

June 4, 2021

Rob Feckner
Performance, Compensation & Talent Management Committee Chair
California Public Employees' Retirement System
400 Q Street
Sacramento, California 95811

Dear Rob,

Re: Annual Incentive Plan Metrics and Additional Considerations

This memo is in response to your request for Global Governance Advisors ("GGA"), in its role as CalPERS' Board compensation consultant, to provide a review of the proposed annual incentive plan metrics for Fiscal Year 2021-2022.

Background:

The current metrics used within the Annual Incentive program were first introduced as part of a new annual incentive plan for the 2016-2017 fiscal year with shared organizational metrics that aligned awards for all positions to the following performance areas:

- Fund Performance (both Total Fund and Asset-Class based)
- Enterprise Operational Effectiveness
- Investment Office CEM Results
- Customer Service
- Stakeholder Engagement

These metrics have continued to be used by CalPERS since then with higher performance expectations set for the Stakeholder Engagement metric in recent years and a decision in Fiscal Year 2019-2020 to move to measuring Fund performance entirely based on Total Fund performance with no weighting on Asset Class performance or Individual investment performance.

Summary of GGA's Assessment:

GGA has reviewed the proposed annual incentive metrics for Fiscal Year 2021-2022 and believes that the metrics still meet the needs of CalPERS at this time. They align to CalPERS mission and strategy while continuing to encourage teamwork by tying CalPERS management to a consistent set of metrics.

While GGA is comfortable with the proposed annual incentive metrics, upon further historical analysis, GGA recommends adjustments to the performance expectations for Customer Service and Stakeholder Engagement. In addition to GGA's recommended adjustments to performance expectations for Customer Service and Stakeholder Engagement in Fiscal Year 2021-2022, GGA also recommends that it work collaboratively with Wilshire Investments LLC to perform a detailed review

of the appropriateness of the Total Fund and Asset Class benchmark indices and variance from benchmark hurdle rates during Fiscal Year 2021-2022 for potential adjustment for Fiscal Year 2022-2023. This detailed review would include market analysis of the benchmark indices used by other peers, variance from benchmark hurdle rates used by peers as well as an objective historic assessment of the performance variance levels and associated payout ratios over the last 5 to 10 years internally at CalPERS. It will also include further analysis of whether to include Asset Class investment performance directly within the Annual Incentive Plan for Asset Class professionals. Given that it has been several years since a detailed review has been performed and that a permanent CIO should be named in the coming months, the purpose of this work is to provide the Board with a greater insight into the reasonableness and market competitiveness of the benchmark indices and performance levels used under the plan to ensure continued confidence in performance expectations moving forward. It will also allow for better alignment with the vision and strategy of the new permanent CIO.

Provided below are more details surrounding GGA’s recommendations for the proposed annual incentive metrics for Fiscal Year 2021-2022.

Corporate Performance Metric Review Details:

Metric #1: Total Fund Performance

NO CHANGE FOR FISCAL YEAR 2021-2022

This metric is based on fund performance against the policy benchmark for the five-year period of July 1, 2017, through June 30, 2022. Payout ratio for intermediate results will be determined by interpolation.

Variance from Benchmark (bps)	Payout Ratio
+35	1.50 (150%)
+30	1.41 (141.7%)
+20	1.25 (125%)
+5	1.00 (100%)
0	0.76 (76.3%)
-15	0.05 (5%)
<-15	0.00 (0%)

Please Note: While GGA is satisfied through its discussions with Wilshire Investments LLC (CalPERS’ investment consultant) that the current variance from benchmark levels are reasonable for the upcoming fiscal year, GGA recommends that it work collaboratively with Wilshire Investments LLC to perform a detailed review of the appropriateness of the Total Fund and Asset Class benchmark indices and variance from benchmark hurdle rates during Fiscal Year 2021-2022 for potential adjustment for Fiscal Year 2022-2023. This detailed review would include market analysis of the benchmark indices used by other peers, variance from benchmark hurdle rates used by peers as well as an objective historic assessment of the performance variance levels and associated payout ratios over the last 5 to

10 years internally at CalPERS. Given that it has been several years since a detailed review has been performed and that a permanent CIO should be named in the coming months, the purpose of this work is to provide the Board with a greater insight into the reasonableness and market competitiveness of the benchmark indices and performance levels used under the plan to ensure continued confidence in performance expectations moving forward. It will also allow for better alignment with the vision and strategy of the new permanent CIO.

Metric #2: Enterprise Operational Effectiveness

NO CHANGE FOR FISCAL YEAR 2021-2022

This metric for 2021-22 is defined as Overhead Operating Costs as a percentage of Total Operating Costs (“OOC”).

- Total Overhead Operating Costs ("OOC") identify all administrative costs not mapped directly to Product and Service Delivery Operating Costs ("PSDOC"); excludes Board and Third-Party Administrator Costs
 - $OOC = OOC / (OOC + PSDOC)$

Score	Payout Ratio
< -1.1%	1.50 (150%)
-1.1% to < -0.6%	1.25 (125%)
-0.6% to 0.0%	1.00 (100%)
> 0.0% to 1.0%	0.75 (75%)
> 1.0% to 1.5%	0.50 (50%)
> 1.5%	0.00 (0%)

Metric #3: Investment Office CEM

NO CHANGE FOR FISCAL YEAR 2021-2022

This metric for 2021-22 is determined by CalPERS annual participation in the CEM benchmarking survey and shows how CalPERS’ investment costs and return performance compares to a customized peer group over a five-year period.

Score	Payout Ratio
Outperforms US Benchmark on Net Value Added (Returns) and Cost by 0.2% and 5 bps, respectively	1.50 (150%)
Outperforms US Benchmark on Returns and Cost by .001% and 1 bps, respectively	1.00 (100%)
Outperforms US Benchmark on Cost or Outperforms US Benchmark on Returns	0.50 (50%)
Underperforms US Benchmark on Returns and Cost	0.00 (0%)

Metric #4: Customer Service

PROPOSED CHANGES FOR FISCAL YEAR 2021-2022

This metric for 2021-22 is based on two Service Dimensions:

- Benefit Payment Timeliness: Percentage of benefit payments issued to our customers within established service levels
- Customer Satisfaction: Customer service with CalPERS services as measured by surveys and other methods

In the interest of improving Customer Service performance throughout the CalPERS System and the maintenance of a fair and defensible structure, GGA recommends the following changes to the 2021-22 Customer Service performance levels and related payout ratios:

Past 2020-21 Metrics

Score	Payout Ratio
≥ 95%	1.50 (150%)
94% to < 95%	1.25 (125%)
92% to < 94%	1.00 (100%)
90% to < 92%	0.75 (75%)
88% to < 90%	0.50 (50%)
< 88%	0.00 (0%)



Proposed 2021-22 Metrics

Score	Payout Ratio
≥ 96%	1.50 (150%)
95% to < 96%	1.25 (125%)
94% to < 95%	1.00 (100%)
93% to < 94%	0.75 (75%)
92% to < 93%	0.50 (50%)
< 92%	0.0 0%)

The following table outlines how our proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Actual	88%	63%	38%
Ideal	80%	60%	20%
Proposed	88%	63%	25%

Please Note: The objective assessment and rationale for the recommended changes in the above scores are outlined in **Appendix A (Pages 8-9)**. The purpose of the assessment is to address concerns trustees had around the historic performance and payouts in this area. As a result of this assessment, GGA is recommending adjustments to the overall scores/performance hurdles to better align them with our recognized probability levels over the past few years.

Metric #5: Stakeholder Engagement

PROPOSED CHANGES FOR FISCAL YEAR 2021-2022

This metric for 2021-22 is based on results of the following three Stakeholder Engagement Survey questions:

- Is CalPERS sensitive to the needs of Stakeholders?
- Does CalPERS do a good job of keeping its stakeholders informed?
- On a scale of one to ten, how would you rate CalPERS being effective in engaging and communicating with stakeholders?

In the interest of improving Stakeholder Engagement performance throughout the CalPERS System and the maintenance of a fair and defensible structure, GGA recommends the following changes to the 2021-22 Stakeholder Engagement performance levels and related payout ratios:

Past 2020-21 Metrics

Score	Payout Ratio
> 83%	1.50 (150%)
> 81% to 83%	1.25 (125%)
> 79% to 81%	1.00 (100%)
> 77% to 79%	0.75 (75%)
> 75% to 77%	0.50 (50%)
≤ 75%	0.00 (0%)



Proposed 2021-22 Metrics

Score	Payout Ratio
≥ 82%	1.50 (150%)
81% to < 82%	1.25 (125%)
80% to < 81%	1.00 (100%)
79% to < 80%	0.75 (75%)
78% to < 79%	0.50 (50%)
< 78%	0.00 (0%)

The following table outlines how our proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Actual	100%	60%	0%
Ideal	80%	60%	20%
Proposed	100%	60%	20%

Please Note: The objective assessment and rationale for the recommended changes in the above scores are outlined in **Appendix A (Pages 10-11)**. Again, the purpose of the assessment is to address concerns trustees had around the historic performance and payouts in this area. As a result of this assessment, GGA is recommending adjustments to the overall scores/performance hurdles to better align them with our recognized probability levels over the past few years. Under this proposal, the Minimum performance expectation is increased, while the Maximum performance expectation is slightly decreased in order to better align with ideal attainment levels over a 5-year period and put in place a more symmetrical payout curve.

Potential Alternative Scoring & Payout Ratio for 2021-22

Score	Payout Ratio
≥ 83%	1.50 (150%)
81% to < 83%	1.25 (125%)
80% to < 81%	1.00 (100%)
79% to < 80%	0.75 (75%)
78% to < 79%	0.50 (50%)
< 78%	0.00 (0%)

The following table outlines how our proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Actual	100%	60%	0%
Ideal	80%	60%	20%
Proposed	100%	60%	0%

Please Note: Stakeholder Engagement is understandably a very important element and under no circumstances does the Board want to unintentionally signal to its stakeholders that engagement with them is not being maintained as a key priority. Therefore, GGA is open to maintaining the 83% maximum performance metric as an alternative to its original proposed Scoring and Payout Ratio structure to signal to CalPERS stakeholders that high satisfaction levels should always be a goal of CalPERS staff. However, GGA points out that an adjustment of the lower end but not at the upper end will lead to the adoption of an asymmetrical payout curve and not align as closely with the Ideal 80%-60%-20% objective probability framework for Threshold, Target, and Maximum performance.


Rob, we trust that this letter addresses your concerns on this matter. If you have any questions on the contents within this letter, please let us know.

Sincerely,

Global Governance Advisors



Peter Landers
Senior Partner



Brad Kelly
Partner

cc: Karen Van Amerongen, CalPERS
cc: Luis Navas, Global Governance Advisors

Appendix A: Historic Probability Assessment and Metrics Adjustment Recommendations

Background:

As part of our ongoing compensation advisory work, GGA recently conducted a high-level incentive metric review for the PCTM Committee and on behalf of the CalPERS Board. In its work, GGA conducted one-on-one interviews with most of the trustees to collect their views and opinions on the compensation program and related processes.

When discussing the overall fairness of the CEO Incentive Plan, many trustees mentioned that they had some uncertainty around two key performance areas and asked that we look deeper into the metrics. These two areas were: Stakeholder Engagement and Customer Service.

As a result, this appendix contains a probability assessment of these areas and the rationale behind GGA's suggested changes in these two areas.

Related Historic Data:

The following table shows the related historic data from 2012 to 2020 provided to GGA:

Year	CalPERS Performance History (%)	
	Customer Service	Stakeholder Engagement
3-Year Avg (2012-2015)	91.39%	-
3-Year Avg (2013-2016)	93.61%	-
3-Year Avg (2014-2017)	93.61%	-
3-Year Avg (2015-2018)	94.39%	-
3-Year Avg (2016-2019)	94.92%	79.68%
3-Year Avg (2017-2020)	96.26%	80.70%
2012-13	87.50%	-
2013-14	92.00%	-
2014-15	94.67%	-
2015-16	94.17%	-
2016-17	92.00%	78.33%
2017-18	97.00%	78.37%
2018-19	95.77%	82.33%
2019-20	96.00%	81.39%
Performance Quartiles (%)		
75th Percentile	95.83%	81.63%
50th Percentile	94.42%	79.88%
25th Percentile	92.00%	78.36%
Average	93.64%	80.11%
Standard Deviation	3.07%	2.06%

Notes:

(1) Performance data was provided by CalPERS.

Customer Service – Historical Analysis against 2020-21 Performance Hurdles

The Customer Service metric is comprised of performance in six key areas:

- Service Retirement satisfaction
- Member Education
- CalPERS Education Events Satisfaction
- Employer Education & Leadership Dialogue
- Service and Disability Retirement Payments
- Timely Resolution of public agency reviews

Prior to the implementation of a new incentive plan in Fiscal Year 2016-2017, CalPERS based this metric on a subset of these areas and therefore GGA used the base data to calculate performance results similar to the consolidated scores implemented and utilized in and after Fiscal Year 2016-17. Assessing probabilities over an eight-year period, GGA produced the following:

Customer Service				
Year	Annual Performance	2021-22 Incentive Performance Hurdles		
	CalPERS Actual	Threshold	Target	Maximum
3-Year Avg (2012-2015)	91.39%	88.00%	93.00%	95.00%
3-Year Avg (2013-2016)	93.61%	88.00%	93.00%	95.00%
3-Year Avg (2014-2017)	93.61%	88.00%	93.00%	95.00%
3-Year Avg (2015-2018)	94.39%	88.00%	93.00%	95.00%
3-Year Avg (2016-2019)	94.92%	88.00%	93.00%	95.00%
3-Year Avg (2017-2020)	96.26%	88.00%	93.00%	95.00%
2012-13	87.50%	88.00%	93.00%	95.00%
2013-14	92.00%	88.00%	93.00%	95.00%
2014-15	94.67%	88.00%	93.00%	95.00%
2015-16	94.17%	88.00%	93.00%	95.00%
2016-17	92.00%	88.00%	93.00%	95.00%
2017-18	97.00%	88.00%	93.00%	95.00%
2018-19	95.77%	88.00%	93.00%	95.00%
2019-20	96.00%	88.00%	93.00%	95.00%
75th Percentile	95.83%	Historical Annual Probability of Attainment		
50th Percentile	94.42%	Threshold	Target	Maximum
25th Percentile	92.00%	88%	63%	38%

2021-22 Performance Targets		Frequency of Historical Performance Compared to FY2021-22 Targets	
Maximum	95.00%	At or Above Maximum	>= 95%
Target	93.00%	Between Target and Maximum	> 93%; < 95%
Threshold	88.00%	At Target	= 93%
		Between Threshold and Target	> 88%; < 93%
		At or Below Threshold	<= 88%

Based on the calculated annual probabilities, it is clear that the lower threshold target and maximum performance levels are relatively low and could be adjusted without any real change in probability except for the maximum performance target.

Customer Service – Historical Analysis against Updated Performance Hurdles

Using the same historic data and adjusting the targets and narrowing the performance ranges results in the following assessment:

Customer Service				
Year	Annual Performance	2021-22 Incentive Performance Hurdles		
	CalPERS Actual	Threshold	Target	Maximum
3-Year Avg (2012-2015)	91.39%	92.00%	94.00%	96.00%
3-Year Avg (2013-2016)	93.61%	92.00%	94.00%	96.00%
3-Year Avg (2014-2017)	93.61%	92.00%	94.00%	96.00%
3-Year Avg (2015-2018)	94.39%	92.00%	94.00%	96.00%
3-Year Avg (2016-2019)	94.92%	92.00%	94.00%	96.00%
3-Year Avg (2017-2020)	96.26%	92.00%	94.00%	96.00%
2012-13	87.50%	92.00%	94.00%	96.00%
2013-14	92.00%	92.00%	94.00%	96.00%
2014-15	94.67%	92.00%	94.00%	96.00%
2015-16	94.17%	92.00%	94.00%	96.00%
2016-17	92.00%	92.00%	94.00%	96.00%
2017-18	97.00%	92.00%	94.00%	96.00%
2018-19	95.77%	92.00%	94.00%	96.00%
2019-20	96.00%	92.00%	94.00%	96.00%
75th Percentile	95.83%	Historical Annual Probability of Attainment		
50th Percentile	94.42%	Threshold	Target	Maximum
25th Percentile	92.00%	88%	63%	25%

2021-22 Performance Targets		Frequency of Historical Performance Compared to FY2021-22 Targets	
Maximum	96.00%	At or Above Maximum	>= 96%
Target	94.00%	Between Target and Maximum	> 94%; < 96%
Threshold	92.00%	At Target	= 94%
		Between Threshold and Target	> 92%; < 94%
		At or Below Threshold	<= 92%

Customer Service – Effect of Proposed Changes

The following table outlines how our proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Actual	88%	63%	38%
Ideal	80%	60%	20%
Proposed	88%	63%	25%

Stakeholder Engagement – Historical Analysis against 2020-21 Performance Hurdles

Similarly assessing the Stakeholder Engagement metric, the probabilities over a five-year period, GGA produced the following:

Stakeholder Engagement				
Year	Annual Performance	2021-22 Incentive Performance Hurdles		
	CalPERS Actual	Threshold	Target	Maximum
3-Year Avg (2016-2019)	79.68%	75.00%	80.00%	83.00%
3-Year Avg (2017-2020)	80.70%	75.00%	80.00%	83.00%
2016-17	78.33%	75.00%	80.00%	83.00%
2017-18	78.37%	75.00%	80.00%	83.00%
2018-19	82.33%	75.00%	80.00%	83.00%
2019-20	81.39%	75.00%	80.00%	83.00%
75th Percentile	81.63%	Historical Annual Probability of Attainment		
50th Percentile	79.88%	Threshold	Target	Maximum
25th Percentile	78.36%	100%	50%	0%

2021-22 Performance Targets			Frequency of Historical Performance Compared to FY2021-22 Targets	
Maximum	83%		At or Above Maximum	>= 83%
Target	80%		Between Target and Maximum	> 80%; < 83%
Threshold	75%		At Target	= 80%
			Between Threshold and Target	> 75%; < 80%
			At or Below Threshold	<= 75%

Based on the calculated annual probabilities, it is clear that the threshold performance target is relatively low and maximum performance target is relatively high. Therefore, both could be adjusted without any real change in probability except for the maximum performance target.

Stakeholder Engagement – Historical Analysis against Updated Performance Hurdles

Using the same historic data and adjusting the targets and narrowing the performance ranges results in the following assessment:

Stakeholder Engagement				
Year	Annual Performance	2021-22 Incentive Performance Hurdles		
	CalPERS Actual	Threshold	Target	Maximum
3-Year Avg (2016-2019)	79.68%	78.00%	80.00%	82.00%
3-Year Avg (2017-2020)	80.70%	78.00%	80.00%	82.00%
2016-17	78.33%	78.00%	80.00%	82.00%
2017-18	78.37%	78.00%	80.00%	82.00%
2018-19	82.33%	78.00%	80.00%	82.00%
2019-20	81.39%	78.00%	80.00%	82.00%
75th Percentile	81.63%	Historical Annual Probability of Attainment		
50th Percentile	79.88%	Threshold	Target	Maximum
25th Percentile	78.36%	100%	50%	25%

2021-22 Performance Targets		Frequency of Historical Performance Compared to FY2021-22 Targets	
Maximum	82%	At or Above Maximum	>= 82%
Target	80%	Between Target and Maximum	> 80%; < 82%
Threshold	78%	At Target	= 80%
		Between Threshold and Target	> 78%; < 80%
		At or Below Threshold	<= 78%

Stakeholder Engagement – Effect of Proposed Changes

The following table outlines how our proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Actual	100%	50%	0%
Ideal	80%	60%	20%
Proposed	100%	50%	25%