Vanguard

Vanguard Investment Stewardship Insights

Our executive pay philosophy

May 2024

We believe well-structured, transparent, performance-linked executive pay policies and practices are fundamental drivers of sustainable, long-term investment returns for a company's shareholders. Providing effective disclosure of pay policies, their alignment with company performance, and their outcomes is crucial to giving shareholders confidence in the link between executives' incentives and the creation of long-term returns for shareholders.

This piece highlights our three main areas of focus for evaluating executive pay plans on behalf of the Vanguard-advised funds.[1]

What we look for in pay plans

We assess all compensation plans on a case-by-case basis and do not believe there is a one-size-fits-all approach to executive pay, as norms and expectations for executive pay vary by industry type, company size, company maturity, and region.

We do, however, look for all plan components within an executive pay plan to be rigorously designed, thoroughly disclosed, and tied to long-term performance goals related to the company's strategic objectives and/or material risks. When we have questions about an executive pay plan, we look to engage with companies to understand more about the plan's structure and outcomes and the compensation committee's process.

Our three areas of focus when we evaluate executive pay plans include:

Alignment of pay and performance:

- We look for evidence of clear alignment between pay outcomes and company performance. This is mainly assessed by evaluating the alignment of incentive targets with corporate strategy and analyzing the three-year total shareholder return and realized pay over the same period compared with a relevant set of peer companies.

1 Vanguard's Investment Stewardship program is responsible for proxy voting and engagement on behalf of the quantitative and index equity portfolios advised by Vanguard (together, "Vanguard-advised funds"). Vanguard's externally managed portfolios are managed by unaffiliated third-party investment advisors, and proxy voting and engagement for those portfolios are conducted by their respective advisors. As such, throughout this document, "we" and "the funds" are used to refer to Vanguard's Investment Stewardship program and Vanguard-advised funds, respectively.

Compensation plan structure:

- We look for plans in which variable compensation makes up most of the executives' total pay and is measured with a long-term focus. We look for boards to set rigorous targets that incentivize long-term shareholder returns, and to disclose performance against these targets.
- We believe a company's compensation committee is in the best position to determine the appropriate set of metrics based on that company's strategic direction and industry conditions. Although we are not prescriptive as to the type of metrics used, we consider several elements when evaluating pay plan structure, including the following:
  - We prefer that incentive plans be grounded primarily in quantitative metrics that are measurable and relate to business strategy and/or material risks. In cases where qualitative metrics are used, we look for disclosure explaining how such metrics are assessed.
  - To better incentivize company outperformance relative to a relevant set of peers, we encourage the inclusion of relative performance metrics, such as relative total shareholder returns or relative operating metrics. Relative metrics may help align executive pay during both good and poor market conditions by protecting against outsized (or undersized) payments to executives. Relative metrics can be used alongside appropriate absolute metrics with rigorous targets aligned with shareholder value creation.
  - When compensation committees choose to include nonfinancial metrics, we look for the same qualities as in financial metrics such as rigor, disclosure, and alignment with key strategic goals and/or material risks. For more information about how we think about the use of nonfinancial metrics, such as environmental, social, and governance (ESG) metrics in pay programs, please refer to our Insight on ESG Metrics in Compensation Plans.

Governance of compensation plans:

- Investors should be able to evaluate whether incentives tied to metrics can drive company performance. To assess this, we look for robust disclosure that ensures investors understand a compensation committee's decisions and the rationale that underlies them. For example, why has a particular metric been introduced, and why now? Disclosures should include how the chosen metrics align with the company's strategy or address a material risk or business opportunity. Disclosure of targets and/or achievement levels against quantitative and qualitative targets can help investors better understand how payouts relate to company performance.
- When shareholders have expressed concerns about a plan's outcomes or structure, we look for committees to be responsive to investor feedback and questions. This responsiveness could include an explanation of the decisions made within the structure of the compensation plan, engagement with shareholders to understand their reactions, or considered and implemented changes to the plan reflecting engagement with shareholders.
- Adjustments to a pay plan outside of the preselected targets and thresholds could indicate that the plan's structure is not effectively driving outcomes, which may lead to a company overpaying for underperformance. Any use of discretion with respect to a plan or metric should be accompanied by thorough disclosure of the rationale so investors can properly understand the compensation committee's decision-making process and any guardrails that have been established alongside the metric. With this philosophy in mind, we look for compensation committees to sufficiently explain significant discretionary changes to compensation outcomes.

Vanguard publishes Investment Stewardship Policy and Voting Insights to promote good corporate governance practices and to provide public companies and investors with our perspectives on important governance topics and key votes. This is part of our effort to provide useful disclosure of Vanguard's investment stewardship voting and engagement activities. We aim to provide clarity on Vanguard's stance on governance matters beyond what a policy document or a single vote can provide. Insights should be viewed in conjunction with the most recent region- and country-specific voting policies.

The funds for which Vanguard acts as investment advisor (Vanguard-advised funds) retain the authority to vote proxies that the funds receive. To facilitate the funds' proxy voting, the boards of the Vanguard-advised funds have adopted Proxy Voting Procedures and Policies that reflect the fund boards' instructions governing proxy voting. The boards of the funds that are advised by managers not affiliated with Vanguard (external managers) have delegated the authority to vote proxies related to the funds' portfolio securities to their respective investment advisor(s). Each external manager votes such proxies in accordance with its own proxy voting policies and procedures, which are reviewed and approved by the fund board annually.

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