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ARTICLE | FEB 2026

Rethinking Long-Term Incentive Metrics Through the Investor Lens

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Total shareholder return (TSR) has become the default long-term incentive (LTI) metric for public companies. Its appeal is clear, since it is observable, externally validated, and intuitively aligned with shareholder outcomes. However, this obscures a critical distinction. TSR is an *investment outcome*, not a universal *measure of management performance*. TSR reflects not only operating execution, but also valuation changes, timing, and macro-economic forces outside management's control, especially over fixed LTI cycles.

Recognizing the limitations of TSR has led many boards to consider return on invested capital (ROIC) as a better alternative. Unlike TSR, ROIC seeks to distinguish the returns produced by management from those influenced by market valuation factors. While that instinct is directionally correct, it carries its own risk. ROIC is a compelling performance management metric when used correctly, but its effectiveness as an LTI tool varies considerably by industry. Investors understand that ROIC should not be employed uniformly, and compensation committees should adopt a similar approach.

The real question is not TSR versus ROIC, but rather how do investors assess value creation in a specific business, and which metrics best capture management's controllable contribution to it? For boards and compensation committees, this reframing has practical implications. Long-term incentive design should follow the economics of the business—not convention—and should mirror how investors evaluate value creation in each industry.

How Investors Actually Evaluate Performance

Across industries, long-term investors tend to anchor their analysis around three questions:

1. Does the company generate economic returns above its cost of capital?
2. Can it reinvest at attractive returns, and for how long?
3. What valuation am I paying today for those future cash flows?

While these investor questions are consistent across the public company spectrum, the metrics used to answer them can vary by industry. In capital-intensive businesses, returns on capital are pivotal. In intangible- or risk-driven businesses, investors rely on various alternatives for economic value creation. To understand what should be measured in LTIs, it helps to understand how investors underwrite value.

Why Investors Use TSR but Rarely as a Measure of Management Skill

Investors care about TSR because it measures what they earn. However, sophisticated investors rarely treat TSR as an indicator of management effectiveness. Instead, they break down returns into:

- Fundamental performance (earnings and cash flow growth)
- Capital allocation decisions
- Valuation change driven by market expectations

Only the first two are meaningfully attributable to management decisions. Valuation change, often the dominant driver of TSR over a short-to-medium time horizon, is shaped by external forces.

Proponents of TSR-centric incentive plans often point to their objectivity, transparency, and alignment with shareholder experience. These are legitimate considerations. TSR is externally validated, difficult to manipulate, and easily understood by investors and proxy advisors. For these reasons, it has become embedded in incentive design practice.

However, these strengths explain why TSR is useful as a reference point, not why it should serve as the primary measure of management performance. Objectivity does not equal controllability, and alignment with shareholder outcomes does not guarantee alignment with the decisions that created those outcomes. Investors recognize this distinction, and compensation design should reflect a similar perspective.

ROIC: Powerful in Some Industries, Misleading in Others

ROIC is discussed here not as a universal incentive metric, but as the most common example of how investors tailor performance evaluation to underlying business economics. ROIC plays a significant role in investor analysis where capital economics are real, observable, and repeatable. In other contexts, it becomes incomplete or actively distortive. The table below illustrates how investor evaluation frameworks differ by industry, and the resulting implications for LTI design.

ROIC Applicability	Industries	Economic Characteristics	How Investors Evaluate Value Creation	Implications for LTI Design

ROIC Works Well	Industrials Manufacturing Consumer Products Energy Utilities Infrastructure	• Tangible capital bases • Large, discrete investment decisions • Clear link between capital deployment and cash flows	• Investors explicitly price ROIC and ROIC vs. WACC (weighted average cost of capital) • Capital efficiency drives valuation	• ROIC or economic profit can be a primary LTI metric • Pair with free cash flow (FCF) to avoid underinvestment
ROIC Requires Modification	Technology Software Digital Platforms	• Heavy intangible investment • Accounting capital understates economic capital	• Investors infer efficiency through FCF scalability, margins, unit economics, and retention	• Use adjusted or directional ROIC • Anchor incentives in FCF and unit economics
	Healthcare Pharmaceuticals	• Long R&D cycles • Binary outcomes • Delayed payoffs	• Investors focus on pipeline quality and portfolio economics	• Use ROIC only at consolidated level • Pair with objective R&D milestones
ROIC Breaks Down	Financial Services	• Capital is both input and constraint • Leverage and risk dominate	• Investors rely on risk-adjusted return on capital (RAROC), return on assets (ROA), return on equity (ROE) with capital and risk guardrails	• Avoid ROIC • Use risk-adjusted returns and balance-sheet metrics
	Early-Stage / Pre-Profit	• Negative returns are expected • Economies not yet stabilized	• Investors underwrite growth efficiency and unit economics	• Avoid ROIC • Introduce later as the business matures

The point is not ROIC itself, but choosing incentive metrics that match how investors value the business.

What This Means for LTI Design

The investor lens does not point to a single "best" metric. It points to fit-for-purpose metric selection. Well-designed LTI plans reflect how investors underwrite value in a specific industry:

- Capital-intensive businesses: ROIC or economic profit paired with free cash flow
- Intangible-driven growth businesses: cash flow scalability, margins, and unit economics
- Risk-based or regulated businesses: risk-adjusted returns and capital strength

- Innovation-driven businesses: milestone-based measures tied to long-term economics

Where ROIC loses explanatory power, investors do not abandon the concept of economic discipline. Instead, they substitute metrics that better capture the same question—whether management is converting resources into durable, risk-adjusted value over time.

Why TSR Still Belongs in the Plan

Across all industries, TSR has a role, but as a validation mechanism, not the core performance driver. From an investor perspective, TSR works best as a reasonableness check:

- Does pay broadly move with shareholder experience over time?
- Are extreme windfalls or disconnects avoided?

Using TSR as a modifier, cap, or secondary screen preserves alignment optics without allowing market volatility to dominate pay outcomes. This mirrors how investors think. Market performance confirms value creation, but it does not define it.

Importantly, this approach is compatible with current governance and disclosure expectations. Retaining TSR as a modifier or cap preserves alignment optics for shareholders and proxy advisors, while allowing companies to designate a more controllable financial or operational measure as the primary performance metric. Framed appropriately, this structure strengthens the link between pay and performance by reducing windfalls and clarifying how management creates value over time.

Alignment Means Paying for the Right Things

Investors do not evaluate all companies through a single metric, and compensation committees should not either. TSR reflects shareholder outcomes but conflates management skill with market forces. ROIC is a powerful measure where capital economics are clear and a blunt instrument where they are not.

The investor lens offers a simple durable lesson: pay executives for the drivers of value creation in a specific business, not for the market's short-term appraisal of them. Long-term incentive plans built on that principle are more precise, more credible, and more aligned with shareholder interests.

In the end, compensation committees must decide whether long-term incentives are meant to reward management for decisions that compound value or for market movements they may not control. Viewing incentive metrics through the investor lens brings more precision and accuracy to pay-for-performance alignment.

About the Author

Eric has 20+ years advising boards and management teams on executive compensation programs that are market-competitive, strategy-aligned, and compliant.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.