GLOBAL GOVERNANCE ADVISORS

Opinion Letter

April 7, 2022

Incentive Metrics Review for FY2022-2023

Prepared for:

Performance, Compensation & Talent Management Committee

400 Q Street
Sacramento, California 95811

CalPERS California Public Employee Retirement System

Peter Landers
Senior Partner
Global Governance Advisors

peter.landers@ggainc.com
416.799.6640
ggainc.com

Brad Kelly
Partner
Global Governance Advisors

brad.kelly@ggainc.com
416.707.4614
ggainc.com

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 current metrics included within the CalPERS Annual Incentive program for 2021-2022 and provide insights on potential improvements for Fiscal Year 2022-2023. This opinion will include GGA's views on the relative weighting between Quantitative and Qualitative performance within the Annual Incentive formula as well as potential changes to the Total Fund/Asset Class investment performance expectations, Enterprise Operational Effectiveness and Stakeholder Engagement metrics used within the plan.

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 Customer Service and Stakeholder Engagement metrics in recent years. A decision was also made 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.

While the metrics have generally worked for CalPERS, there has been some question in recent years around the relative weighting between Quantitative and Qualitative performance within the Annual Incentive program as well as how to properly measure Overhead Operating Costs. A more recent concern is what to do with the Stakeholder Engagement metric in situations where there is a materially low response rate to survey questions.

GGA notes little concern with the Investment Office CEM and Customer Service metrics and therefore does not recommend any changes being required to these metrics at this time.

This memo is intended for information purposes with GGA coming back to the Performance, Compensation and Talent Management ("PCTM") Committee in June with formal recommendations for Fiscal Year 2022-2023 performance metrics and hurdles provided at that time.

Typical Performance Metrics Observed in the Pension Fund Industry

In GGA's consulting experience working with countless pension funds of all sizes across North America, GGA observes the following performance metrics that are commonly found within Annual Incentive programs:

- Relative Total Fund Return vs. Market Benchmark (measured over one and/or rolling multi-year performance periods),
- Relative Asset Class Returns vs. Market Benchmark (measured over one and/or rolling multi-year performance periods),
- Execution against Strategic Plan Objectives (namely for the CEO), and
- Individual Performance Evaluation (typically Qualitative in nature).

In addition to these common metrics, many pension funds also report the use of:

- Customer Service (i.e., Member Services or Investment Office), and
- Stakeholder Engagement (as measured through surveys and feedback).

Other metrics that are less commonly found, but used in some cases include:

- Total Fund Costs,
- Internal Operational Metrics, and
- Environment-Related Metrics.

Analysis of the types of incentive metrics used at various North American pension funds within CalPERS' peer group is provided in **Appendix A**.

Overall, the performance metrics used by CalPERS cover many important areas at the organizational level by focusing on Investment performance (both from a returns and cost perspective) as well as Customer Service and Stakeholder Engagement which are important areas of performance on the Pension Administration side of CalPERS. The specific areas measured for Customer Service and Stakeholder Engagement around Benefit Payment Timeliness, Customer Satisfaction, as well as meeting the needs of CalPERS' stakeholders and keeping them informed also align with what GGA observes at other North American pension funds. The incorporation of a measure of Operational Effectiveness through the Overhead Operating Costs as a Percentage of Total Operating Costs measure is a market leading practice and provides a way of measuring how the fund is managing its non-investment costs as well.

That said, the biggest gap that GGA continues to observe at CalPERS is the lack of weighting on Asset Class investment performance within the Annual Incentive formula for investment professionals working within a specific asset class. While GGA understands that this change was made in 2019-2020 in the spirit of breaking down silos within the Investment office and focusing all investment staff towards meeting the Total Fund performance expectations of CalPERS, it is misaligned with the majority of the competitive marketplace. The reason for this is the greater line-of-sight and control that an investment professional working within a specific asset class has over the performance of that asset class, which a pension fund wants to reward for when performance is high and penalize when performance is low. With all investment professionals rewarded solely on Total Fund performance, there is less ability to differentiate between higher and lower performers or recognize and reward certain asset class teams that have demonstrated stronger results over a given period.

It is important to note that Total Fund performance is still incorporated within the Annual Incentive formula within North American pension funds, albeit at a smaller weighting than Asset Class performance for investment professionals working within specific asset classes. This still encourages all investment professionals to work together to achieve Total Fund objectives as a sizeable portion of their Annual Incentive is still tied to Total Fund results. Positions such as CEO, CIO, Deputy CIO, and other executive roles with more oversight over Total Fund operations are typically not measured by Asset Class performance and instead, investment performance is measured solely on Total Fund performance within the Annual Incentive formula.

Pension funds that have adopted a Long-Term Incentive Plan ("LTIP") base 100% of the future payout under that plan to forward-looking Total Fund investment performance over the long run (typically 3-4 years in length) for all LTIP-eligible participants. This has the effect of trying to break down any internal silos by aligning all investment and executive staff towards strengthening sustainability and achieving Total Fund performance expectations over the longer-term in order to earn a meaningful LTIP payout at the end of each performance period.

A comparison of CalPERS' current weighting between Total Fund and Asset Class investment performance within its Annual Incentive program for investment professionals working in specific asset classes against the broader pension fund marketplace is provided below.

Comparison of CalPERS to Marketplace - Total Fund vs. Asset Class Performance

CalPERS		Pension Fund Marketplace	
Total Fund Performance	Asset Class Performance	Total Fund Performance	Asset Class Performance
100%	0%	33%-40%	60%-67%

As demonstrated above, CalPERS is overweighted on Total Fund performance within its Annual Incentive formula for Asset Class investment professionals and should consider tying a meaningful portion of the Annual Incentive for Asset Class professionals to the performance of their asset class.

Weighting between Quantitative & Qualitative Performance

GGA notes the concern in recent years at CalPERS that too much weighting is placed on Qualitative performance which is tougher to measure and reward realized performance. It also can open the fund up to criticism and increased levels of scrutiny due to the subjective nature of determining performance.

GGA reviewed the current weighting between Quantitative and Qualitative performance for Annual Incentive-eligible staff at CalPERS and notes the following high-level observations below.

Quantitative vs. Qualitative Performance at CalPERS – Observations

Participant/Group	Observation
CEO	Quantitative weighting is competitive
CIO	Quantitative weighting is below market
COIO	Quantitative weighting is below market
All Investment Management Positions	Quantitative weighting is below market
General Counsel	Quantitative weighting is competitive
Chief Actuary	Quantitative weighting is competitive
CFO	Quantitative weighting is competitive
Chief Operating Officer	Quantitative weighting is competitive
Chief Health Director	Quantitative weighting is competitive

The biggest area identified for improvement is in Investment positions where market practice is to place 70% to 75% weighting on Quantitative performance within the Annual Incentive formula with no more than 25% to 30% weighting allocated to Qualitative performance of the individual in their role.

While generally the weighting on Quantitative performance is competitive for non-investment roles, GGA notes that many of the deputy roles (i.e., COO, CFO, General Counsel, etc.) have no weighting on Total Fund investment performance against benchmark. While GGA agrees that from a risk mitigation standpoint, tying too much of their Incentive to areas such as Total Fund performance where they have less control over and may be incented to “look the other way” in order to drive higher investment results and a higher Incentive payout, market practice is to at least apply some weighting (15% to 25%) on Total Fund performance. This encourages greater teamwork, less silos between Investment and Non-Investment staff, and aligns all Incentive-eligible staff to Total Fund results for a portion of their Incentive payout. It also helps maintain a meaningful overall weighting on Quantitative performance within the Annual Incentive formula, making the results less subjective and easier to defend if challenged by plan stakeholders, media, or the general public.

A more detailed breakdown of the weighing on Quantitative vs. Qualitative performance against typical market practice is provided in **Appendix B**. Specific analysis of how CalPERS compares to equivalent roles within CalSTRS is also provided in **Appendix C**.

Total Fund and Asset Class Investment Performance Expectations

In a separate report, GGA has conducted a historical probability analysis using existing performance expectations for Total Fund and Asset Class performance to evaluate the fairness and reasonableness of the Value-Add expectations relative to benchmark indices. GGA conducted its analysis using the following rule of thumb that organizations look to generally align to when setting performance expectations:

- Threshold Performance: Should be achieved 80% of the time (i.e., in 8 out of 10 years)
- Target Performance: Should be achieved 60% of the time (i.e., in 6 out of 10 years)
- Maximum Performance: Should be achieved 20% of the time (i.e., in 2 out of 10 years)

Historical analysis of the last 5 to 10 years has shown a consistent pattern relating to Total Fund and Asset Class investment performance expectations. The hurdles have been set with a wider range, meaning that CalPERS investment professionals are usually guaranteed to always achieve Threshold performance, but are never able to achieve Maximum performance. This means that their performance tends to fall in between Threshold and Maximum performance on a consistent basis. The setting of current Threshold performance levels below the benchmark return is observed at CalPERS which does not align with other pension funds who set a minimum expectation of meeting the benchmark return. In GGA's experience, there should be more volatility in terms of Incentive payout outcomes which is why setting a narrower performance range from Threshold to Maximum performance (i.e., making it harder to achieve Threshold performance, but also a little easier to achieve Maximum performance) is defensible. This means that it is not a "gimme" that Threshold performance will be achieved and provides more motivation and incentive for investment professionals given there is a more likely chance to achieve Maximum performance and a Maximum multiplier. In GGA's experience, it can be demotivating to affected staff if it becomes expected that a Maximum level of performance is an impossibility and can never be achieved, which is not a desired outcome for any organization.

Enterprise Operational Effectiveness

Questions have arisen recently in two areas relating to the Enterprise Operational Effectiveness metric used within the Annual Incentive formula:

(i) Should Operating Costs include lump sum retirement payments?

(ii) Should the metric used for incentives be the same as a relevant metric focused on as part of CalPERS's strategic plan?

Question #1 – Including Lump Sum Retirement Payments

GGA understands that currently lump sum retirement payments paid out to individuals retiring each year are included within the Operating Cost calculation used in determining Annual Incentives. These lump sum payments are accumulated by retiring employees based on all of their years employed within the California public service and are not limited to just their specific service time within CalPERS. However, CalPERS assumes the full liability to make these payments as they come due upon retirement. In an ideal situation, CalPERS would only be liable for the lump sum retirement payment tied specifically to time at CalPERS which would be calculated and would make sense to include within the Operating Cost formula. However, that is not currently the case, and it would be a large administrative undertaking to separate out CalPERS service time from time spent working within other areas of the California public service. In similar situations to this, GGA has observed organizations exclude the lump sum retirement payment from the Operating Cost calculation as the timing of when someone chooses to retire and the accumulated retirement payment obligation from outside of CalPERS are outside of the control of CalPERS staff and therefore should not penalize them when calculating Operating Costs.

Question #2 – Using the Same Metric for Incentives and Strategic Plan

GGA understands that as part of the new strategic plan for 2022 to 2027 there has been some discussion around tweaking the way in which CalPERS measures Enterprise Operational Effectiveness improvement. Historically, a target of 1.5% to 2% reduction in Overhead Costs has been set annually under the strategic plan, but the new strategic plan calls for a reduction in Overhead Costs as a percentage of Total Administrative Costs compared to a baseline year.

In GGA's experience, targeting a consistent reduction in costs each year is not sustainable as eventually an organization can only cut so many costs before it starts to affect service levels, quality, and employee morale. A growing organization also will be taking on additional costs in order to grow and scale the organization meaning that reducing costs may not even be possible. A better way of measuring performance in this area is to measure the ratio of certain costs (such as Overhead) over total costs for the organization and to ensure that this ratio remains within a reasonable range on an annual basis. This allows for the inevitable increase in Overhead Costs as the organization grows and helps ensure that they do not grow disproportionately to total administrative costs.

GGA is also a proponent of tying incentive metrics directly to metrics outlined within the strategic plan to ensure staff's Incentive compensation is tied directly to success against approved strategic plan objectives, so there is alignment of interests. In this regard, if a new metric/methodology is approved for measuring Operational Effectiveness at CalPERS as part of the 2022-2027 strategic plan, then GGA would have no concern with adjusting the metric used under the Annual Incentive formula.

Stakeholder Engagement

Historically, CalPERS has had high participation rates in the various stakeholder engagement surveys it has conducted with members and other stakeholders, which has allowed CalPERS to have a high degree of confidence in the results of the surveys conducted and performance outcomes that determine payouts under the Annual Incentive plan. However, in recent years CalPERS has experienced lower response rates from certain stakeholder groups to the point that there is some concern that the results of the survey for those groups should be considered in determining performance under the Annual Incentive plan. Ways in which GGA has seen organizations deal with this issue is by setting a minimum participation rate (e.g., either as a total number or as a percentage of eligible respondents) with which to include a group's results in the calculation. Another approach utilized in the marketplace is to aggregate all individual results together and weight each respondent equally as opposed to calculating a simple average of the different group results. While this would require further calibration to ensure performance expectations are fair and reasonable when compared to prior methodology, this would allow CalPERS to avoid having to include a group that has a materially low number of responses and statistically insignificant in the calculation, with weightings that could bias the results positively or negatively.

GGA notes that stakeholder perception survey results continue to be included within the 2022-2027 strategic plan with targets set for each group as well as an overall rating target. Therefore, stakeholder perceptions are still viewed as critically important area for CalPERS to measure when assessing its success against its strategic plan. It is our understanding that CalPERS is working on the development of a new metric relating to participation in the stakeholder perception surveys as part of the 2022-2027 strategic plan as well. While pension funds tend to measure solely the results of stakeholder perception surveys and not necessarily participation rates in the survey, given a new metric is being included in the strategic plan relating to survey participation, GGA would have little concern with adjusting the Stakeholder Engagement metric calculation used within the Annual Incentive to incorporate participation rates.

GGA Recommendations for Consideration

Based on its analysis, GGA feels that CalPERS' Annual Incentive metrics are not broken and that only small tweaks are required moving forward. GGA outlines the following recommendations for CalPERS' consideration, which have been broken down into decisions falling under Board authority and those that can be followed up by the CEO and CIO under their Board-delegated authority:

Recommendations to be Considered Under Board's Authority:

1. For investment staff (including the CIO), increase the weighting on Quantitative performance to 75% of the Annual Incentive formula, an increase from the current 60% weighting.
2. As per GGA's separate report on historical probability of current investment performance expectations at the Total Fund and Asset Class level, which will be presented in June 2022, adjust performance hurdles accordingly to provide for a narrower performance range between Threshold and Maximum performance.
3. Exclude annual lump sum retirement payments from the calculation of Overhead Costs when measuring Enterprise Operational Effectiveness performance.
4. In alignment with the approval of the 2022-2027 strategic plan, ensure alignment between any revised Enterprise Operational Effectiveness metric measured under the strategic plan with what is measured under the Annual Incentive Plan.
5. Continue to measure Stakeholder Engagement under the Annual Incentive Plan to align with the strategic plan. That said, consider the adoption of a participation rate target that would also be used to measure performance in this area on annual basis along with the current survey results.
6. If certain groups are not responding as much to stakeholder perception surveys, consider moving away from a Group Average approach to calculating results and incorporate a methodology that equally weights individual responses.

Recommendations to be Considered by CEO and CIO under Board Delegated Authority:

1. For investment staff working in specific asset classes, add an Asset Class investment performance weighting within the Annual Incentive formula. To ease CalPERS back into this approach, GGA recommends that CalPERS keep the current 50% weighting on Total Fund performance and 10% weighting on Total Fund CEM performance with 15% weighting taken from Qualitative performance for these professionals and tied to Asset Class performance results. This will lower the weighting on Qualitative performance within the plan for these professionals to a level more in-line with the market while still placing the majority of Annual Incentive payouts on Total Fund results. Over time, GGA will work with CalPERS to determine whether an increased weighting on Asset Class performance is required moving forward from the recommended 15%.

2. For the COO, CFO and General Counsel, consider placing some weighting on Total Fund investment performance (no higher than 15%) to align closer with the CEO and most other Annual Incentive-eligible staff.

Conclusion and Next Steps

We look forward to discussing this letter at the April meeting and following up with more defined performance metrics and performance expectations at the June meeting. 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

Appendix A: Incentive Metrics Used by Identified CalPERS Pension Peers

GGA notes that many of CalPERS U.S.-based pension fund peers do not provide adequate disclosure on the design of their Incentive programs and therefore information for these funds has been omitted from the table below.

	Company	Areas of Performance Considered								
		Total Fund	Asset Class	Personal Performance	Total Fund Costs	Customer Service	Stakeholder Engagement	Operational	Strategic Execution	Other
	CalPERS	√		√	√	√	√			
(1)	CalSTRS	√	√	√					√	
	CPPIB	√	√	√				√		√
	Caisse	√	√	√						√
	Texas Teachers	√	√	√		√			√	
	OTPP	√	√	√		√		√	√	√
(2)	OMERS	√	√	√	√				√	√
	Prevalence - Of Those Disclosing	***100%***	***100%***	***100%***	***17%***	***33%***	***0%***	***33%***	***67%***	***67%***

"*" Indicates that information not disclosed.

Notes:

(1) Customer Service and Stakeholder Engagement are considered indirectly as part of Strategic Execution and do not have specific weightings allocated.

(2) Total Fund Costs considered when evaluating CEO's personal performance.

Appendix A: Incentive Metrics Used by Identified CalPERS Pension Peers cont'd.

Performance Area	CalPERS Metric Used	Examples of Performance Metrics
Total Fund	- Total Fund Return Relative to Benchmark - Total Fund Return Relative to CEM US Benchmark	- Total Fund Return Relative to Benchmark - Absolute Total Fund Return - Total Fund Volatility
Asset Class		- Asset Class Return Relative to Benchmark Index - Absolute Asset Class Return
Total Fund Costs	- Total Fund Costs Relative to CEM US Benchmark	- Managing Cost Effectiveness of Total Fund
Customer Service	- Benefit Payment Timeliness - Customer Satisfaction	- Customer Satisfaction with Business Processes - Peer Service Level Comparison Relative to CEM Results - Service Excellence Index - Comprehensive Annual Review of Performance Factors Relating to the Business & Operational Management of the Investment Branch - Survey of the CIO, Deputy CIO & Investments Staff Rating of Implementation Success & Customer Service
Stakeholder Engagement	- Score against Annual Engagement Survey	- Employee Engagement Survey & Employee Turnover - Comprehensive Annual Review of Performance Factors Relating to Investment Office Engagement Strategy & Outreach of the Investment Branch

Appendix A: Incentive Metrics Used by Identified CalPERS Pension Peers cont'd.

Performance Area	CalPERS Metric Used	Examples of Performance Metrics
Operational	- Total Overhead Operating Costs as % of Total Operating Costs	- Productivity Relative to CEM Results - Integrated technology, data, and knowledge advantage initiative
Strategic Execution	- Business Objectives	- Performance against Organizational Leadership Priorities - Board Evaluation of Status of Strategic Plan & Objectives - Annual Strategic Execution - Board or CEO Evaluation of Strategic Plan Performance
Personal Performance	- Leadership	- Individual performance against personal objectives - Developing subordinate staff and recruit/retain talent - 360 Leadership Score - Contribution to Short & Long-Term Areas of Focus - Comprehensive Review of Personal Performance Factors
Other		- Developing organizational structure, systems, and processes - Relationships with Board, Committees, Direct Reports - Increase Support of Local Companies & Economy - Board Risk Adjustment Factor - Adopting Best-in-Class Climate-Related Financial Disclosure - Increasing Low-Carbon Assets - Reduce Carbon Intensity of Portfolio - Increase Renewable Energy & Sustainability Investment

Appendix B: Quantitative vs. Qualitative Weighting at CalPERS vs. Market

Participant/Group	CalPERS		Pension Fund Marketplace	
	Quantitative	Qualitative	Quantitative	Qualitative
CEO	75%	25%	70%-80%	20%-30%
CIO	60%	40%	70%-75%	25%-30%
Deputy CIO	60%	40%	70%-75%	25%-30%
COIO	60%	40%	70%-75%	25%-30%
All Investment Management Positions	60%	40%	70%-75%	25%-30%
General Counsel	50%	50%	50%-60%	40%-50%
Chief Actuary	50%	50%	50%-60%	40%-50%
CFO	50%	50%	50%-60%	40%-50%
Chief Operating Officer	50%	50%	50%-60%	40%-50%
Chief Health Director	50%	50%	50%-60%	40%-50%

GGA notes the following points relating to the table above:

- For senior non-investment roles at CalPERS, the weighting on Quantitative performance within the Incentive program is on the lower end, but still within market norms.
- Investment-related roles at CalPERS tend to have less weighting on Quantitative performance than what is observed in the market.

Appendix C: Quantitative vs. Qualitative Weighting at CalPERS vs. CalSTRS

Participant/Group	CalPERS		CalSTRS	
	Quantitative	Qualitative	Quantitative	Qualitative
CEO	75%	25%	30%	70%
CIO	60%	40%	75%	25%
Deputy CIO	60%	40%	80%	20%
COIO	60%	40%	20%	80%
Investment Management – Asset Classes	60%	40%	80%	20%
Investment Management – Strategy & Risk	60%	40%	60%	40%
Investment Management – Sust. Invest	60%	40%	55%	45%
Investment Management – Risk	60%	40%	50%	50%
Investment Management – Innovation	60%	40%	60%	40%
Investment Management – Engagement	60%	40%	30%	70%
Project Management/Customer Service	60%	40%	50%	50%
General Counsel	50%	50%	n/a	n/a
Chief Actuary	50%	50%	0%	100%
CFO	50%	50%	20%	80%
Chief Operating Officer	50%	50%	15%	85%

GGA notes the following points relating to the table above:

- Certain roles at CalPERS are not comparable at CalSTRS and have therefore been excluded from the table.
- For senior non-investment roles at CalPERS, while similar areas of performance are considered as part of determining Incentives, it is done so using more Quantitative metrics than at CalSTRS.
- Investment-related roles at CalPERS tend to have less weighting on Quantitative performance than Qualitative performance when compared to similar roles at CalSTRS, with the exception of Engagement and Strategy & Risk roles.
- CalSTRS' General Counsel position is currently not eligible to receive an Incentive payout.
- CalSTRS' Chief Actuary position is currently evaluated solely on Qualitative performance in their role.

Appendix D: GGA's Detailed Recommendations for Consideration

- Areas highlighted in **GREEN** represent a proposed increase in weighting from Fiscal Year 2021-2022.
- Areas highlighted in **RED** represent a proposed decrease in weighting from Fiscal Year 2021-2022.

Participant/Group		Quantitative						Qualitative	
		Total Fund	Asset Class	Enterprise Operational Effectiveness	INVO CEM	Customer Service	Stakeholder Engagement	Leadership	Business Objectives
CEO	Proposed	15%	*	20%	10%	15%	15%	25%	*
	Current	15%	*	20%	10%	15%	15%	25%	*
CIO	Proposed	65%	*	*	10%	*	*	12.5%	12.5%
	Current	50%	*	*	10%	*	*	20%	20%
Deputy CIO	Proposed	65%	*	*	10%	*	*	12.5%	12.5%
	Current	50%	*	*	10%	*	*	20%	20%
Asset Class Investment Management Positions	Proposed	50%	15%	*	10%	*	*	12.5%	12.5%
	Current	50%	*	*	10%	*	*	20%	20%
General Counsel	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Actuary	Proposed	*	*	20%	10%	10%	10%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Financial Officer	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Operating Officer	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Health Director	Proposed	*	*	20%	10%	10%	10%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%