The Problems With Relative TSR Performance Measures – Directors Should Watch For Risk

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Relative Total Shareholder Return was introduced to Australian public companies by one of our directors in the early 1990s. It has become by far the most common long term incentive (LTI) performance measure used for executive remuneration.

This month we focus on the issue of risk and the use of the relative TSR measure for executive incentive pay. Given that ASX Governance Principle 7 requires boards to develop mechanisms for dealing with risk, we thought we would provide an overview of a major risk factor neglected by most boards, i.e. use of relative TSR as a performance measure for incentive pay.

Typically a company's long term performance is compared to a group of other companies over a 3 year period using relative TSR. The methodology typically assumes that any dividends received during the performance period are reinvested to purchase more shares. The companies in the comparison group are then rank ordered according to their 3 year TSR and compared to the TSR achieved by the company employing the executives. Usually a reward is payable if the performance of the company is better than 50% of the comparison group. This level of TSR is called the median level. That is, median TSR is that TSR that is greater than 50% of the TSRs achieved by the other companies. The maximum reward is usually paid for achieving a TSR greater than 75% of the TSRs of the sample companies. This is known as the 75th percentile TSR.

Relative TSR is popular because it is fairly easy to understand and communicate, and can be calculated at any time for any performance period. But it does have problems that directors should be aware of. Some of these have been covered in our **February 2006, March 2006** and **May 2006** newsletters.

Relative TSR depends on rank ordering the returns received by

shareholders in a period. Returns are a function of share price appreciation. To have share prices appreciate executives take risk. The bigger the risk the more likely the relative TSR level achieved will be at the top end or bottom end of the TSR scale.

But the odds may be stacked against the executives from the beginning. The comparison group may consist of companies with higher volatility in earnings than your company. This places them in the box seat for outperforming your company most times in relative TSR. That is, at any one point in time a proportion of these companies are almost certain to rank higher than your company. An indicator of this is to look at the comparison companies' beta compared to your company's beta. If they are higher, then they are riskier and also some are more likely to outperform your company over a given period. The impact of this is:

- Executives see the reward system as unfair. They are less likely to get a reward, so they look elsewhere for a company that provides better probabilities of reward, and/or
- They seek to change your company's direction to take it on a riskier path.

The lack of fairness will lose you good people. The change in risk profile may result in your share price's risk premium being reduced for lower earnings reliability (in some cases even if average earnings increase), i.e. it may trade at a lower price earnings ratio.

In Australia the problem is exacerbated because there are rarely enough companies of similar size in the same industry sector with similar risk profiles. Given this, relative TSR could be a big demotivator.

But, because many shareholders like relative TSR, what can a board remuneration committee do to make the system fairer? One way is to adopt a risk adjusted method of TSR. That is, what TSR can be expected if the comparison group had the same risk profile? This is surprisingly easy to calculate and apply. Most institutional investors are well aware of the methodology for portfolio management and other purposes, so they should have no problem with a risk adjusted relative TSR method. And the method can retain the

advantages of the usual relative TSR, in that it can be calculated at any time for any performance period.

For directors who like a little math, we provide information below on two methods of calculating shareholder return performance that takes risk into consideration. For others who want to go back to the news section press **HERE**.

The two methods are called the Treynor Performance Index and the Sharpe Performance Index. Both are similar with the only difference in calculation being the method for adjusting risk. The Treynor Index relies on "beta" and is more suited for comparing against a well-diversified group of companies. For comparison against a portfolio that is not diversified, the Sharpe Index replaces beta with standard deviation.

The underlying equation for adjusting TSR for risk is as follows:

(TSR — risk-free rate) / (risk measure*)

*Beta for Treynor; standard deviation for Sharpe

As an example, let's compare two companies with the following assumptions:
– Risk-free rate of 5%
– Acme TSR of 12%
– Acme beta of 1.40
– Billings TSR of 10%
– Billings beta of.95

Using the Treynor Index, the resulting adjusted TSR would be 5.0% for Acme and 5.3% for Billings. Although Billings provides a lower standard TSR relative to Acme, it does so at significantly lower risk. This delivers a better-adjusted return to shareholders.

Guerdon Associates suggest board remuneration committees consider various TSR methodologies. The Australian market currently suffers from a "One Size Fits All" approach where tailoring is badly needed. The methodologies described above are particularly useful for clients comparing themselves against general industry peer groups. Given the paucity of true comparators, many companies end up with a broad based group that is not reflective of their business dynamics. Using a risk

adjustment can help level the playing field, enabling valid cross-industry comparisons.

There are also other approaches to using TSR and many situations when TSR is inappropriate for validly assessing and paying for executive performance. **Ask us for more information**.