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June 11, 2016

Mr. Michael Bilbrey
Chair of the Performance, Compensation, and Talent Management Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Incentive Compensation Program

Dear Mr. Bilbrey:

You requested Wilshire's opinion with respect to the proposed incentive compensation metrics provided by Grant Thornton. Wilshire has largely focused on the aspects that pertain to the Investment Office (INVO) given our role as the Investment Committee's general consultant. Wilshire has provided input during this process, some of which is reflected in the proposal.

Please note that Wilshire is opining on the materials provided by Grant Thornton and has not had the benefit of recent discussions to clarify some of the issues listed below. To that end, it is possible that some of our comments could be addressed easily.

Overview

Overall, Wilshire believes that the some of the proposed metrics are **appropriate** and create a better alignment with CalPERS and INVO. However, there are other metrics that **contradict** the PCTM Committee's past actions. Furthermore, there are certain metrics that may merit **clarification or reconsideration**.

Appropriate Metrics

Wilshire strongly supports the use of discretion in the INVO awards. Grant Thornton has proposed a range of 0% to +150% of target. This flexibility will make it easier to reward superior performers while minimizing the ability of others to "free ride." As an organization, CalPERS faces certain management challenges with respect to differentiating between top performers, average performers, and below average performers. This discretion can be used as an effective management tool to help differentiate. Clearly, caution should be exercised in the use of this discretion and open communication between managers and their direct reports is encouraged.

Wilshire recommended and is in favor of the inclusion of the "risk-based incentive metrics" where incentive compensation can be reduced or eliminated for violation of risk management principles or adverse outcomes. A reduction or elimination of incentive compensation for violating significant risk policies and principles is fairly straightforward. However, a reduction or elimination of incentive compensation for adverse outcomes – low or negative returns, for example – could be somewhat complicated by other factors: the portfolio may have outperformed significantly in a down market or Staff may have chosen to position the portfolio defensively. While the PCTM Committee has maintained this authority in the past, Wilshire notes that a reduction in incentive compensation has rarely occurred and should continue to be reserved for only rare occurrences.

Contradictory Metrics

Prior iterations of the Incentive Compensation program included multiple time periods, including a five year measurement period. Several years ago, the Committee decided to move to a consistent three year measurement period. Grant Thornton is proposing a five year window (for most participants). Wilshire agrees that the five year measurement period better reflects CalPERS long-term investment horizon, consistent with Investment Belief # 2 (A long time horizon is a responsibility and an advantage, but notes the reversal from prior PCTM actions.

Similarly, the proposed "incentive curve" reverses a prior decision by the PCTM Committee to not pay incentive compensation for negative relative performance. While the logic that risk taking to avoid a "near miss" is clear and we favor the curve's reduced slope, Wilshire notes that this is contradictory to prior PCTM actions.

Clearly, the PCTM can – and should as appropriate – reverse prior decisions as more experience and information is gained. Since the rationale for prior decisions was supported at that time, Wilshire deems it appropriate to highlight these items of note.

Metrics Needing Clarity or Reconsideration

Wilshire notes that Grant Thornton recommends "Inter-period weights = equally weighted (no overweight of final year)." Compound annual rates of return are the industry standard across the investment industry. Equally weighting returns of individual years does not fully capture the impact of returns on portfolio values or their impact on portfolio drawdown. Wilshire, therefore, recommends clarifying this language as appropriate. So, while we agree with the approach of treating each year equally, we highlight that an equal-weighted methodology should use compounding to aggregate across years rather than a simple average.

The use of Cost Effective Measurement metrics for INVO is initially intuitive, but could have unintended consequences. First, all returns are currently stated net of external investment management fees and Staff has been developing a methodology to "charge" internal management fees across asset classes. Thus, via their impact on net-of-fee investment returns, costs have been considered in the Incentive Compensation program. Including separate cost measures would, in some ways, "double count" costs. For example, the scatter plot provided by CEM and shown on page 15 of the Grant Thornton materials shows net relative returns versus costs – in this case, costs are "double counted." If "cost and performance are equally weighted," one unintended consequence could be to minimize costs at the expense of potential relative performance. Reducing costs is more "certain" than relative outperformance. Since private asset classes tend to have more "alpha" associated with them, simply reducing the exposure to those classes – and perhaps reducing relative or even absolute performance – could be one approach to "managing" the incentive compensation payout.

CalPERS' Investment Belief # 8 states that "Costs Matter," a point with which Wilshire wholeheartedly agrees. However, a more nuanced approach may be needed. Peer relative costs when adjusted for allocations could be one such approach to consider.

Lastly, Wilshire suggested adding a risk-adjusted measure of performance, such as Sharpe Ratio. The inclusion of such a metric could be done at the total fund or asset class level. Adding a risk-adjusted performance measure could be one way to address Wilshire's concern about paying for negative performance.

Conclusion

Wilshire supports the effort to create an incentive compensation plan that improves on the alignment between CalPERS and INVO Staff. However, as noted above, we believe that there are several critical areas that the PCTM Committee should address with Grant Thornton.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

Wilshire

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