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Memorandum

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To: Bill Slaton, Board of Administration and Chair of the Performance, Compensation and Talent Management Committee ("PCTMC") of CalPERS

Date: March 5, 2017

From: Eric Gonzaga / Grant Thornton LLP

Re: CEO Incentive Compensation

Dear Mr. Slaton,

Background

The Performance, Compensation and Talent Management Committee ("PCTMC") engaged Grant Thornton ("us", "we", or "Firm") to provide potential incentive concepts for a separate incentive strategy for CalPERS CEO.

In 2016, the PCTMC worked with Grant Thornton to update its total compensation philosophy, and implement a new annual incentive plan. The PCTMC also received recommendations on design of a long-term incentive plan from Grant Thornton, as well as an updated salary structure that reallocates the mix of pay amongst salary, annual incentives, and long-term incentives. The latter recommendations were not implemented, and will be under consideration going forward for 2018/2019, as well as potential refinements to the annual incentive plan.

The PCTMC is interested in engaging the CEO as part of the incentive plan discussion and, hence, has requested potential plan alternatives for the CEO separate and apart from the overall executive incentive plan.

Currently, 75% of the CEO's incentive compensation opportunity is tied directly to the same organizational metrics as shared with the rest of the plan participants (Total Fund Performance, Stakeholder Engagement, Investment Office CEM, Customer Service, and Enterprise Operational Effectiveness), while the remaining 25% of the award is tied to qualitative criteria linked directly to Organizational Leadership.

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Considerations

In our experience, Grant Thornton generally has designed incentive plans that optimize behavioral alignment between the CEO and the full executive team, whether in a government, industry, or tax-exempt setting. Typically, this means use of shared metrics and outcomes that are aligned for all executives, and often even non-executives. We believe that this is best practice at CalPERS, and will continue to be best practice.

The CEO's perspective on incentive strategies and goals are of the utmost importance to the design, administration, and implementation of a successful incentive strategy, with the CEO often responsible for development and proposal of appropriate goals for subsequent Board approval. As the leader of the organization and its strategy, the CEO typically works in partnership with the Board through the approval process. Any incentive strategy that does not integrate the top executive's opinions and perspectives will often be less than optimal.

However, given CalPERS limitations in involving the CEO in the process, we do think it appropriate to consider a separate plan for the CEO altogether, in order to ensure involvement of the senior-most executive and decision-maker in the organization.

Thus, we propose for consideration two alternatives:

- Salary Only Plan
- Discretionary Incentive Plan

These alternatives are discussed below.

Alternative A: Salary Only

This structure is the most simple, and likely has the least risk. It could work as follows:

- Increase salary by the amount of annual incentive opportunity taken away.
- Salary would be increased based on the existing performance review process.

In order to implement this strategy, CalPERS would need to adjust the CEO's salary range and review its current performance review methodology to ensure appropriate market competitive pay levels, and ensure appropriate diligence in evaluating the CEO's performance.

The primary downside of this methodology is simply that pay is entirely fixed, and there is only modest compensatory opportunities to reward for outstanding performance (absent further significant increases to fixed compensation), and little ability to reduce compensation or provide meaningfully lower rewards for performance that does not meet target.

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Alternative B: Discretionary Incentive Plan

This structure is relatively simple, and maintains an ability to recognize performance via qualitative assessment. It could be implemented as follows:

- Increase salary by a modest amount, while reducing current annual incentive opportunities.
- Provide an incentive award based on current organizational leadership objectives as are currently identified, potentially including core CEO value or behavioural expectations as well.
- These qualitative objectives would be rated under the current 0, 1.0, and 1.5 scales based on a written qualitative review (with written self-review by the CEO, and formal review by the PCTMC), with the ultimate weighted average determining whether the CEO gets a threshold, target, or outstanding performance award. In completing the assessment, the PCTMC could consider how CalPERS performed from an outcome standpoint for the outcomes defined in the separate executive incentive plan – but it would only be a portion of what the PCTMC considered as part of its qualitative scoring of performance related to the organizational leadership and behavioural expectations.

This alternative has the advantage of still providing a meaningful portion of pay at risk, which should drive desired behaviors, while still creating a distinct pay plan separate and apart from the executive incentive plan due to the differing award mechanism. Additionally, it still encourages alignment with outcomes, since the executive incentive plan goals could still be considered as a component of overall evaluation of the CEO. Finally, this structure can appropriately reward the CEO for overall roles and responsibilities, which cannot always be perfectly identified in any outcome oriented incentive plan.

The primary downside of this alternative is the less than optimal alignment of pay for performance between the CEO and executives, and less objective evaluation of the CEO's performance, since it is inherently qualitative and subjective, and subject to challenges in administration.

Recommendation

Our primary preference is for CalPERS to continue the plan as is, and even potentially adding the CEO into a long-term incentive plan consistent with other executives. However, we also recognize that absolute critical importance of the CEO actively participating in and guiding discussions on appropriate metrics and goals for the year.

Thus, if CalPERS must create a separate plan for the CEO in order to allow for such collaboration, we recommend Alternative B. This technique, although requiring a salary increase and reduced incentive, still allows for adequate pay for performance, while allowing collaboration between the CEO and the Board.

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If you have any questions or require additional information, please feel free to contact us at (612) 677-5336.

Sincerely,

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CAVEATS

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The advice expressed in the Memorandum is not an opinion as to the tax consequences of the transaction. We would need to perform a more thorough review and analysis before we could render an opinion. Our conclusions are limited to the issues addressed in this Memorandum, and are based on facts, assumptions, documents and representations we have received from you, and on any assumptions stated herein. We have neither independently investigated nor verified these facts, representations or assumptions, although we have considered their reasonableness. If any of the facts, representations or assumptions reflected in the Memorandum are not accurate, our conclusions are not applicable.

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