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Rewards = Results

They say what gets measured gets done. In the case of executive compensation, the saying may aptly be modified to what gets *rewarded* gets done. When considering the outlook for a business, the key question investors should ask is whether the company's compensation plan directly incentivizes management to achieve long-term success in the business.

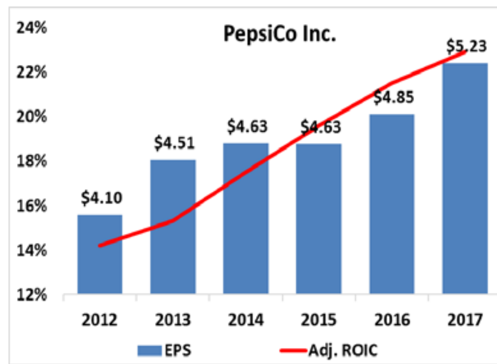
Executive compensation plans are typically comprised of an annual salary, an annual cash bonus, and a long-term component in the form of equity or stock options that vest over several years. Because long-term incentive plans (LTIPs) make up a significant portion of total pay (often upwards of 60%), understanding their effect on management decisions is crucial.

Do incentives based on share price performance alone sufficiently tie executive pay to business performance? Not necessarily. For example, while traditional stock options are not explicitly tied to performance targets, they are worthless if the stock doesn't appreciate. However, keep in mind that they could promote short-termism and excessive risk taking by executives in order to achieve a payout. Options may also end up rewarding stock market performance that is out of management's control, as is the case where an entire sector appreciates because of changes in a commodity price or macroeconomic variable.

More and more we are seeing the evolution of LTIPs to include other forms of equity-based compensation, such as performance share units (PSUs). PSUs are shares (or cash tied to the value of shares) issued to management only if the company meets specific pre-determined criteria over the subsequent few years. The performance criteria can be any measurable operational or financial statistic deemed important by the board.

Research has shown that particular incentive metrics are correlated with predictable financial outcomes. For example, incentives based on revenue growth alone have been associated with weaker profit margins over time, if management prioritizes growth at any cost. Earnings per share (EPS) is a common LTIP metric that often correlates with share buybacks. This is unsurprising, as companies that consistently buy back their shares can grow EPS at a substantially faster rate than would be possible through operational improvements alone. Returns metrics such as return on equity or return on invested capital (ROIC) have been connected to strong corporate performance over a range of measures, making them some of our preferred LTIP metrics.

The financial performance of QV Global Equity Strategy holding PepsiCo Inc. is a good example of rewards leading to results. Pepsi's LTIP represents over 70% of the CEO's total compensation and is 100% linked to the achievement of EPS growth, ROIC improvement and relative total shareholder return (TSR) over 3-year periods. As shown, the company has delivered steady growth in both earnings per share and ROIC. Over the same period, average TSR has exceeded 14% per year (in USD).



Source: Bloomberg, company filings

Another strong example within our strategies is Fortis Inc., with a LTIP of 25% options that vest over 4 years and 75% PSUs. The PSUs vest based on 3-year TSR relative to a utility peer group and 3-year cumulative EPS versus a pre-determined target. Over the last 10 years, the company has achieved average growth in EPS of more than 7% per year. The LTIP for QV Canadian Equity Strategy holding ARC Resources is notable for its emphasis on long-term value creation, comprised of 3-year PSUs, options that don't fully vest until the 5th year after they are granted, and restricted stock that vests in years 8, 9 and 10.

Incentive metrics should align with a company's long-term strategy. Royal Dutch Shell's recent plans to link pay with carbon emission targets is a strong signal to investors that climate risk management is an important component of the business's long-term sustainability. As shareholders, we are focused on long-term results. A well-designed compensation plan can ensure management teams are too.