



Performance, Compensation & Talent Management Committee

Agenda Item 6d

September 17, 2019

Item Name: Long-Term Incentive Program Design and Implementation of Revised Salary/Incentive Ranges for Investment Management Positions (Second Reading)

Program: Administration

Item Type: Action

Recommendation

Approve a Long-Term Incentive Program design for covered investment management positions.

Executive Summary

This item presents the second reading of the design and implementation plan recommendations from the board's primary executive compensation consultant, Grant Thornton, for the Long-Term Incentive Program (LTIP) approved by the board in February 2019. The LTIP will be effective beginning in fiscal year 2019-20. Additionally, this item presents information on the implementation plan associated with the revised salary and incentive ranges which were also approved by the board in February 2019 and became effective July 1, 2019.

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 individuals to meet our organizational priorities.

Background

In 2016, the board engaged Grant Thornton (Consultant) 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. At that time, the Consultant made initial recommendations on

reallocating the mix of pay between base salary and annual incentives, as well as adding a long-term incentive 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 for Executive and Investment Management Positions (Policy).

In June 2018, the board approved a revised compensation structure for the Chief Investment Officer (CIO) position due to the need to fill a vacancy for that position. In December 2018, the Consultant conducted a pay philosophy discussion for all remaining investment management positions and presented three compensation structures designed around the goal of moving to "median peer pay" (market 50th percentile based on peer comparator group) for total cash (base salary plus incentive). The Committee expressed interest in two of the three options and requested the Consultant return with details.

In February 2019, the Consultant presented details on the two options preferred by the Committee and the board approved the option that included: base pay adjustments for all investment management levels, incentive range adjustments for some investment management levels, and the addition of a long-term incentive component for all investment management levels within the investment office. The option approved by the board achieves the expressed goal of establishing total cash (base salary plus incentive) earning opportunities aligned with the market 50th percentile. The Committee asked the Consultant to return with details on the long-term incentive component design and implementation. CalPERS team members also indicated they would return with implementation details associated with the new base salary and incentive ranges.

In June 2019, the Consultant presented the first reading on the design of a Long-Term Incentive Plan (LTIP). The proposal included the following features:

- LTIP awards would be based on absolute Total Fund returns over a five-year period
- Initial payouts for the first cycle would occur at the end of the fifth year of the performance cycle, with payouts occurring annually for each overlapping five-year performance period thereafter
- Performance levels for the entire five-year period would be based around the Board-approved expected rate of return (actuarial assumed rate of return) in the first year of the performance period
- Initial LTIP award values would be based on the lower of the employee's actual annual incentive or their annual incentive range target
- Payouts at the end of the fifth year of each five-year performance period would range from 0% to 150% of the initial LTIP award value based on Total Fund performance and board-approved performance levels

The Committee discussed threshold, target, and maximum performance levels for total fund returns and asked the Consultant to bring back updated options and recommendations to incorporate the Committee's feedback.

Analysis

The intent of adding a LTIP for all investment management positions within the Investment Office at CalPERS is to establish a unified focus on total fund return levels that contribute to the

long-term sustainability of the fund, while maintaining a substantial amount of “pay at risk” to incent strong performance. Based on the Committee’s feedback in June 2019, the Consultant has brought back three options for the Committee’s consideration. The Consultant’s presentation (Attachment 1) further explains the details of their recommendations.

Based on the Committee’s direction today, CalPERS team members and the Consultant will update the Policy (if necessary) to incorporate the selected LTIP design. Slide 37 in Attachment 1 highlights three key provisions from the current Policy which would likely require changes to ensure the LTIP is appropriately administered. Other less substantive revisions would likely be required, as well. All modifications to the Policy will be brought before the full Board for adoption at a future meeting, effective for the 2019-20 fiscal year.

Implementation of Revised Base Pay and Incentive Ranges

In February 2019 when the board approved the long-term incentive component to be included in the compensation structure for the investment management positions, it also approved revised base salary and incentive ranges. The combination of increases is aimed at bringing total compensation into alignment with the 50th percentile of CalPERS investment management comparator group, as outlined in the Policy. Incentive ranges were adjusted and consolidated to establish a single incentive range for each classification. At the Chief Executive Officer’s and Chief Investment Officer’s discretion, caps may be set within the single range based on variables such as role, function, and placement within the organization, with incentive ranges never exceeding the board-approved ranges.

Base Pay Salaries and Incentive Ranges for Current Investment Management Position Incumbents

With the establishment of market-comparable base salary ranges, and the adjusted and consolidated incentive ranges, the Consultant and CalPERS team members reviewed current base salaries and incentive ranges to determine whether any adjustments for current incumbents may be necessary. It was determined there were two categories of impacted individuals to be addressed; individuals whose salaries were previously below the minimum of the new salary ranges and individuals whose incentive range opportunities have been reduced due to range consolidation. CalPERS increased salaries to the new minimum for those in the first category of individuals, effective July 1, 2019. For the second category, CalPERS will grant a five percent base salary increase effective July 1, 2019, to minimize any adverse impact to total cash (base salary plus incentive) earning potential.

Base salaries for all investment management positions will continue to be reviewed as part of the annual performance evaluation process. Increases may be granted in accordance with relevant Policy provisions and factors such as equity, performance, experience, and tenure.

Establishing Appropriate Incentive Range Caps for Investment Management Positions Outside of the Investment Office

Currently, three investment management positions exist outside the investment office (Chief Compliance Officer, Deputy Chief Compliance Officer, and Controller). The incentive ranges for these positions are currently restricted to align with the incentive opportunities of other enterprise peer-level positions. Incentive ranges for these positions will remain capped to ensure ongoing alignment with enterprise peers. If future organizational structure changes are

made which result in the addition of investment management positions outside the investment office, this same approach will be used to set appropriate caps within the existing incentive ranges.

Budget and Fiscal Impacts

As proposed by the Consultant, fiscal year 2024-25 will be the first year in which CalPERS could make LTIP payments to investment team members following the completion of the first five-year performance period in fiscal year 2023-24. Payments would only be made if minimum Board-approved performance levels are met.

At the maximum long-term incentive level and based on estimated future salaries, CalPERS estimates LTIP payments may cost up to \$25.6 million for the five-year performance period which ends in fiscal year 2023-24. This figure includes required OASDI and Medicare costs. Maximum payouts would indicate the fund performed at or above the maximum performance level, as outlined in the Consultant’s proposal.

For comparison, the table below shows potential estimated costs of annual incentives earned at target (also based on estimated future salaries and including required OASDI and Medicare costs), plus long-term incentive when achieved at the various performance levels. Costs are shown in millions.

Incentive Type	Annual at Target + LTIP below Threshold (All Options)	Annual at Target + LTIP at Threshold (Options B, C Only)	Annual at Target + LTIP at Goal/Target (All Options)	Annual at Target + LTIP at Maximum (All Options)
Annual	\$17.1	\$17.1	\$17.1	\$17.1
LTIP	\$0	\$8.5	\$17.1	\$25.6
Total	\$17.1	\$25.6	\$34.2	\$42.7

In comparison, total incentive payments budgeted in fiscal year 2019-20 are \$12.1 million, and \$10.5 million was budgeted in in 2018-19. Actual annual incentives paid to investment management positions in fiscal year 2017-18 were \$9.3 million. Analysis of awards paid out from fiscal year 2015-16 through 2017-18 indicate annual incentive awards, on average, were paid out near incentive range targets.

Benefits and Risks

As approved by the board in February, the addition of a long-term incentive component better aligns compensation for investment management positions with the market 50th percentile, increasing CalPERS’ ability to attract and retain highly qualified individuals who can successfully implement strategies that improve fund sustainability and increase funded status to benefit members.

Attachments

Attachment 1 – Long-term Incentive Program Design Recommendations (Grant Thornton LLP presentation)

Tina Campbell
Chief, Human Resources Division