**Relative Performance Benchmarks: Do Boards Get It Right?**

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**Executive Summary:**

The explicit usage of relative performance based (RPE) grants has been steadily increasing. The common wisdom behind such grants is that they help induce costly effort from the CEO either within a contracts or tournaments-based framework. This paper is the first to assess the efficacy of firms' self-reported RPE benchmarks in filtering out the common component of stock returns as disclosed in their proxy statements, analyze their implications for firm performance, and examine the factors that drive differences in benchmarking quality of their chosen benchmarks. Findings raise questions about the appropriateness of index-based benchmarks for RPE contracts in lieu of a specific peer set.

**Abstract:**

Standard principal-agent models predict that the board will design incentive contracts that filter out common shocks in performance to motivate costly effort from the CEO—a process that entails the judicious selection of benchmarks for relative performance evaluation (RPE). This paper evaluates the efficacy of firms' chosen RPE benchmarks and documents that, relative to a normative benchmark, index-based RPE benchmarks perform 14% worse in their time-series return-regression R2; firms choosing specific peers as RPE benchmarks only modestly underperform. Structural estimates suggest that index-based benchmarks exhibit at least 16% greater measurement error variance and imply an average performance penalty of 106 to 277 basis points in annual returns. Finally, reduced-form estimates suggest that ineffective and index-based RPE benchmarks are associated with poorer corporate governance and lower realized ROA and stock returns. Collectively, these findings provide new evidence on the explicit practice of RPE and their implications for corporate governance and firm performance.

**Keywords:** Empirical Contract Theory; Relative Performance Evaluation; Common Shock Filtration; Search-Based Peers; Board Of Directors; Governing and Advisory Boards; Executive Compensation; Performance Evaluation; Corporate Governance