Performance, Compensation & Talent Management Committee

Agenda Item 6b

December 18, 2018

Item Name: Pay Philosophy Discussion for Investment Management Positions

Program: Administration

Item Type: Action

Recommendations

Review the pay philosophy used for the CIO position and select option(s) to receive compensation data for remaining investment management positions at a future meeting.

Executive Summary

Competitive compensation levels are an essential factor for the Board's goal of recruiting and retaining highly qualified individuals for covered executive and investment management positions. Following on the pay philosophy decisions made by the Committee earlier this year to revise the compensation structure of the CIO position, today's item turns the focus to the other investment management positions covered by the Board's compensation setting authority. The Board's Executive Compensation Consultant, Grant Thornton LLP (Consultant), will present recommendations and options for the Committee's consideration in setting compensation levels for the investment management positions covered by the Board's Compensation Policy for Executive and Investment Management Positions (Compensation Policy). Based on the Committee's direction, the Consultant and human resources team members will bring back comparator group data and implementation plans over the next few Committee meetings.

Strategic Plan

This agenda item supports CalPERS' Strategic Goal to promote a high-performing and diverse workforce in the 2017-22 Strategic Plan. The Executive Compensation Program provides a means for recruiting, retaining, and empowering highly-skilled executives to meet organizational priorities and strengthen the long-term sustainability of the pension fund by generating returns to pay member benefits.

Background

In 2016, the Board engaged Grant Thornton as the Board's primary executive compensation consultant to conduct a comprehensive review of CalPERS' incentive compensation programs to ensure alignment with CalPERS' goals and strategies as well as best practice in implementation. The Consultant's analysis concluded that while base salaries for the investment management positions were generally positioned near the competitive median, total cash compensation levels (annual base salary plus annual incentive) lagged well below market and were positioned below the market 25th percentile. The Consultant also made recommendations on reallocating the mix of pay between base salary and annual incentives, as well as adding a long-term incentive plan component.

In May 2018, the Performance, Compensation and Talent Management Committee (Committee) affirmed the purpose statement and peer comparator groups used for establishing base pay ranges for positions covered under the Board's Compensation Policy. The Policy's purpose statement explains that "compensation policy… represents the strategic decision that pay must be high enough to encourage highly qualified individuals to accept and remain in positions, but not so high as to attract candidates solely for the compensation. Moreover, compensation systems must be carefully structured to both recognize labor market forces and reinforce maximum performance through placing a substantial portion of total annual compensation at risk." This statement is intended to set the direction of the compensation program and the tone for decisions around salary and incentive ranges for covered positions.

In June 2018, the Committee approved a revised compensation structure for the Chief Investment Officer (CIO) position recruitment, with base salary positioned at the market's 75^{th} percentile and total cash compensation (annual base salary plus annual incentive) positioned between the 50^{th} and 75^{th} percentile of the market.

This agenda item continues the process of assessing the remaining investment positions covered by the Board's Compensation Policy in light of market pay levels and continuing the discussion around how total compensation packages should be set.

Analysis

Grant Thornton will present potential alternatives for bringing total cash compensation levels for the investment management series closer to market levels. At the time of the last comprehensive salary survey in 2015, base salaries for covered investment management positions were generally near 50^{th} percentile of the market, while total cash levels fell well below the 25^{th} percentile of the market.

Earlier this year, the Committee added the words "highly qualified" to their Compensation Policy purpose statement to further clarify the desired purpose of the compensation program. This change provides a focal point for the Committee in consideration of the direction of the compensation program. CalPERS' ability to recruit and retain highly qualified individuals contributes to success in the organization's effort to gain the best returns for our members.

The Committee began this process by evaluating the compensation structure for the CIO position and re-setting base salary and incentive opportunity to be more appropriately aligned with market data. The purpose was to establish a competitive total cash compensation package to attract highly qualified candidates to fill the vacancy.

The Committee should now turn their focus to the other investment management positions to define a pay philosophy and set relevant compensation levels. Taking this action will help ensure the Investment Office can retain highly qualified existing talent and attract and retain highly qualified future talent. Recruitment and retention are critical factors which contribute to CalPERS' ability to improve funded status and maintain fund sustainability. It is also important for our pipeline of potential future team members to include highly qualified external candidates. As the job market becomes increasingly competitive, compensation decisions become increasingly important.

For CalPERS' investment management positions, the Committee will need to select a direction that reflects the desired positioning against market data.

Next Steps and Look Ahead

Any changes to the existing salary ranges and incentive schedules approved by the Committee over the next few meetings will become effective July 1, 2019. Depending on the Committee's direction, team members will work with the Consultant to bring back data and develop an implementation plan, including guidelines for placement of current employees into revised salary and incentive ranges; potential phase-in options; and mechanics for any new compensation program components (if applicable). A comprehensive implementation plan will provide a framework to place both external and internal candidates within appropriate salary ranges at time of hire or promotion.

CalPERS team members will incorporate any approved changes to base salary ranges, incentive schedules, and any other plan design options into the Board's Compensation Policy and will bring back the updated policy at a future meeting.

Budget and Fiscal Impacts

The costs associated with increasing salary and annual incentive levels would represent an overall increase in annual cost, dependent on the options selected by the Committee and individual positioning in the revised salary ranges and annual performance for incentive payouts. Based on fiscal year 2017-18 figures, the total cost of base salary and incentive payouts for the investment management positions being discussed today represented approximately 0.01 percent of assets under management (AUM) by CalPERS.

Of the nearly 120 current employees covered by the compensation program, only a small subset, approximately nine percent, are classic members with no cap on their pensionable earning potential. The remaining participants are subject to Internal Revenue Code and Public Employees' Pension Reform Act (PEPRA) caps on their compensation that can be considered as pensionable. Incentive compensation, as paid at CalPERS, is never pensionable.

It is important to understand the impacts to compensation that can be reported vary considerably, depending on individual factors such as membership start date or past service. Although it's anticipated the group subject to caps will continue to grow, the actual number covered by caps can increase or decrease as employees may come to CalPERS from other agencies or leave CalPERS for other opportunities.

Benefits and Risks

Decisions which better align compensation with market will increase CalPERS' ability to attract and retain highly qualified individuals who can successfully implement strategies to improve and maintain fund sustainability and increase funded status. Continuing to have compensation levels below market puts CalPERS at risk of not being competitive in the recruitment and retention of necessary talent.

Attachments

Attachment 1 – Presentation Slides

Tina Campbell
Chief, Human Resources Division