GLOBAL GOVERNANCE ADVISORS

Opinion Letter

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Annual Incentive Plan Metrics & Additional Considerations

Prepared for:

Performance, Compensation & Talent Management Committee

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CalPERS California Public Employee Retirement System

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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 2022-2023.

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.

Summary of GGA's Assessment

GGA has reviewed the proposed annual incentive metrics for Fiscal Year 2022-2023 and believes that the metric performance areas still meet the needs of CalPERS at this time. They align to CalPERS mission and updated strategic plan 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 CalPERS consider implementing an adjustment to the performance expectations for Total Fund investment performance against benchmark. While GGA has also completed historical analysis on Asset Class investment performance results, it recommends holding off on adding in an Asset Class performance metric until at least Fiscal Year 2023-2024. This recommendation reflects the fact that the new CIO has only been in their role for a short time and that GGA has not had sufficient time to fully understand their vision for the investment team and the investment strategy they will be expected to achieve. Holding off on any material changes in this area will allow GGA time to collect feedback from the CIO on their vision and strategy for the investment team and work with CalPERS' Board investment consultant, Wilshire, to develop appropriate recommendations, if any, to incorporate Asset Class performance within the annual incentive plan for eligible staff.

Provided below are more details surrounding GGA's recommendations for the proposed annual incentive metrics for Fiscal Year 2022-2023.

Corporate Performance Metric Review Details:

Metric #1: Total Fund Performance

PROPOSED CHANGES FOR FISCAL YEAR 2022-2023

GGA recommends a narrowing of the performance expectations between Threshold (Minimum) and Maximum performance and the elimination of potential payouts on this metric when performance is below the five-year benchmark comparison to align with common market practice. This will also help protect the long-term sustainability of CalPERS and sends a message to incentive plan participants that below market performance is not acceptable. The lowering of the Maximum performance expectation to a level more in-line with historical performance at CalPERS will make this expectation seem more reasonable to achieve and can therefore act as more of a motivator to drive performance.

Past 2021-22 Metrics

Performance (bps)	Payout Ratio
+35	1.50 (150%)
+30	1.41 (141%)
+20	1.25 (125%)
+5	1.00 (100%)
0	0.76 (76%)
-15	0.05 (5%)
< -15	0.00 (0%)

Proposed 2022-23 Metrics

Performance (bps)	Payout Ratio
+10	1.50 (150%)
+5	1.00 (100%)
0	0.00 (0%)

The rationale and historical analysis that led to the Proposed 2022-23 Metrics is contained within a separate report titled, *Investment Performance Metrics Assessment*.

Metric #2: Enterprise Operational Effectiveness

NO MATERIAL CHANGE FOR FISCAL YEAR 2022-2023

This metric for 2022-23 is defined as Overhead Operating Costs as a percentage of Total Operating Costs ("OOCP").

- 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
    - OOCP = 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%)

The cost calculation methodology would exclude leave balance payouts, as CalPERS will now pay those out of a unique org. code that includes payouts across both service delivery and operational areas, as well as cost areas excluded from the measure. By excluding the unique org code, this proposal mitigates the risk of inaccurate cost calculations that could occur as a result of the blended expenses that cannot be reasonably dissected. To clarify, team members may have leave balances accrued prior to joining CalPERS, and often they laterally transfer across service delivery and operational areas during their careers. The agenda item associated with this recommendation includes further information in this area.

Once baseline data is established for the associated strategic plan measure, GGA will assess whether adjustments to the performance expectations and associated payout ratio for this metric are necessary to maintain alignment between the two.

Metric #3: Investment Office CEM

NO CHANGE FOR FISCAL YEAR 2022-2023

This metric for 2022-23 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

NO CHANGE FOR FISCAL YEAR 2022-2023

This metric for 2022-23 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

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%)

Metric #5: Stakeholder Engagement

NO MATERIAL CHANGE FOR FISCAL YEAR 2022-2023

This metric for 2022-23 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?

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%)

GGA notes recent concerns about the number of responses provided by respondents in totality through Stakeholder Engagement questions. It is GGA's recommendation that CalPERS establish a threshold number of responses it feels is statistically impactful to ensure meaningful results are determined in this area. If the number of responses falls below the minimum threshold, then it would be typical for discretion to be used. This discretion could include: measuring performance results as per the current approach, reducing potential payouts calculated to reflect the low number of responses, or applying no weighting to this metric within the Incentive calculation and re-allocating this portion to other non-investment related metrics.

We trust that this letter addresses your concerns on this matter and look forward to discussing it in more detail at the June PCTM meeting. If you have any questions on the contents within this letter, please let us know.

Sincerely,

Global Governance Advisors

Peter Landers | Brad Kelly
Senior Partner | Partner

cc: Karen Van Amerongen, CalPERS