CalPERS

Performance, Compensation & Talent Management Committee

Agenda Item 8b

February 20, 2019

Item Name: Salary and Incentive Options for Investment Management Positions

Program: Administration

Item Type: Action

Recommendations

Approve revised base pay ranges and incentive award ranges for investment management positions covered by the Board's compensation setting authority.

Executive Summary

Competitive compensation levels are an essential factor for the Board's goal of recruiting and retaining highly qualified individuals for positions covered by the Board's compensation setting authority under Government Code section 20098. Today's item presents salary and incentive data requested by the Performance, Compensation and Talent Management Committee (Committee) for investment management positions, including the Chief Operating Investment Officer, Managing Investment Directors, Investment Directors, Investment Managers, and Associate Investment Managers. The Board's primary compensation consultant, Grant Thornton LLP (Consultant), will present options for the Committee's consideration based on the Committee's direction and feedback in December 2018. Based on discussion at that time, the recommendations being presented today target the market 50th percentile for combined annual base salary and incentive opportunity.

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 Committee affirmed the purpose statement and peer comparator groups used for establishing base pay ranges for positions covered under the Board's Compensation Policy for Executive and Investment Management Positions (Compensation Policy). The Compensation Policy's purpose statement explains 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 75th percentile and total cash compensation (annual base salary plus annual incentive) positioned between the 50th and 75th percentile of the market. The purpose was to establish a competitive total cash compensation package to attract highly qualified candidates to fill the vacancy.

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. 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.

Analysis

Grant Thornton will present data on the two compensation alternatives requested by the Committee in December 2018 with the expressed goal of moving pay for these investment management positions into alignment with the market 50th percentile (Attachment 1). The Committee will need to select which of these options they would like to implement to achieve the expressed goal. Market data presented in this item is based on a comparator group compensation survey conducted by McLagan and presented to the Board in 2015, with conservative adjustments made to ensure data more closely represents today's market.

The sole focus of today's action is to align pay with market positioning and allow CalPERS to compete for highly qualified talent where vacancies exist currently and in the future. Depending on the option selected by the Committee, team members will work with the Consultant to identify an appropriate implementation plan and/or phase-in approach for presentation to the Committee prior to the changes taking effect for the 2019-20 fiscal year. While high-level impacts will be discussed today, team members and the Consultant will return at a future meeting to review details regarding other implementation impacts.

Option A, as presented in December 2018, would move compensation levels to the market 50th percentile by establishing above-market base salary ranges and below market annual incentive ranges, resulting in increased cost for base pay and reduced cost and focus on incentive pay.

The key benefit of this option is to discourage inappropriate risk-taking by focusing primarily on fixed pay. Alternatively, this option creates a significant increase in fixed pay, which would result in an immediate cost increase associated with transitioning current incumbents into the structure while balancing total compensation levels against current earning opportunities.

Option C, also as presented in December 2018, would move compensation levels to the market 50th percentile by establishing market-aligned base salary ranges, largely maintain existing incentive opportunity ranges, and add a long-term incentive opportunity. Compared to Option A, this option would result in a lesser increase to the cost of fixed pay and would balance the focus on annual and long-term performance. The benefit of this option is a more balanced approach and improved alignment with the long-term mission of the organization. Immediate costs associated with this option are not as significant, given base pay for the majority of current incumbents already falls within the recommended ranges. The anticipated cost increase of annual and long-term incentive would be relative to the increase in base pay. Depending on implementation details of long-term incentive, at least a portion of the costs would be deferred. Payouts would be made in accordance with thresholds established as part of the implementation plan and details will be provided at a future meeting. Participation in the long-term incentive program would be limited to covered positions in the Investment Office.

In addition to the revised salary and incentive ranges, the Consultant is also recommending use of a single incentive opportunity range for each investment management classification, reducing complexity and the potential for inequity between peers. This change will impact the Investment Manager and Investment Director classifications that currently have multiple incentive ranges. Implementation of a single incentive range for each classification would include a policy provision allowing caps to be set within the single range based on variables such as role, function, and placement within the organization.

Revising compensation to align with the market becomes increasingly important as CalPERS continues to compete with other public systems and private institutions for highly skilled investment talent. Even in situations of healthy turnover, there will continue to be employees who move on to other opportunities or retire, resulting in the need to fill positions with top-talent. Over the last three years, the average vacancy rate for the investment management classifications was 12 percent, versus 13 percent for the Investment Office as a whole.

Next Steps and Look Ahead

Any changes to the existing salary ranges and incentive schedules approved by the Committee will become effective July 1, 2019, for the following positions: Managing Investment Director, Investment Director, Investment Manager, and Associate Investment Manager. Team members recommend any change to the existing Chief Operating Investment Officer position salary and incentive ranges be made effective immediately to address the recruitment needs of this vacant, single-incumbent position. Depending on the Committee's direction, team members will work with the Consultant to 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 (e.g., long-term incentive, if applicable). A comprehensive implementation plan will provide a framework to place both external and internal candidates equitably within appropriate salary ranges at time of hire or promotion. As with the implementation of any new compensation structure, there will be impacts to current incumbents which may not be standardized across the collective population covered by the Board's Compensation Policy.

If the Board approves Option C, which includes a long-term incentive component, further Committee action may be required to address potential impacts to other covered positions. If required, additional information will be brought back at a future Committee meeting.

CalPERS team members will also 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, contingent on the option selected by the Committee, individual positioning in the revised salary ranges, and annual performance for incentive payouts. Several variables impact the cost of the investment management incentive program, such as vacancy levels, fund performance, individual performance, individual incentive plan measures/metrics, and where incumbents are within base salary quartiles due to tenure and performance year-over-year. In addition, levers in the Board's Compensation Policy may also impact cost. This includes levers to address both satisfactory or unsatisfactory performance, as well as the ability to defer, reduce, or eliminate awards in specific negative return situations.

Using CalPERS' current salary and incentive structure, the projected cost of the program if all positions were filled at mid-salary and achieving target annual incentive levels would be approximately $34.5 million. For comparison purposes, the same scenario (mid-salary plus target incentive) in Option A would yield a cost of approximately $57.4 million. Of that, $44.4 million would be attributed to base salary and $13.0 million as variable pay and subject to fund and individual performance factors. Option C (mid-salary, target annual incentive, and long-term incentive) would yield an estimated cost of $58.9 million, with $31.1 million tied to base salary and $27.8 million as variable pay. As a percentage of total assets under management (AUM), CalPERS' current compensation structure would represent approximately 0.010 percent of AUM. At the midpoint of the proposed salary ranges, plus the target incentive potential, Option A would increase that to 0.016 percent of AUM, and Option C would increase it to 0.017 percent of AUM (see Attachment 1, page 14).

For comparison purposes, the average cost of salary and annual incentive payouts over the last three fiscal years was approximately $28.43 million. It is important to keep in mind that this figure does not include any positions which were vacant or individuals who did not qualify for an incentive award due to qualifying tenure in the program. Based on these figures, the total cost of base salary and incentive payouts over the last three fiscal years represented around 0.008 percent of assets under management (AUM) by CalPERS over the same period. While incentive award payouts will vary year-to-year based on fund and individual performance factors, higher incentive award payouts generally correlate with higher fund returns and performance, with hurdle rates set by the Board.

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 highly qualified talent. If the Committee chooses to postpone action today, implementation of any revised base salary ranges and/or incentive award ranges could be delayed to fiscal year 2020-21. In addition, it may be necessary to conduct a more current salary survey, resulting in increased contracting costs.

Attachments

Attachment 1 – Consultant's recommendations and presentation slides

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