



GLOBAL
GOVERNANCE
ADVISORS

Compensation Policy Workshop



California
Public Employee
Retirement
System

November 30, 2022

Outline

Topics Covered In Today's Workshop

- Sharpening Our Focus..... 4
- Program Principles..... 11
- Incentive Program Design 16
- Measuring Investment Performance..... 20
- Comparator Groups 26
- Salary Adjustment & Performance Matrix..... 38
- Authority to Defer, Reduce, or Eliminate 47
- Session Wrap Up..... 52



Action Required For Today

© all rights reserved 2022



- The purpose of today's discussion is to decide on specific policy changes that will help to refine and improve the overall effectiveness of the CalPERS compensation program for senior leadership and investment staff.
- Specifically, today the Board should determine:
 - A revised peer group framework
 - Salary adjustment and performance matrix
- All other items discussed today will be included in a revised redline version of the policy to be discussed in the February PCTM Committee meeting.

Sharpening Our Focus

Board Members Have a Clear Role

© all rights reserved 2022



- Success is based on clear roles and focused efforts
- Effective Boards remain focused on strong strategic direction and oversight

The Board's role is to pull management out of the trees to see the forest.

– Pearl Zhu, Digitizing Boardrooms

- Compensation design should always align with your strategic vision and positively impact attraction, retention, & performance

Market Leading Funds Today

© all rights reserved 2022



- Recruiting top investment professionals and highly skilled Board members
 - Building internal asset management teams to replace costly external service providers
- Offer higher compensation opportunity levels to attract, motivate and retain top talent
 - Substantially lower external management fees more than offset this cost
- Internal teams often perform better as investors since the entire team is directly aligned with the mission and vision of the pension fund
 - Often incentivized through strong long-term incentive plans
- Global offices in New York, Hong Kong, Sydney, London, etc.

The above changes have led to Pension Fund deficits being reduced or almost eliminated

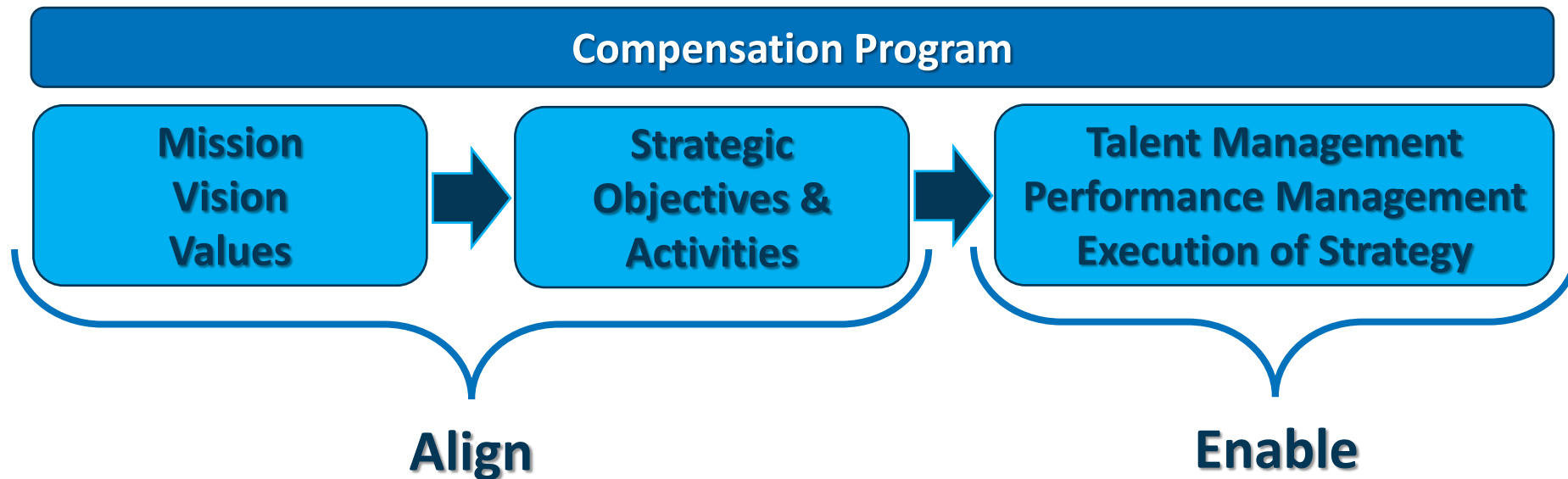
Enhancing Organizational Effectiveness



© all rights reserved 2022

Compensation Governance

- Decisions should align with the mission, vision and values of the organization
- Help align and enable fund strategy and activities
- Improve attraction, retention and performance of staff



Importance of Incentive Programs

© all rights reserved 2022



Recognition of contribution

- McKinsey Study
 - Employees want good pay, benefits, etc.
 - Really want to be valued
- Transparency is key
 - Clear (objective) incentive plans
 - Realistic expectations
 - Multiple check-ins
- Less of a fringe benefit & more of a necessity
 - Is it doing what we intended it to do?
 - What is our underlying intention?



Teams Are Important

© all rights reserved 2022



2016 High Performance Teams Study

- Study of 297 teams
 - 97 high-performance teams
 - Compared to a control group of 200
- Discovered three key areas that stood out:
 - Teammates play to their strengths
 - Teammates feel safe to share ideas
 - Teammates are aligned on values

Teams need to be recognized for the collective performance they achieve



Positive Incentive (At Risk Pay) Plans

© all rights reserved 2022



Effective Plans:

- Are clear on expectations and process
- Promote buy-In
- Based on influence
- Assess attainability
- Rely on strong communication
- Are simple
- Are renewable
- Are affordable



Program Principles

What Are They?

© all rights reserved 2022



Stated principles in a compensation program:

- Support the purpose and objectives of the policy
- Help establish a foundation and direction for benchmarking activities
- Add clarity and aid transparency
 - For trustees, managers, and general team members



Opinions We Collected

© all rights reserved 2022



CalPERS Board Members Shared the Following:

CalPERS Compensation program should be:

- Aligned to the mission of the pension system
- Reasonable, fair, and equitable
 - Within the internal structure as well as compared to the outside market
 - Need to also consider broader rank and file employees
 - Support equity, diversity, and inclusion within the System
 - Ensure team members that they are competitively compensated
- Enticing, and not a deterrent when seeking or retaining talent
 - Enable long careers within the System
 - Recruitment needs to focus on the provision of a strong “overall package”

Opinions We Collected

© all rights reserved 2022



CalPERS Board Members Shared the Following:

CalPERS Compensation program should also be:

- Motivating and performance-based
 - Compensation should not be the sole reason for working at CalPERS
 - Team members should be clear on the performance expectations
 - Team members should be clear on the System's priorities
- Adaptable considering that roles continue to change
- Clear and understandable
- One element that helps to unify team members
- One element that helps to set a positive culture and work environment

Our Recommendation

© all rights reserved 2022



CalPERS Compensation program is designed and managed to:

- Be fair and equitable
 - Competitively positioned at the median of a defined mix of peers
 - Aligned with CalPERS' commitments to internal equity, diversity, and inclusion
- Enhance the attraction and retention of top talent
- Enable transparency for CalPERS Board, leadership, and team members
- Support a strong and performance-based work culture

Incentive Program Design

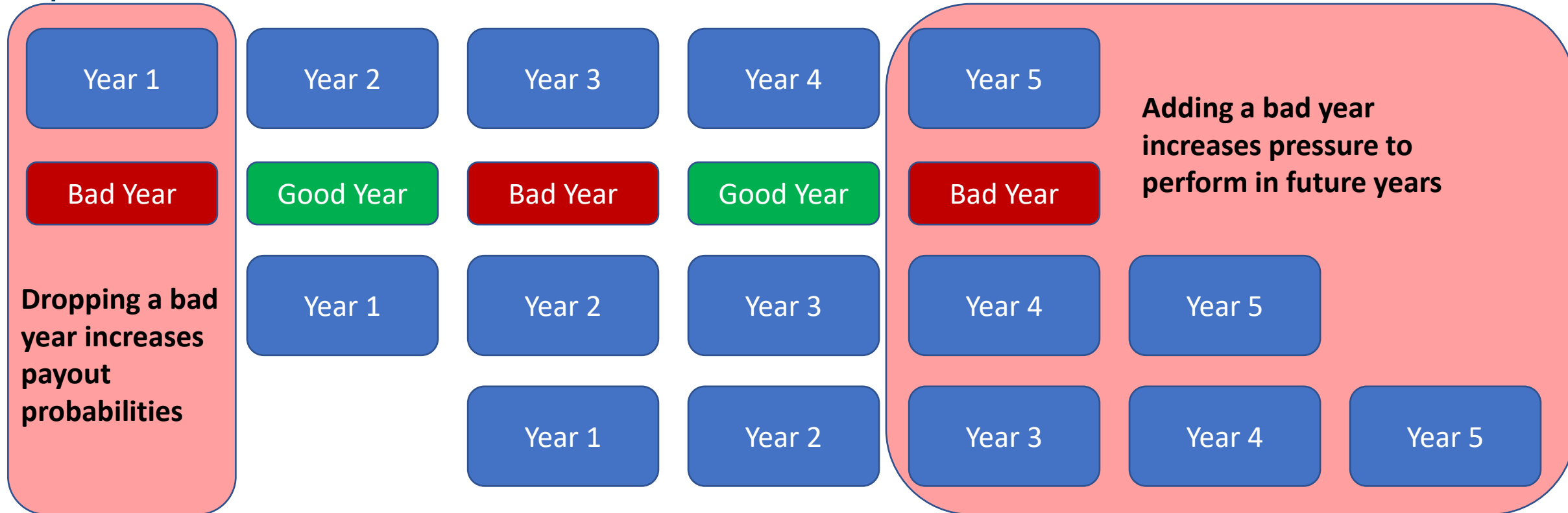
Protecting System Sustainability



© all rights reserved 2022

Incentivising the Right Things (The Blend is Important):

- 5-year rolling averages focus performance and attention on longer-term performance:



Protecting System Sustainability

© all rights reserved 2022



Addressing Absolute & Relative Performance:

- Annual Incentive: 5-year rolling average performance against a select benchmark.
- Long-Term Incentive: 5-year rolling average against CalPERS' actuarial threshold.

Annual Incentive

Year 1 Year 2 Year 3 Year 4 Year 5

RELATIVE Performance
against a benchmark

Long-Term Incentive

Year 1 Year 2 Year 3 Year 4 Year 5

ABSOLUTE Performance against
the actuarial threshold

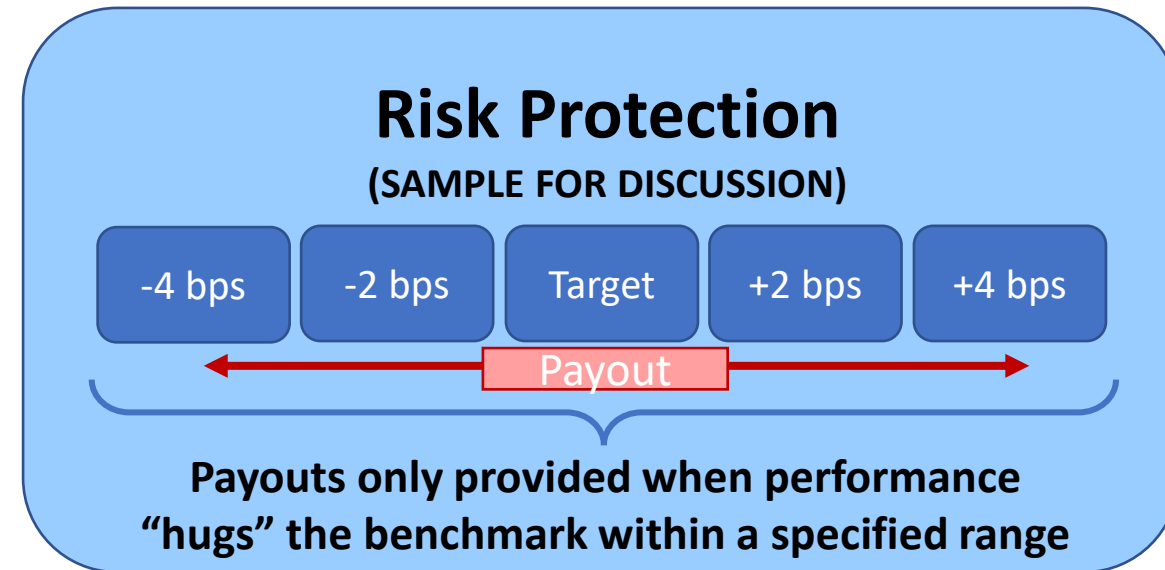
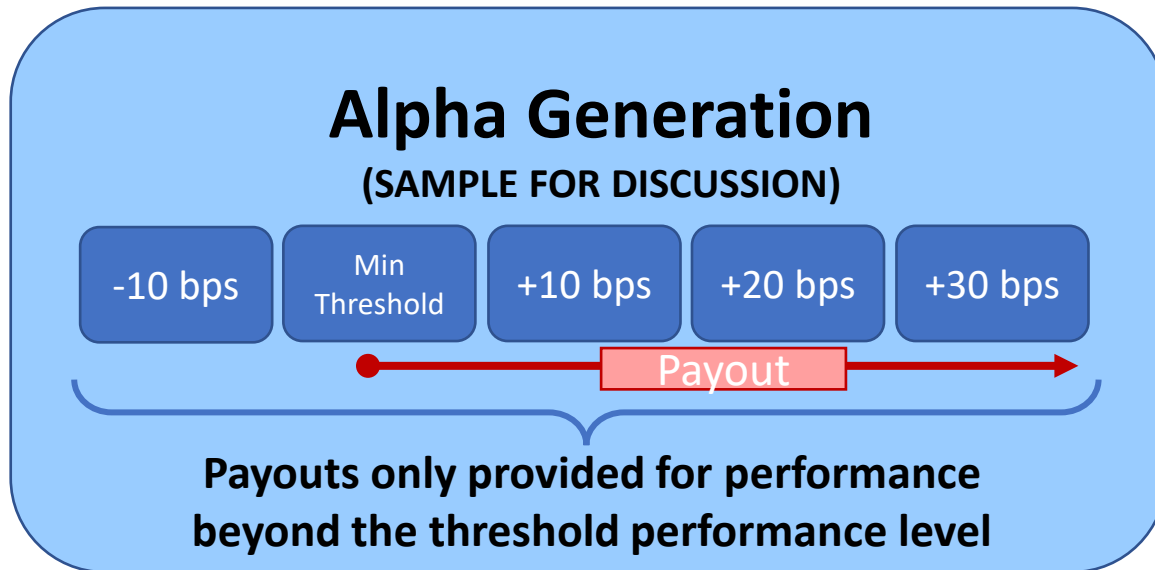
Addressing Risk

© all rights reserved 2022



Risk Should Be Addressed With Hurdle Calibration:

- Asset Classes can be incentivized differently based on the purpose of the asset class:



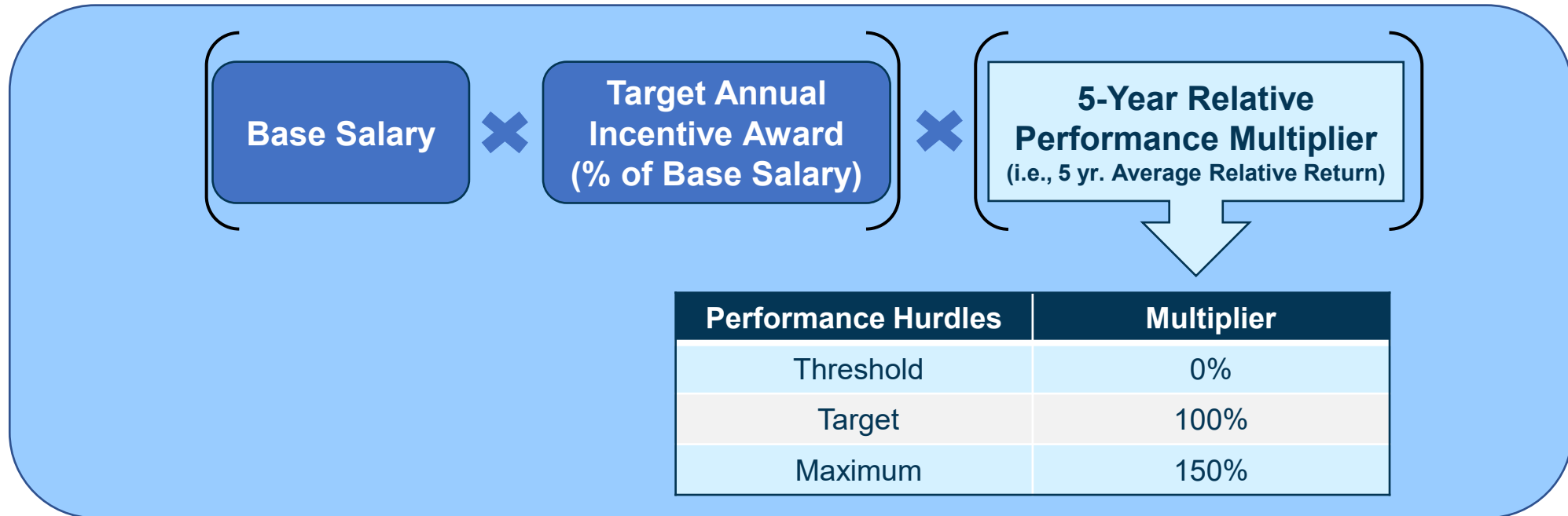
Measuring Investment Performance

Performance Periods Measured



© all rights reserved 2022

5-Year Returns Only Measured (Current Design):



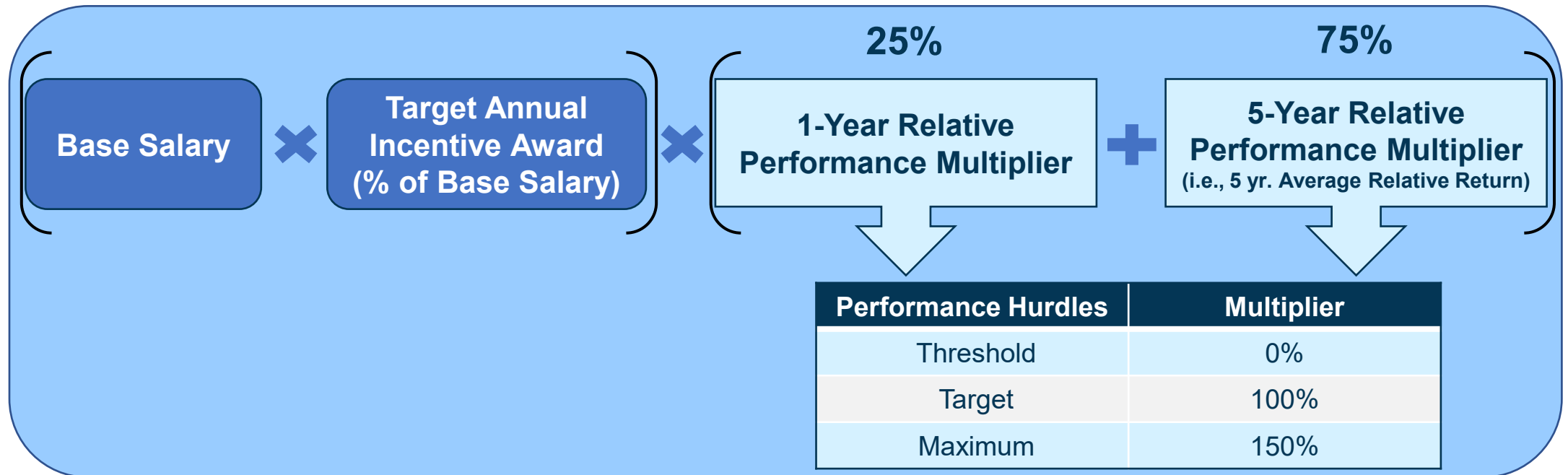
- Reflects longer-term investment performance, but may not adequately take into account extraordinary 1-year results (both positive or negative).

Performance Periods Measured



© all rights reserved 2022

1 & 5-Year Returns Measured (Possible Consideration):



- Puts a high weighting on longer-term investment performance, but incorporates extraordinary 1-year results through an allocated weighting.

Ways to Measure Performance

© all rights reserved 2022



Relative Performance vs. Index

Pros

- This type of plan design would be considered typical market practice and be well understood by participants and potential new professionals brought into the organization.
- With emphasis only on Relative performance within the plan design, participants will receive payouts due to their skill in making high value investment decisions (providing added value over passive investing) and not just due to overall market condition improvement.
- In periods of downturn in the market, if professionals are beating the benchmark (losing less value than the market), they will still receive an incentive payout, which can help from a retention standpoint.

Cons

- Plan design could reward participants for being the “best of the worst” when absolute returns are negative.
- Plan design has no alignment to the required Actuarial Threshold for pensioners.
- Can be more complicated to understand and administer with the use of customized benchmarks as opposed to common market indices.
- Determining appropriate benchmarks for illiquid assets such as Infrastructure, Real Estate and Private Equity can be challenging.

Ways to Measure Performance

© all rights reserved 2022



Relative Performance vs. Other Managers

Pros	Cons
<ul style="list-style-type: none">• With emphasis only on Relative performance within the plan design, participants will receive payouts due to their skill in making high value investment decisions (providing added value over other investment managers) and not just due to overall market condition improvement.• In periods of downturn in the market, if professionals are beating the benchmark (losing less value than other managers), they will still receive an incentive payout, which can help from a retention standpoint.	<ul style="list-style-type: none">• This type of plan design is not prevalent among public pension funds.• Plan design could reward participants for being the “best of the worst” when absolute returns are negative.• Plan design has no alignment to the required Actuarial Threshold for pensioners or to passive indices that could be invested in.• It is difficult to determine an appropriate universe of managers to compare to due to the unique investment factors facing each manager.

Ways to Measure Performance

© all rights reserved 2022



Absolute Performance

Pros

- Greater emphasis is put on Absolute performance, which can be aligned with CalPERS' required actuarial threshold for pensioners.
- Plan design will not reward participants for being the “best of the worst” when absolute returns are negative.
- Due to caps on STIP payouts, there is a lower risk of participants accruing “excessive” payouts under the plan.
- There is already familiarity within CalPERS for this type of design as the Long-Term Incentive is determined based on Absolute performance.
- The use of Absolute Performance only would be considered a market-leading design practice.
- Setting Absolute return targets for illiquid assets such as Infrastructure, Real Estate and Private Equity may be easier than trying to find directly comparable market benchmarks to measure Relative Value Add performance.

Cons

- This plan design is still not standard market practice among public pension funds and may hurt CalPERS in attracting and retaining key talent for the organization, as people are more familiar with Relative performance.
- With emphasis only on Absolute performance within the plan design, participants may receive payouts due to overall market condition improvement and not necessarily due to their skill in making high value investment decisions (i.e., rising tide lifts all boats).
- The plan design can be harsh if market conditions deteriorate and lead to significant negative returns outside of the professionals' control and may not account for the value saved for pensioners by investment decisions.
- By eliminating Relative performance from the plan design, participants are not encouraged to out-perform the benchmark, which could lead them to provide less value add over passive investing.
- Professionals in Public Equities and Fixed Income may react negatively to the change as it is not common for these asset classes.

Comparator Groups

Purpose of a Comparator Group

© all rights reserved 2022



A comparator group:

- Clearly defines the:
 - Size of the comparator organizations
 - The sectors that the organizations operate within
 - The scope of the roles to be compared
- The defined comparator group can include prescriptive/objectively-defined mixes of multiple groups



Opinions We Collected

© all rights reserved 2022



CalPERS Board Members Shared the Following:

CalPERS Compensation peers should include:

- Similar-sized public funds in North America
 - Transformed funds are also important comparators given what CalPERS is trying to do
- Endowment funds
 - Should be considered in investment roles as can lose talent to these organizations
- For-profit, private sector investment organizations
 - Difficult to compete against high paying private sector, but can lose investment talent to it
 - Too dependent on high priced outside consultants – need to build internal capabilities
 - Less concerned about losing non-investment talent to the private sector, but is still a threat

Opinions We Collected

© all rights reserved 2022



CalPERS Board Members also Shared the Following:

- Public state agencies
 - Makes a lot of sense when looking at non-investment talent
 - But could be a hindrance when trying to move forward
- A blended peer group makes sense on many levels
 - Open to a prescriptive split between public & private (e.g., 2/3 public, 1/3 private sector)
 - Need to be attracting people with current skills and experience

Always use Similar Peers

© all rights reserved 2022

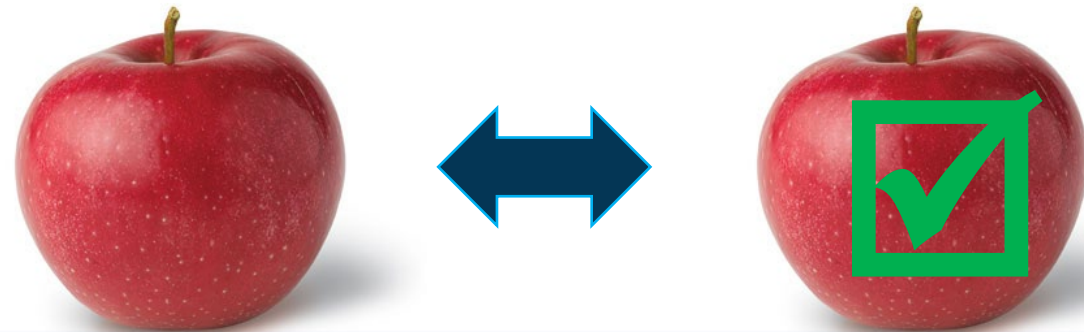


Peer group or market data should be comprised of organizations that are:

- Of similar size (e.g., assets, members, etc.)
- Similar sectors (e.g., investment, pensions, etc.)
- Similar region

The positions should be:

- Similar in scope
- Similar responsibilities



Overall, it is very important to know what your peers are doing.

Comparator Group Make-Up of Pension Peers

© all rights reserved 2022



For Non-Investment Executive Positions:

	Organization	Peer Group Make-Up			Peer Group Weighting		
		Pension Funds	Public Agencies	Private Sector	Pension Funds	Public Agencies	Private Sector
	Canadian Pension Plan Investment Board (CPPIB)	*	*	*	*	*	*
(1)	Caisse de depot et placement du Quebec (Caisse)	√	√	√	Not formalized		Not formalized
	California State Teachers' Retirement System (CalSTRS)	√		√	67%		33%
	Teacher Retirement System of Texas	√		√	Not formalized		Not formalized
	Ontario Teachers Pension Plan (OTPP)	√		√	Not formalized		Not formalized
	British Columbia Investment Management Corp. (BCIMC)	√		√	Not formalized		Not formalized
(2)	State of Wisconsin Investment Board (SWIB)	√		√	Not formalized		Not formalized
(3)	Virginia Retirement System (VRS)	√		√	75%		25%
	State Teachers Retirement System of Ohio	*	*	*	*	*	*
	Ontario Municipal Employees' Retirement System (OMERS)	√		√	Not formalized		Not formalized
	Healthcare of Ontario Pension Plan (HOOPP)	*	*	*	*	*	*

* Information not disclosed publicly

(1) For the CEO, a group of 7 leading pension funds only is used. All other non-investment staff are compared to both Public and Private Sector peers in Quebec as well as financial sector companies.

(2) Only use internally managed pension plans as well as banks and insurance companies, excluding east and west coast financial centers.

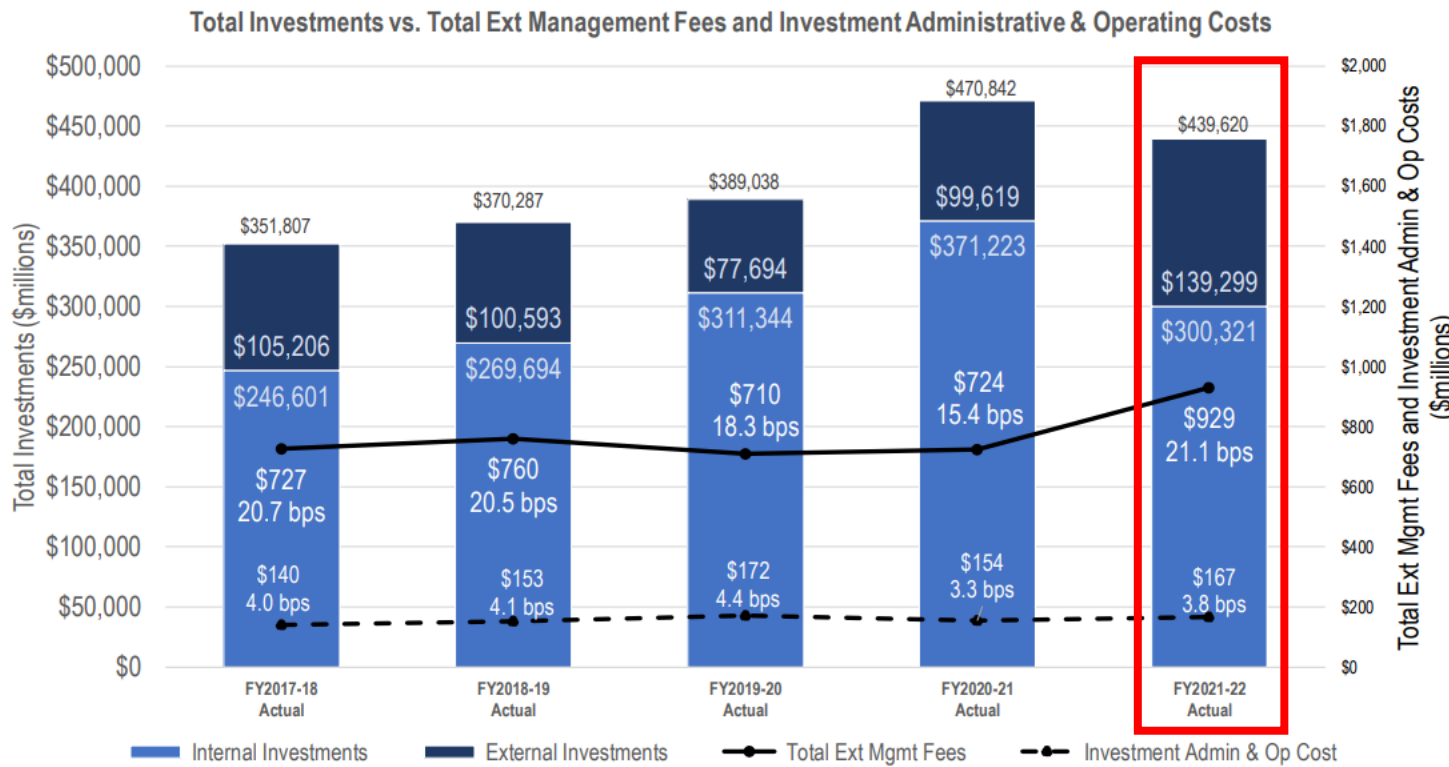
(3) 75/25 weighting on Pension Funds and Private Sector is for their Investment staff.

Where are Investment Management Costs Going?



© all rights reserved 2022

Investment Expenses FY 2017-18 thru FY 2021-22



By bringing more investing in-house, CalPERS would end up paying its Own People A LITTLE MORE and External Managers MUCH LESS.

Fees are based on Total Ext Mgmt Base and Performance Fees

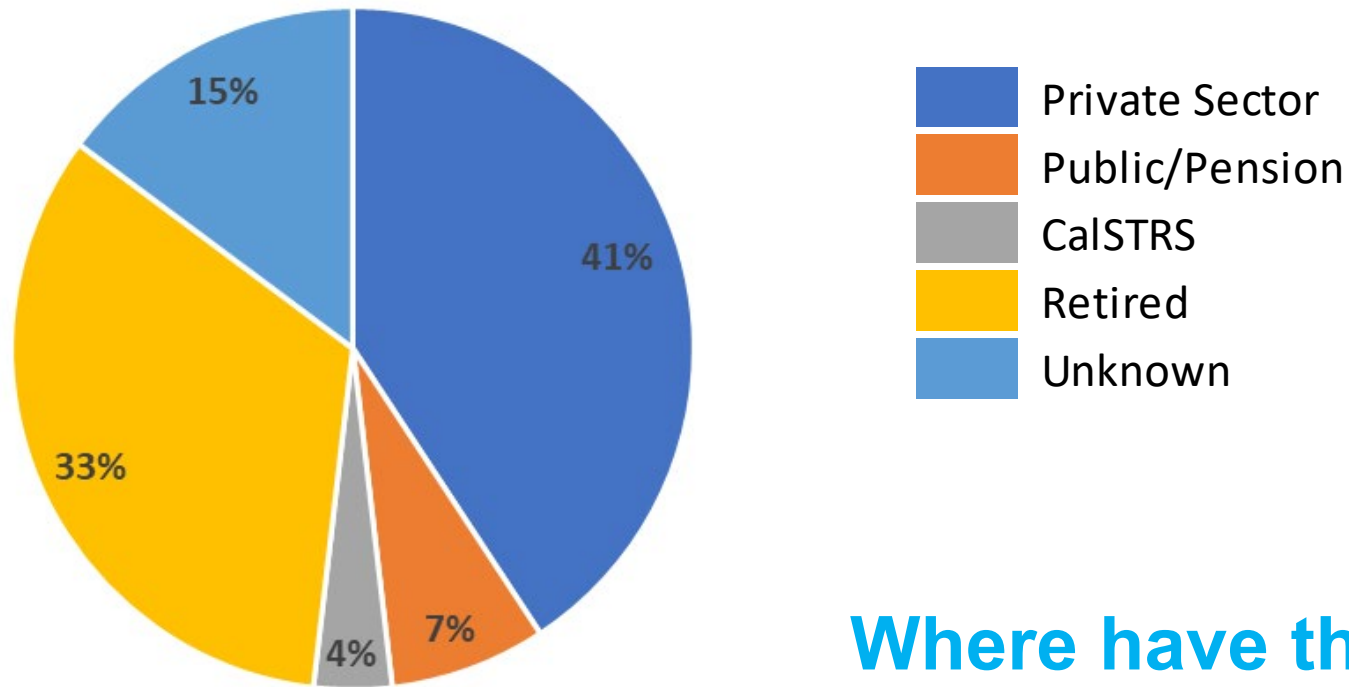
End Result: SIGNIFICANT Savings for CalPERS

Talent Attrition (July 2019 – Sept 2022)

© all rights reserved 2022



Investment Management



Where have they gone?

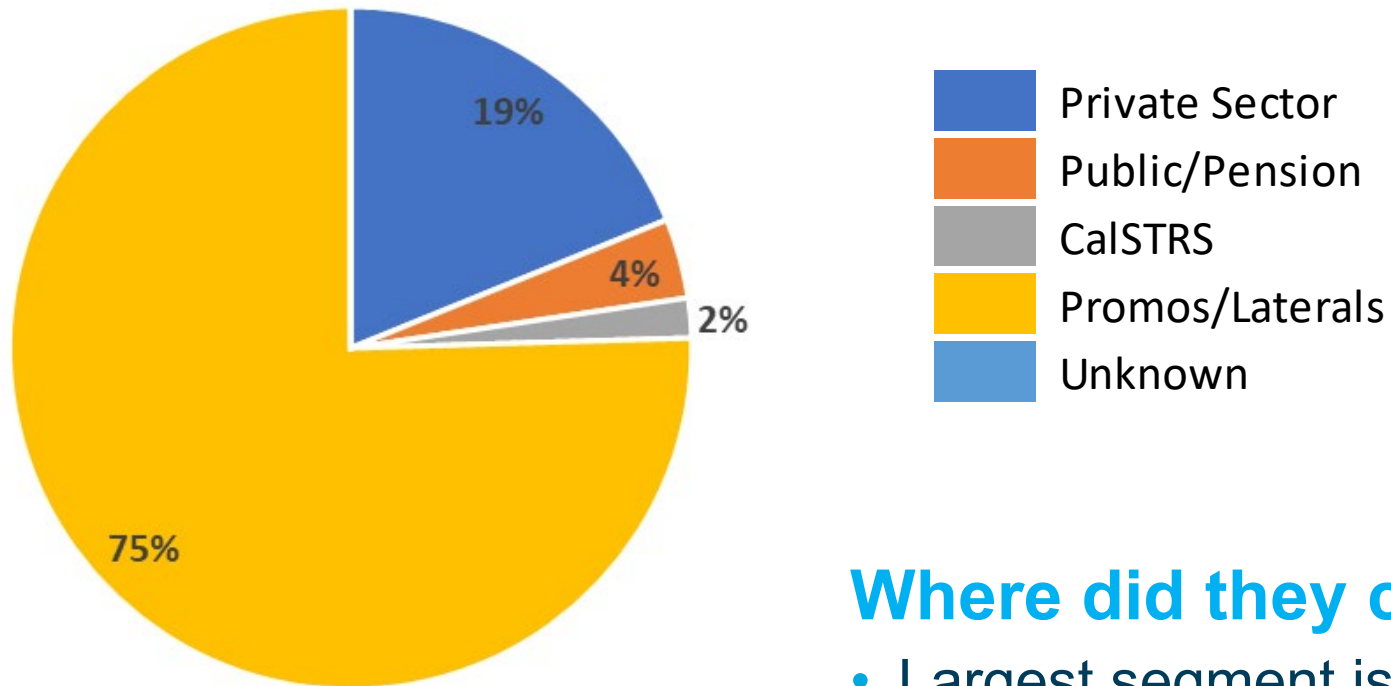
- Largest segment is to the Private Sector

Talent Attraction (July 2019 – Sept 2022)

© all rights reserved 2022



Investment Management



Where did they come from?

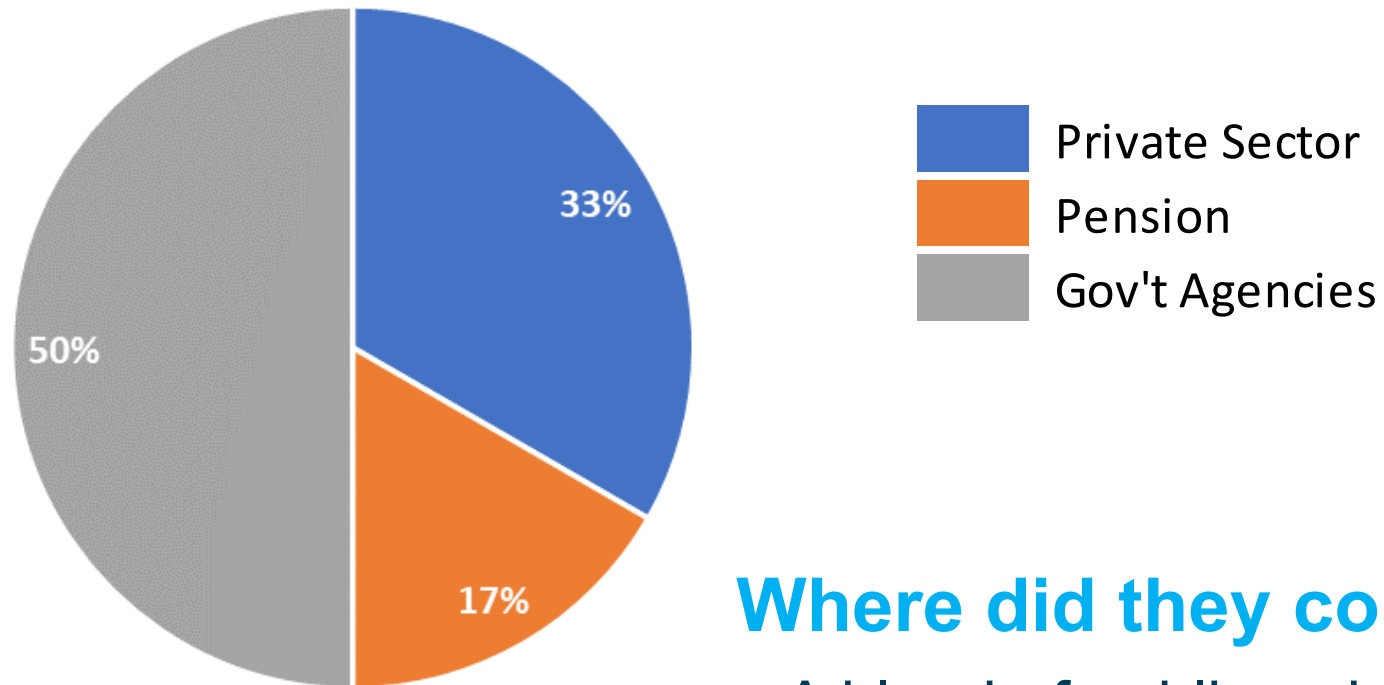
- Largest segment is from internal promotions and lateral moves

Executive Talent Attraction

© all rights reserved 2022



Executive Team



Where did they come from?

- A blend of public, private, & pension experience

Our Recommendation

© all rights reserved 2022



CalPERS Peer Group should remain as a blended group:

	Public Pension Funds	Public Sector Agencies	Private Sector Organizations
Investment Positions	2/3 weighting		1/3 weighting (Endowments, Funds, Insurers)
Non-Investment Positions	1/3 weighting	1/3 weighting	1/3 weighting

CalPERS Comparison Peer Group should be comprised of?



Salary Adjustment & Performance Matrix

Purpose of a Salary Adjustment Matrix

© all rights reserved 2022



A salary adjustment matrix provides:

- Clearly defined levels of performance
- Associated salary increases at each defined performance level

The purpose of a matrix is to:

- Provide clarity for the Board, leadership, and team members
- Aid in the administration of the compensation program



Opinions We Collected

© all rights reserved 2022



CalPERS Board Members Shared the Following:

- Performance assessments and salary adjustments should be fair and equitable
- Should take into consideration general public sector practices in the state but also aligned to the broader marketplace
 - Should consider inflation levels, where relevant
- Should take into consideration the expanded nature of the compensation (i.e., incentive opportunities) for employees covered under this policy, namely:
 - Investment professionals
 - Senior non-investment executives (i.e., CEO, COO, CFO, etc.)

Opinions We Collected

© all rights reserved 2022



CalPERS Board Members also Shared the Following:

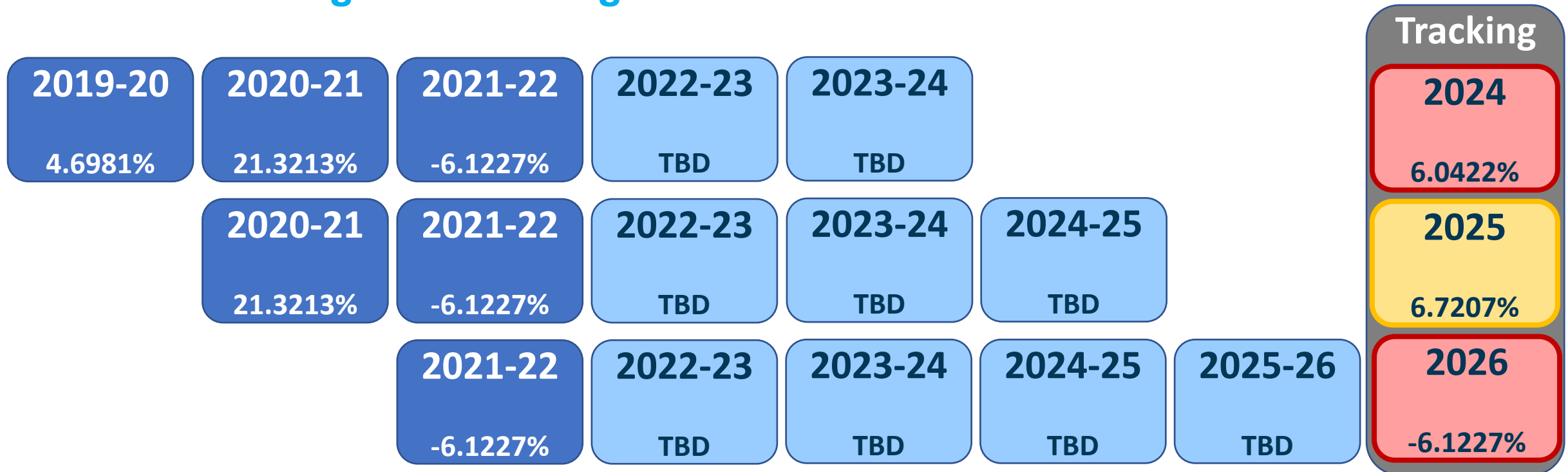
- Compensation should be sustainable - a 3% target salary increase makes sense
- At-risk Incentive pay should be more of the focus
 - Salary increases should not make a material impact/difference
- Accountability needs to be strengthened
 - Performance should reflect actual performance over the course of the entire performance period; not everyone can be exceptional
 - Asset class performance should be considered
 - Not sure how to strengthen the accountability structure, especially if public sector practices continue to prevail

Tracking LTIP Value



© all rights reserved 2022

Communicating LTIP tracking should motivate behaviors:



NOTE: By 2024 LTIP will be 50% of the total incentive opportunity and payouts which should consistently focus team members on annual absolute return performance.

Typical Salary Adjustments

© all rights reserved 2022



CalPERS should consider relevant North American practices:

- A recent North American survey throughout all major sectors showed that the median expected salary increase increased to 3% for 2022
- Typical assessment distributions normally has most of the employees landing on target or “Successfully Meets Expectations” levels
- The following is a generally accepted standard for employee performance distribution:

Individual Performance Rating	Targeted % of Employee Population
High Performer (Far Exceeds/Exceeds Expectations)	25%-30%
Target Performer (Successfully Meets Expectations)	60%-70%
Low Performer (Partially Meets/Does Not Meet Expectations)	5%-10%

Our Recommendation

© all rights reserved 2022

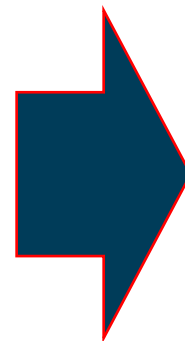


Normalize the assessment of base pay performance adjustments:

- Expand the original 4-level assessment rating to the proposed 5-level standard.
- Maintain alignment with any downward proposals for the general team members

Current Matrix

Overall Performance Rating	Percentage Increase
Outstanding	7%
Consistently Exceeds Standards Expectations	5%
Meets Standards	3%
Does Not Fully Meet Standards Expectations	0%



Recommended Matrix

Overall Performance Rating	Percentage Increase
Exceptional	5%
Consistently Exceeds Expectations	4%
Fully Meets Expectations	3%
Occasionally Meets Expectations	2%
Does Not Meet Expectations	0%

Our Recommendation

© all rights reserved 2022



To further support a performance-based culture:

- Consider placing more weight on incentives
 - Place less emphasis on base salaries
 - Place more emphasis on performance-based payouts
- Send out LTIP payout tracking/projection reports
- Help to re-enforce the perceived LTIP value
- Strengthen the retention value of the incentive program

CalPERS Annual Compensation Adjustments Should be Based on?



Authority to Defer, Reduce, or Eliminate

Purpose of Discretion & Triggers

© all rights reserved 2022



Discretion provides the Board:

- Permission, power, and freedom to act

Triggers provide the Board:

- Guidance on when discretion can/should be considered and possibly applied
 - Just because a trigger has been hit, that does not mean the Board has to defer, reduce or eliminate incentives as many boards choose not to exercise discretion in these situations

Both discretion and triggers:

- Provide clarity and transparency for trustees, managers, and team members
- Aid in the administration of the compensation program
 - Help avoid possible perceptions of mistreatment and distrust

Opinions We Collected

© all rights reserved 2022



CalPERS Board Members Shared the Following:

- Generally, members understand the intent and purpose of clarifying when discretion could/should be applied
- Unsure if this is a prescriptive direction that mandates future action
- Concerned that the Board needs to be comfortable with how triggers might be perceived by CalPERS stakeholders and external community
- Generally, appreciate the addition/inclusion of these elements and the clarity that they provide for Board members

When Including Discretion

© all rights reserved 2022



Typical things that should be considered:

- Compensation policies must be clear on the specific situations/circumstances when their incentives might be eliminated, adjusted, or deferred
 - This provides administration clarity
 - Enhances the transparent and fair treatment of employees
- Higher levels of attrition is a common outcome when employees' pay is altered and they feel caught off-guard, treated unfairly or perceive their employment rights were breached in some way

Our Recommendation

© all rights reserved 2022



To protect the best interests and sustainability of the System:

- CalPERS must retain the ability to alter incentive payouts under clear and extenuating circumstances
- This section be expanded to more clearly identify situations and/or circumstances where plan participants can anticipate payout and/or timing adjustments - Three distinct “Qualifying Triggers”
 - Investment (Total Fund & Asset Class)
 - Policy Violations
 - Reputational Risks
- Discretion can be applied when the Board identifies a triggering event
- Include an outline of actions that can be taken upon any trigger violation
 - Discretion means that actions are not defined as mandatory
- The proposed language would be similar to what is currently found in compensation policies at other pension systems.

Session Wrap Up

Summary: Action Required For Today

© all rights reserved 2022



Did we achieve what we set out to do?

- Specifically, did the Board determine:
 - A revised peer group framework
 - A revised salary adjustment and performance matrix framework
- Did the Board provide additional direction toward further policy revisions for February's PCTM Committee meeting?





GLOBAL
GOVERNANCE
ADVISORS



Peter Landers, Senior Partner

peter.landerson@ggainc.com
+1.416.799.6640

Brad Kelly, Partner

brad.kelly@ggainc.com
+1.416.707.4614