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August 7, 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: Proposed Modifications to the Incentive Compensation Program

Dear Mr. Bilbrey:

You requested Wilshire's opinion with respect to the proposed changes to the incentive compensation program 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. We have provided extensive feedback during this process working with Grant Thornton, PCA, and Staff, which is reflected in the proposal.

Overview and Recommendation

Overall, Wilshire believes that the proposed metrics are appropriate and create a better alignment of interests between CalPERS as an organization and the investment office. Wilshire noted in our June opinion letter that there are items that contradict the PCTM Committee's past actions; however, Wilshire supports the features of the proposed plan and has had ample opportunity to confer with Grant Thornton to confirm our understanding of how the proposed plan would work.

Wilshire recommends that the Performance, Compensation, and Talent Management (PCTM) Committee approve the plans as proposed for 2016-2017. Specifically, Wilshire has reviewed the proposed plan for the CIO and recommends for the PCTM Committee's approval. The proposed plan simplifies the incentive compensation plan and makes the linkage between compensation and success very transparent.

Comments

Wilshire strongly supports the use of discretion in the INVO awards. Grant Thornton has proposed a range of 50% to +150% of target. This flexibility will make it easier to reward superior performers while minimizing the ability of others to "free ride." This discretion can be used as an effective management tool to help differentiate between top performers and others who are not excelling.



Clearly, caution should be exercised in the use of this discretion and open communication between managers and their direct reports is encouraged.

As noted in our June letter, 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.

One feature that Wilshire would like to see included as an additional design feature in future years is the inclusion of risk-adjusted returns (for example, Sharpe Ratio) so that the “how” of returns drives incentive compensation as does the “how much.” There is significant complexity around this topic that needs to be considered – for example, when returns are negative a better Sharpe ratio would be achieved by having taken more risk, not less. Thus, additional conversation should occur and Wilshire recommends that the risk-adjusted performance metric be included in 2017-2018 plans.

It is important to note that Wilshire, serving as the Investment Committee’s general consultant, will act as an independent check on the total fund “costs” calculated and used in the incentive curve. Wilshire will work with Staff to gather cost data and ensure it is used appropriately in the incentive curve calculation.

Conclusion and Recommendation

Wilshire supports the effort to create an incentive compensation plan that improves on the alignment between the organization and INVO Staff. Having spent additional time working with Grant Thornton, Wilshire believes that the proposed plan greatly simplifies and clarifies the incentive compensation program and focuses on critical measures of success – performance and cost.

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

Best regards,

A handwritten signature in black ink, appearing to read 'Ann J. ...'.