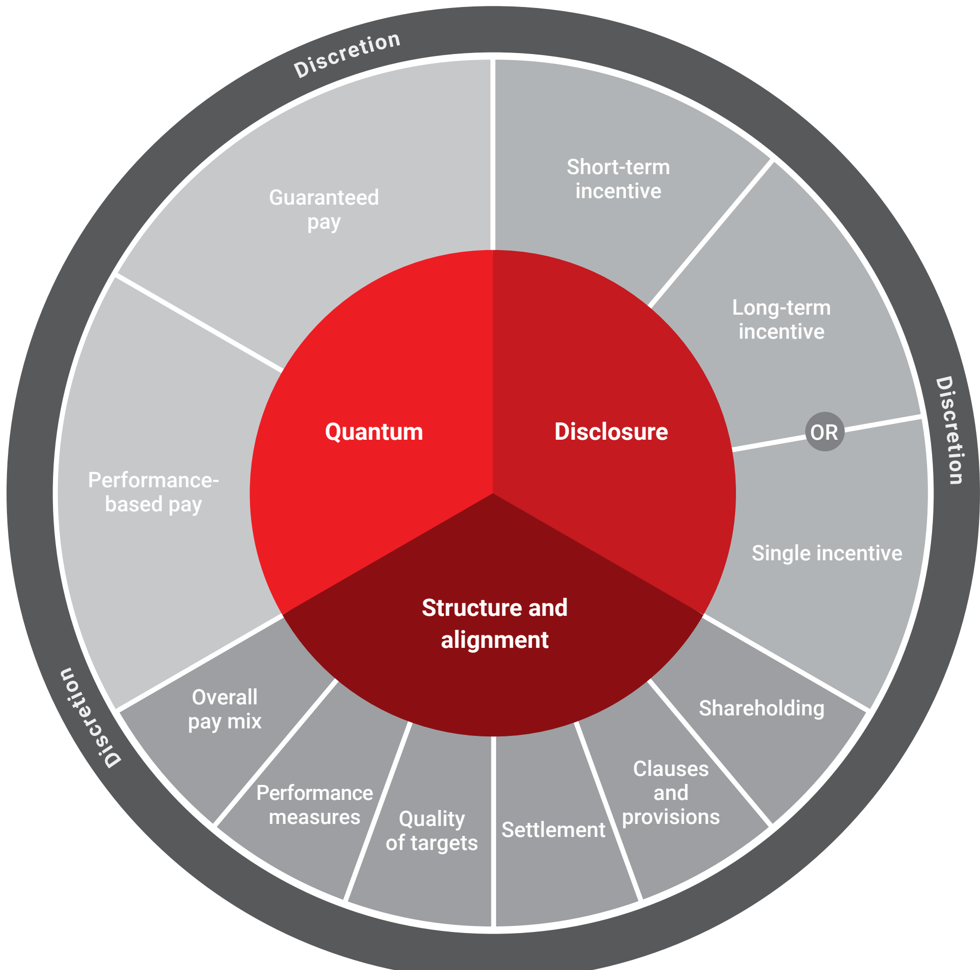
What is Allan Gray's approach to assessing executive remuneration?

Remuneration practices and policies are ever-changing. Many of today's remuneration schemes are vastly different from the simple share-option schemes of the past. The landscape of executive remuneration continues to evolve as executives are expected to deliver outcomes for a widening range of stakeholders.

We believe that a company's remuneration policy should aim to attract, reward and retain competent executives, while aligning the interests of executives and shareholders. We realise that this is easier said than done. We aim to play a constructive role in this regard and frequently engage with company boards, particularly remuneration committees, to encourage the adoption of appropriate executive incentive schemes.

Our remuneration scheme assessment framework involves a qualitative scorecard that covers the key remuneration considerations outlined in our Policy on ownership responsibilities and summarised below. We rate each key remuneration factor (illustrated below), as well as the overall remuneration scheme, on a scale from "excellent" to "good", "average" or "poor".

Figure 1: Remuneration framework



When evaluating a company's executive remuneration scheme, we 1) assess whether the structure achieves adequate alignment between shareholder and executives' interests and evaluate the strength of the pay-performance correlation, 2) establish whether there is sufficient disclosure to enable shareholders to make informed decisions, 3) determine whether the quantum of pay is reasonable and 4) consider the overarching use of discretion by remuneration committees. We evaluate each scheme on a case-by-case basis and take into account the special circumstances that may be affecting a company at the time.

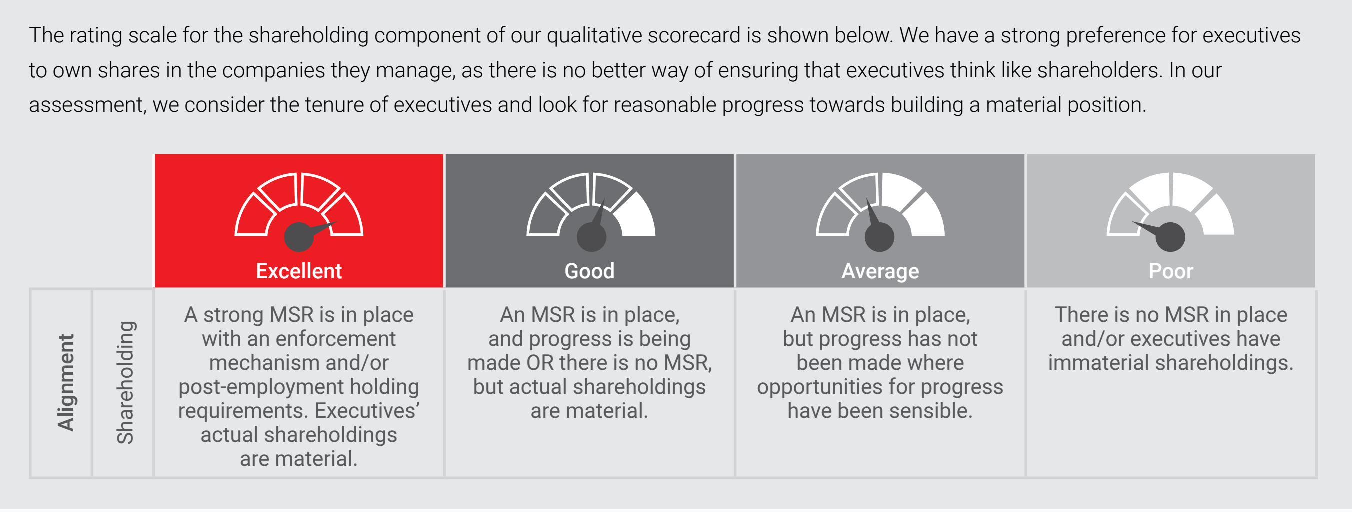
Structure and alignment

Typical executive pay structures include a guaranteed portion, a short-term incentive (STI) and a long-term incentive (LTI). The total guaranteed pay (TGP) refers to the base salary, pension benefits and any other benefits and allowances that an executive is entitled to under the contractual cost-to-company package. This portion of pay is usually paid in cash and is not subject to performance conditions, meaning irrespective of how the executive or the company performs, the executive is entitled to this TGP.

The STI (or bonus) refers to the portion of pay that is dependent on the executive achieving performance targets that are evaluated over a short period of time, typically a year. This element of pay is also generally paid in cash, although some companies settle a portion of STIs in equity. Lastly, the LTI typically refers to the portion of pay that is dependent on the executive achieving performance targets that are evaluated over a longer term, typically three to five years. There are some exceptions to this, such as retention shares. LTIs are generally settled in equity or somehow linked to the share price performance of the company in question.

We prefer a greater weighting to LTIs as a percentage of the total reward opportunity. In our view, this creates improved alignment with long-term shareholders. Furthermore, performance-based pay should be subject to sufficiently stretching performance targets to ensure that executives only get paid this portion if they have created shareholder value.

We believe it is important for executives to own shares in the company they manage, as this incentivises them to think like owners. We encourage companies to implement formal minimum shareholding requirements (MSRs) to ensure that executives build and maintain a meaningful stake in the business. In our experience, it is crucial that the MSRs have an enforcement mechanism where executives are restricted from cashing out a portion of their performance-based pay until the required shareholding level is achieved. We also support the incorporation of malus and clawback provisions into executive remuneration policies. They have become a universally accepted corporate governance practice aimed at curtailing excessive risk-taking, discouraging short-termism and enhancing executive accountability.



The rating scale for the shareholding component of our qualitative scorecard is shown below. We have a strong preference for executives to own shares in the companies they manage, as there is no better way of ensuring that executives think like shareholders. In our assessment, we consider the tenure of executives and look for reasonable progress towards building a material position.

		Excellent	Good	Average	Poor
Alignment	Shareholding	A strong MSR is in place with an enforcement mechanism and/or post-employment holding requirements. Executives' actual shareholdings are material.	An MSR is in place, and progress is being made OR there is no MSR, but actual shareholdings are material.	An MSR is in place, but progress has not been made where opportunities for progress have been sensible.	There is no MSR in place and/or executives have immaterial shareholdings.

Pay-performance correlation

There should be a clear link between performance-based pay and the performance outcomes of an executive, which are usually measured by a range of financial and non-financial factors. Ideally, this performance-based pay should not be affected by factors outside the executive's control, such as a cyclical upswing in an industry. Such considerations should be adjusted for as far as possible, for example, by comparing the total shareholder return of a company to those of comparable companies that are affected by similar exogenous factors. Similarly, an executive who performs much better than their peers in a struggling industry should be rewarded accordingly.

Median or average performance should earn minimal performance-based pay. In other words, base pay should not be disguised as performance-based pay. If all executives in an industry are simultaneously being rewarded for performance above the mean, whose performance was below average?

While we support the inclusion of non-financial performance measures such as ESG-related metrics, when relevant and material, we prefer the mix of performance factors to be geared towards financial rather than non-financial measures. Shareholders often have little insight into whether performance is measured robustly on non-financial measures and we have seen these abused at several companies, where soft factors are referenced to grant executives large payouts despite poor financial performance. Furthermore, the quality of strategic decision-making by executives typically drives long-term financial performance and business sustainability. Reliance on financial measures provides some level of comfort that executives and shareholders are rewarded in tandem.

We recognise that there will probably always be some element of chance in performance-based remuneration. Remuneration committees should attempt to control for this as far as possible, as explained below.

Quantum

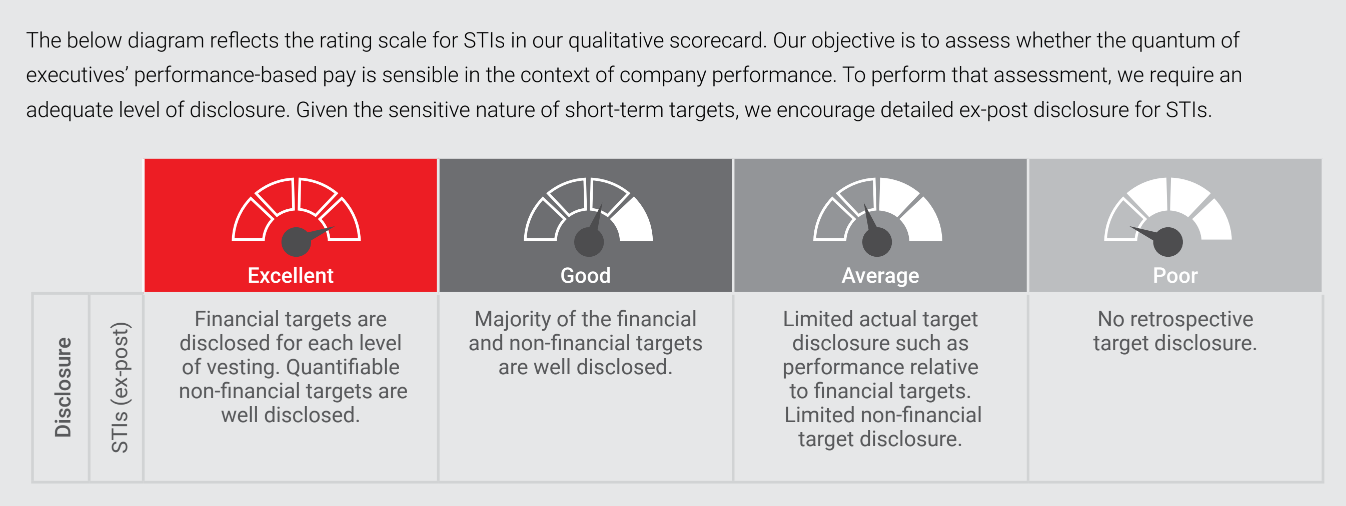
A comparative benchmark analysis is a good starting point for evaluating the quantum of executive pay. In our view, an executive's base salary and performance-based pay, respectively, should not materially exceed the median base salary and performance-based pay offered for comparable roles in similar companies. While this serves as a useful sense check, it might not be appropriate in all instances.

It is also important to remain cognisant of the risk of the unwarranted escalation in executive pay levels as companies continuously upgrade pay packages to match those of their peers. Some companies operate in industries that have unsustainably high levels of executive pay, which could render a comparative benchmark analysis ineffective in determining what is "reasonable". It is therefore equally important to assess the quantum of pay in absolute terms and, where relevant, use other reasonability assessments such as executive pay versus median employee pay at the company in question. Potential performance-based pay should also be capped unless the executive is willing to bear unlimited downside risk to match unlimited upside potential.

Disclosure

There should be sufficient disclosure for shareholders to evaluate the above considerations. We believe that disclosure should allow shareholders to follow performance-based remuneration from the remuneration policy through to the outcomes in the implementation report. We encourage remuneration committees to disclose targets used to assess the performance of executives as well as the methodology applied in determining the value of performance-based awards made to each of the company's executives.

For STIs, we encourage retrospective (ex-post) disclosure of the factors that are considered in determining quantum, the weighting assigned to each factor and an assessment of how executives performed versus the target on each of these factors. How these considerations translate into the quantum of awarded STIs should also be disclosed.



We encourage the same level of disclosure for LTIs, except that performance targets should be stated upfront instead of ex-post. After-the-fact disclosure means that shareholders cannot assess whether targets are sufficiently stretching in advance. Disclosures should be made both for LTIs that vest during the year under review and for those awarded during the year under review.

A lack of disclosure can lead to a strong remuneration scheme not receiving support due to the inability of shareholders to adequately evaluate it. We strongly encourage transparency in both the remuneration policy and implementation report.

Discretion

In principle, we are not opposed to the use of discretion by remuneration committees. However, discretion can be misused to reward executives inappropriately in periods of underperformance, undermining the notion of "pay for performance".

That said, we realise that a completely formulaic approach to determining pay outcomes might not always be appropriate. In cases where formula-based outcomes do not adequately reflect executive performance and shareholder experience, we encourage remuneration committees to apply judgement to determine fair remuneration outcomes.

Where discretion is applied, either to allow for vesting of awards where performance targets are not met or to adjust the value of vested awards, remuneration committees should provide a clear indication and adequate justification of how they arrived at the adjusted outcomes through annual reports so that shareholders can determine whether discretion has been duly exercised. We consider whether symmetry exists in the application of discretion: Is discretion only applied to increase rewards when metrics do not capture good performance, or equally, to decrease them when metrics overstate performance?

We encourage remuneration committees to exercise discretion pragmatically and only when deemed necessary. In our framework, we view discretion as overarching, as it can be applied to any aspect of the remuneration framework.

The JSE requires companies with a primary listing on the exchange to table separate non-binding advisory votes on the remuneration policy and the implementation report at annual general meetings. These are important resolutions, as they provide shareholders with a direct say on executive remuneration. JSE-listed companies are also required to engage with dissenting shareholders if either report fails to garner more than 75% approval.

We believe that we can play a constructive role in the continued improvement of companies' remuneration schemes, either through engagement or by recommending that our clients vote against policies or implementation reports which have fallen materially behind current best practice. An adverse voting recommendation typically leads to discussions with the remuneration committee on how we believe the current scheme could be improved, even when not required by the JSE. It is important to note that a recommendation to our clients to vote against a company's remuneration policy or implementation report does not necessarily suggest that we lack confidence in the company's executive directors. Similarly, a favourable recommendation does not necessarily suggest that we are completely satisfied with all aspects of the policy or report.

Where there have been egregious remuneration outcomes despite our efforts at engagement or the recommendation of dissenting votes, we may consider voting against the reappointment of members of the remuneration committee in question.

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