflect that. Conversely, if the TSR has been strong and a company's operational performance has been a little weaker, it may take a while for that TSR to come down. That's really the challenge.

When I talk about TSR, I'm usually talking about relative TSR. It's TSR of the company versus a set of peers. A set of peers might include ten or fifteen companies. It's appropriate to measure performance of a company to its peers if the company and the peers all have the same operating model. If you're calculating TSR for a company and you're comparing it to other companies that we consider peers, but don't really look exactly like the company that we're studying, you're going to have a mismatch between the performance of our company and the peers.

If we have the luxury to measure TSR over a ten-year period, I would say you should automatically include TSR in the program because we could say pretty clearly and comfortably that measuring TSR over ten years will give a good indication of performance. In most plans, we're measuring TSR over three years and that's really the issue. Within a three-year period, your operation performance can be out of synch with TSR and you're going to pay on that basis.

The biggest takeaway I can give a compensation committee chair is that when you are looking at your long-term incentive plan designs, you should always consider TSR for inclusion in your program, but study it carefully. Study the pros, study the cons, and then make your decision.