

A better way to design performance shares



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A major change in **U.S. executive pay** over the past 20 years has been the replacement of stock options with performance shares

A 2023 study found that 87% of S&P 500 companies use performance shares (vs only 18% using stock options). 72% of performance share companies used stock price or TSR as their vesting measure, and 70% of those companies used relative TSR as their vesting measure.[1]

The goal of performance shares is to avoid paying managers for stock price increases due to market and industry factors beyond their control. But we'll see that relative TSR vesting leads to substantial pay for market and industry performance. It increases pay for industry performance instead of eliminating **pay for industry performance**.

We'll show that there is a better vesting measure that eliminates pay for industry performance.

Pay and performance history of Aetna

The pay and performance history of Aetna CEO Mark Bartolini highlights the rationale for the shift from options to performance shares, but also highlights the weakness of relative TSR vesting.

Bartolini became the President of Aetna in 2007 and the CEO in 2010. When CVS announced its acquisition of Aetna in December 2017, the takeover price gave Aetna a 332% return, adjusted for inflation, under Bartolini's leadership.[2] But over the same period, Aetna's peers also did quite well.

Companies in Managed Health Care rose 272% over the same period, leaving Aetna with a relative TSR of only 24% (when we adjust for Aetna's industry beta). Put another way, only 29% of Aetna's 2017 stock value was attributable to its initial value plus Aetna's excess return; the rest was due to industry performance.[3]

Bartolini's total pay for 2007-2017 was \$636 million. By contrast, market pay for the same period was only \$115 million.[4] This means that Bartolini's total pay was 453% above market when shareholder value was only 24% better than Aetna's peers.

Approximately 48% of Bertolino's total compensation, \$304 million, was derived from stock and option grants without performance conditions. These are the gains that have led institutional

investors to push for performance conditions. But another 48%, \$305 million, came from stock and option grants *with* performance conditions.

For example, he received a grant in August 2013 of 600,000 options subject to a three-year relative TSR performance condition. 500,000 options vested in August 2016 because Aetna's three-year TSR was better than 5 of 7 peer companies. The expected value of the performance options was \$11.1 million at grant and roughly \$18.1 million by the time CVS acquired Aetna[5].

The realised value of the vested option shares at the acquisition price was \$71.4 million. Thus, the realised value of the performance options was 294% more than their expected value, even though Aetna's relative TSR was only 24% over the whole 11-year period and only 19% over the three-year vesting period.

Bertolini's performance options are so valuable because he fully participates in the industry return on the vested shares. Relative TSR operates as a gate, not a filter. We can express the stock price at vesting as stock price at grant $\times (1 + i\text{TSR}) \times (1 + r\text{TSR})$ where $i\text{TSR}$ is the industry TSR and $r\text{TSR}$ is the relative TSR. This means that the vested stock value with relative TSR vesting is stock price at grant $\times (1 + i\text{TSR}) \times (1 + r\text{TSR}) \times (1 + r\text{TSR})$.

We can see from this expression that relative TSR vesting does not eliminate the industry component of the stock return; it multiplies the industry return by $(1 + r\text{TSR})^2$. The industry return will be eliminated if the vesting multiple is $1/(1 + i\text{TSR})$. Multiplying this by one in the form of $(1 + r\text{TSR})/(1 + r\text{TSR})$, we can see that the better vesting multiple can also be expressed as $(1 + r\text{TSR})/[(1 + i\text{TSR}) \times (1 + r\text{TSR})]$. In other words, the vesting multiple should be the percentage of the stock value that's attributable to the grant value plus the excess return.

References

[1] ClearBridge 200 Long-Term Incentive Plan Report, October 2023, available at www.clearbridgecomp.com.

[2] Stephen O'Byrne, "Aetna's \$640 Million CEO Is Overpaid by \$440 Million", Seeking Alpha, December 20, 2017, available at <https://seekingalpha.com/article/4133015-aetnas-640-million-ceo-is-overpaid-by-440-million>.

[3] $(1 + 24\%)/(1 + 332\%) = 29\%$.

[4] His cumulative market pay was \$93 million. Market pay is a present value number, while Bartolini's 2017 pay value is a future value number. When we adjust for normal expected accretion, the expected future value of \$93 million is \$115 million.

[5] This assumes that the expected return on the option was 12%

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