GLOBAL GOVERNANCE ADVISORS

April 5, 2021

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

Dear Rob,

Re: Chief Investment Officer Compensation

This memo is in response to your request for Global Governance Advisors ("GGA"), in its role as CalPERS' Board compensation consultant, to provide its opinion on a market competitive compensation structure for the Chief Investment Officer ("CIO") position. This opinion will include GGA's views on the inclusion of Long-Term Incentive Plan ("LTIP") eligibility to the role for any new incumbent.

Background:

Currently, CalPERS is in the process of recruiting for a new permanent CIO to replace the former CIO, as the role has been vacant since August 2020. The Performance, Compensation & Talent Management Committee ("Committee") initially requested its former Board compensation consultant to provide its opinion on CIO compensation structure, which it presented at the November 2020 Committee meeting. At that time, CalPERS was in the process of finalizing an agreement with GGA as its new Board compensation consultant and the view of the Committee was that the Committee should wait to make a decision on CIO compensation until it had received a recommendation from its new compensation consultant.

Since then, CalPERS has continued with its CIO search process, where the topic of CIO compensation (specifically whether the role will be eligible to receive LTIP or not) has been brought forward as a key concern of any new candidate contemplating taking the role. CalPERS has recently announced that it is putting its CIO search on hold until June 2021 with one of the primary reasons being the need to receive a formal recommendation on whether the CIO position at CalPERS should participate in the LTIP that is currently offered to other members of the investment staff.

Typical Elements of CIO Compensation Structure:

In GGA's consulting experience working with countless pension funds of all sizes across North America, as demonstrated in the research in **Appendix A**, GGA observes the following key elements of a CIO compensation structure:

- Base Salary (provided at all pension fund organizations);
- Short-Term Incentive (generally provided at large-sized pension funds); and

- Long-Term Incentive (provided at all large-sized Canadian pension funds, private sector investment firms, and increasingly being adopted by large U.S. pension funds such as CalSTRS).

Where LTIP is put in place, the CIO or an equivalent position within a pension fund is always made eligible to participate in the plan. This is because the LTIP is most often or principally based on long-term (3+ years) of Total Fund investment performance and given that it is the CIO's responsibility to oversee the long-term investment performance of the fund, it makes logical sense to include them within the plan along with other investment staff and senior executives from a line-of-sight perspective. Given the level of compensation provided to the CIO position within a fund, it also allows the fund to justify the level of Incentive pay provided by demonstrating a clear link between CIO pay and the long-term returns they helped generate for plan members. If positive results are achieved for plan members (e.g., meeting or exceeding the required rate of return on an annualized basis in CalPERS' case) over the long run, then the CIO earns a LTIP payout, but if performance is not achieved for plan members, then the CIO would receive no payout. This places pay at-risk as opposed to providing a CIO with a higher base salary which locks a fund in to paying a higher fixed cost with no ability to adjust compensation downward when Target performance is not achieved.

Excluding the CIO but including all other investment staff or senior executives with less oversight over Total Fund investment performance within the LTIP could lead to a lack of long-term alignment between the CIO and other investment and senior team members. This lack of long-term alignment can also lead to a lack of cohesion and teamwork between the CIO and other members of the investment and senior executive team which could possibly lead to lower long-term returns for plan members. Having a consistent compensation structure to offer to all members of the senior executive and investment teams (including the CIO) helps reduce this risk.

In addition to the pay and performance rationale, LTIP is also offered to CIOs or equivalent positions within a fund in order to remain market competitive. Senior talent that CalPERS would be looking to recruit into the CIO role most likely will be coming from a pension fund or private sector organization that offers LTIP as part of their existing compensation package. This means that the question of whether LTIP will be included within their compensation package at their new employer will come up during CIO recruitment interviews, which CalPERS has experienced already during the current CIO search process. Within almost all of CalPERS identified peer group (save for a few U.S. pension funds), LTIP is currently offered to the CIO or equivalent role and is based on long-term Total Fund investment performance (either on an Absolute basis or relative to a benchmark index). If CalPERS were to continue to exclude the CIO from the current LTIP program, CalPERS would remain less competitive in the external marketplace and hinder the System in its recruiting efforts.

GGA Recommendation:

Highlighted in the table below is GGA's recommendation for a market competitive CIO salary range and incentive levels for CalPERS. While GGA has relied on market data provided to CalPERS as part of its June 2018 review of CIO compensation, we have also analyzed this data against more current data we have observed for peers similar to CalPERS in the U.S. pension

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fund industry. The recommended CIO compensation structure and levels will allow CalPERS to be market competitive externally while providing for a reasonable level of internal equity between the CIO position and other roles within CalPERS investment and management structure.

CIO Compensation Recommendation Table

	CalPERS (Current)	GGA Recommendation	Range in Market Data
Base Salary Range	\$424,500 - \$707,500 (Midpoint: \$566,500)	\$424,500 - \$707,500 (Midpoint: \$566,500)	\$400,000 - \$520,000
Annual Incentive Range (% of Salary)	0-150% (Target: 100%)	0-150% (Target 100%)	*
LTIP Range (% of Salary)	n/a	100-150%	*
“Low” Total Direct Compensation (Min Salary + Target Annual Incentive + Target LTIP)	\$849,000	\$1,273,500	\$1,400,000 - \$1,500,000 (25th percentile)
“Mid” Total Direct Compensation (Mid Salary + Target Annual Incentive + Target LTIP)	\$1,133,000	\$1,699,500	\$2,100,000 - \$2,300,000 (50th percentile)
“High” Total Direct Compensation (Max Salary + Max Annual Incentive + Max LTIP)	\$1,768,750	\$2,830,000	\$3,000,000 - \$3,200,000 (75th percentile)

GGA’s recommendations are as follows:

- Keeps fixed costs (i.e. Base Salary range) unchanged;
- Maintain the Annual Incentive Range unchanged to ensure appropriate compression with the Deputy CIO position internally; and
- Introduce LTIP eligibility for the CIO position with a Target LTIP of 100% of Base Salary, but align with the current CalPERS LTIP structure and allow for LTIP grants below 100% of Base Salary if the CIO’s Annual Incentive for the year before is below 100%.
    - While this structure is put in place to maintain consistency with how other LTIP eligible participants at CalPERS are currently treated, GGA notes that tying the size of LTIP grant to the previous year’s Annual Incentive result is not aligned with broader external market practice where the size of LTIP grant is typically not tied directly to Annual Incentive results.

The increased compensation tied to the LTIP is fully at-risk and will only be earned if CalPERS achieves a 7% or higher Compound Annual Growth Rate ("CAGR") over a 5-year period for plan members. At "Maximum" performance, the LTIP payout of over $1 million will only be provided if CalPERS achieves an 8.4% CAGR over 5 years, which would translate to over $32 billion in additional returns above CalPERS' required actuarial rate of return, given the current level of assets at CalPERS ($445.13 billion).

From an internal equity perspective, the recommended CIO compensation structure will continue to position the CIO as the highest paid position within the investment office. The recommended Annual Incentive and LTIP ranges will also provide an appropriate level of spread between the CIO and Deputy CIO from a compression perspective which would be commonly observed in the marketplace. It also recognizes the more senior role, increased responsibilities, and accountability the CIO holds within CalPERS .

The midpoint of the existing base salary range, $566,000, is positioned around the 75th percentile of the market according to historical data provided by McLagan and GGA's understanding of current Base Salary levels in the pension fund marketplace for similar-sized funds to CalPERS.

The recommended Target Total Direct Compensation (i.e., Midpoint Salary and Target Annual and Long-Term Incentive) of $1,699,500 is positioned between the 50th and 75th percentiles of Total Cash Compensation, which aligns with CalPERS' stated compensation philosophy to set Target Total Compensation between the 50th and 75th percentiles of Total Cash Compensation within the market. It would be positioned between the 25th and 50th percentiles for Total Direct Compensation, when LTIP is included in the market data.

The Maximum Total Direct Compensation (i.e., Maximum Salary plus Maximum Annual and Long-Term Incentives) of $2,830,000 would be positioned well above the 75th percentile for Total Cash Compensation in the market, although this is not an apples-to-apples comparison as Total Cash Compensation in the market excludes the value of LTIP. Positioning for Total Direct Compensation (which includes LTIP for a more apples-to-apples comparison) would fall just below the 75th percentile of the market for a CIO at similar-sized organizations within CalPERS' peer group, which makes sense from a pay-for-performance perspective.

GGA notes that it has been a few years since CalPERS last formally reviewed the competitiveness of compensation levels for investment and senior executive staff, including the CIO position. GGA's observations above are based on historical data provided to CalPERS as well as GGA's understanding of current trends at similar-sized organizations to CalPERS within its peer group. We encourage CalPERS to conduct a formal market compensation review for the CIO as well as other investment and executive staff in the months ahead to confirm the overall market competitiveness of its Total Direct Compensation package.

While CalPERS has historically evaluated market competitiveness in relation to Total Cash Compensation (Salary + Annual Incentive), GGA encourages the Committee to think more holistically moving forward. This would involve positioning Total Direct Compensation (Salary + Annual Incentive + LTIP) at the 50th percentile for Target performance and closer to the 75th percentile for Maximum performance. This approach will allow CalPERS to remain market competitive in its recruiting efforts and help attract the future investment and executive talent it needs and properly align pay with performance over the long run.

Conclusion:

GGA recommends that CalPERS adjust the CIO compensation structure to include LTIP eligibility. While Salary and Annual Incentive ranges would remain the same, a newly developed LTIP range will allow CalPERS to remain market competitive from a Total Direct Compensation perspective as it looks to recruit for its new CIO and be in alignment with broader market practices. The inclusion of the CIO in the current LTIP will create greater alignment and a shared investment focus over the long-term within the investment office while recognizing the important role the CIO plays in ensuring long-term investment returns meet the required rate of return for plan members.

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	Brad Kelly
Partner	Partner

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

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Appendix A: Compensation Eligibility at Identified CalPERS Peers

Organization	Salary	Annual Incentive	Long-Term Incentive
CalSTRS	√	√	√
Texas Teachers’	√	√	√
Wisconsin Investment Board	√	√	
Georgia Employees’ Retirement System	√		
State Teachers’ Retirement System of Ohio	√	√	
Virginia Retirement Systems	√	√	
CPPIB	√	√	√
Caisse de depot	√	√	√
OTPP	√	√	√
OMERS	√	√	√
HOOPP	√	√	√
GE Asset Management	√	√	√
General Motors Asset Management	√	√	√
Lockheed Martin Investment Management Co.	√	√	√
DuPont Capital Management	√	√	√
Investment Management/Advisory Firms	√	√	√
Banks	√	√	√
Insurance Cos.	√	√	√
Prevalence	**100%**	**94%**	**78%**

Notes:

(1) Only Georgia Employees’ Retirement System does not disclose publicly the use of incentive compensation.

(2) CalSTRS is in the process of adopting a formalized LTIP program to cover multiple years of performance while Texas Teachers’ has instituted a 1-year deferral of 50% of their Annual Incentive as a form of LTIP. Canadian pension fund and private sector peers have instituted LTIP programs generally ranging in length from 3 to 5 years (sometimes longer, if Stock Options are adopted).

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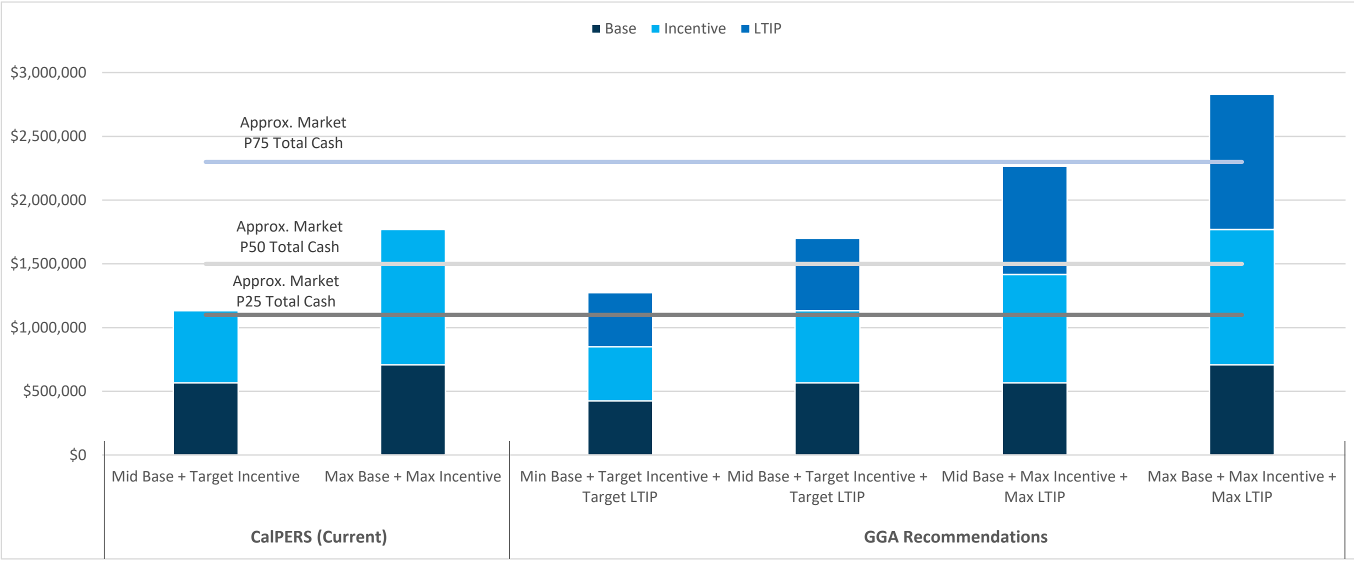
Appendix B: Illustrative of GGA's CIO Compensation Recommendations

Total Cash Compensation:



Total Direct Compensation: