

Long-term Incentive Program Design Recommendations and CIO Compensation Design

September 17, 2019

Today's Agenda

- Discuss and decide long-term incentive program design

Long-term Incentive Program Design Recommendations

Definitions

Term	Definition
CAGR	<ul style="list-style-type: none"><li data-bbox="311 380 1769 511">▪ Acronym for “compound annual growth rate.” CalPERS Total Fund returns for the Long-term Incentive Program (LTIP) will be measured using a CAGR formula, which takes into consideration the compounding of returns over each entire five-year performance period.<li data-bbox="311 532 1812 663">▪ Measuring returns using a CAGR formula provides a more accurate representation of performance than using “average annual returns,” which is a measure that can overstate performance when there are negative returns over an extended performance period.
Expected Rate of Return	<ul style="list-style-type: none"><li data-bbox="311 691 1669 778">▪ The CalPERS’ expected rate of return for Total Fund performance in the first year of each LTIP five-year performance period will serve as the “target” (goal) performance level for the entire five-year period.<li data-bbox="311 800 1802 887">▪ E.g.: if the CalPERS expected rate of return is 7.0% in Year 1 of a performance period, “target” (goal) performance would be equal to 7.0% annual returns over five years (measured using the compound annual growth rate).

Definitions (continued)

Term	Definition
Initial LTIP Value	<ul style="list-style-type: none">▪ The initial LTIP award value amount will be allocated in Year 1 of each five-year performance period, upon which payouts will be based at the end of that five-year performance period.▪ Initial LTIP award values will be calculated based on the lower of: (i) a participant's actual annual incentive payout in Year 1; or (ii) their annual incentive range target in Year 1.▪ The initial LTIP award value will be subject to a Payout Multiplier (see below) based on CalPERS' Total Fund returns over the five-year performance period.
Payout Multiplier	<ul style="list-style-type: none">▪ A multiplier used to determine each participant's actual award payout at the end of each five-year performance period. It ranges from 0% to 150% of the initial LTIP award value based on CalPERS' Total Fund returns over the performance period

Definitions (continued)

Term	Definition
Performance Period	<ul style="list-style-type: none"><li data-bbox="330 380 1731 465">▪ The period of time over which performance will be measured to determine the Payout Multiplier (a five-year performance period is being presented as Grant Thornton's recommendation for CalPERS).
Total Fund Returns	<ul style="list-style-type: none"><li data-bbox="330 524 1808 609">▪ Total Fund returns will be measured using the "net time-weighted rate of return" of Total Fund performance over a five-year period.

Decisions Made at February 2019 Meeting

- CalPERS Performance, Compensation & Talent Management Committee (“PCTMC”) adopted compensation “Option C”
- Option C makes the following changes to compensation for investment management positions covered by the Board’s compensation-setting authority:
 - Increases salary midpoints to market 50th to 75th percentile
 - Adjusts and consolidates annual incentive ranges
 - Introduces a Long-term Incentive Program (LTIP)

Decisions Made at June 2019 Meeting

- The Committee discussed threshold, target, and maximum performance levels for Total Fund returns, and asked GT to return with updated options/recommendations that incorporated the Committee's feedback

Executive Summary



LTIP Recommendations – Overall Plan Design

- GT recommends an LTIP with the following features:
 - Measure Total Fund returns over five years
 - Target (goal) performance for entire period is based on the expected rate of return in Year 1 of that period
 - Initial LTIP award values are calculated based on the lower of: (i) an employee's actual annual incentive earned in Year 1; or (ii) their annual incentive range target in Year 1
 - LTIP actual award payouts for the first five-year performance period will occur at the end of Year 5; LTIP awards may then be granted annually with overlapping five-year performance periods
 - Actual LTIP award payouts can range from 0%-150% of the Initial LTIP award value based on Total Fund performance and related thresholds

LTIP Recommendations – Employee LTIP Levels

- GT recommends employees’ Initial LTIP values be based on the lower of (i) their actual annual incentive earned in Year 1, or (ii) their target annual incentives in Year 1

Classification	Annual Incentive Range (% of Salary)	Initial LTI Value
Associate Investment Manager	0 – 40% (27% target)	Lower of 27% <u>or</u> Actual Annual Incentive
Investment Manager	0 – 60% (40% target)	Lower of 40% <u>or</u> Actual Annual Incentive
Investment Director	0 – 75% (50% target)	Lower of 50% <u>or</u> Actual Annual Incentive
Managing Investment Director	0 – 105% (70% target)	Lower of 70% <u>or</u> Actual Annual Incentive
Chief Operating Investment Officer	0 – 75% (50% target)	Lower of 50% <u>or</u> Actual Annual Incentive

- Final LTIP payouts will range from 0% to 150% of Initial LTIP values based on Total Fund returns over the five-year performance period

LTIP Recommendations – Performance Level Options

- Based on the Committee's feedback from the June meeting, GT has provided updated LTIP performance level options
- GT's plan design recommendations (as detailed on slide 10) apply to all three options listed below; the only difference between the options are the Total Fund performance levels at which payouts occur

Design Option	Performance Level Design (Payout Multiplier Listed in Parenthesis)		
	Threshold (0.5 or 50%)	Target (1.0 or 100%)	Maximum (1.5 or 150%)
Option A	No threshold performance level; no payout for below 7%	7.0%	8.4% (120% of Target)
Option B	5.60% (80% of Target)	7.0%	8.4% (120% of Target)
Option C	6.10% (87% of Target)	7.0%	8.4% (120% of Target)

LTIP Recommendations – Performance Level Options (continued)

Option	Description	GT Commentary
Option A	<ul style="list-style-type: none"> ▪ Performance level design requested by the Committee in June ▪ Option A has the same threshold and target performance levels (i.e., no payouts will occur unless the target performance level is reached) 	<ul style="list-style-type: none"> ▪ It is fairly unique to have an LTIP with no threshold performance level ▪ Utilizing such a design may introduce a greater degree of risk into the plan, as a substantial amount of compensation can be earned at a specific level of performance (i.e., Target performance) <ul style="list-style-type: none"> – If Target performance is 7.0%, there could be potential for undue risk taking if Total Fund returns over the five-year performance period are slightly below 7.0% – More simply put, Total Fund returns of anything less than 7.0% will have no payout, while returns of 7.0% have a 1.0 multiplier on the Initial LTI Value

LTIP Recommendations – Performance Level Options (continued)

Option	Description	GT Commentary
Option B	<ul style="list-style-type: none"> ▪ Original plan proposed by GT ▪ Threshold and maximum performance levels are set at -20% and +20% of target, respectively 	<ul style="list-style-type: none"> ▪ Having threshold and maximum performance the same "distance" from target is a standard incentive design at public and private organizations ▪ Setting a threshold performance goal an appropriate distance from target mitigates undue risk taking by having payouts for below target performance, while also ensuring that a sufficient level of returns are needed to justify a payout
Option C	<ul style="list-style-type: none"> ▪ New option that sets threshold at projected 10-year performance (6.1%) 	<ul style="list-style-type: none"> ▪ The only difference between Option B and C is a slightly more difficult performance threshold for Option C (Option B has a threshold of 5.6%, while Option C is 6.1%) ▪ GT would be comfortable with an LTIP based on Option C

LTIP Performance Design – Option A



Option A – Performance Levels

The table below shows proposed performance levels for Total Fund returns over five years:

Performance Level	Total Fund Returns
Maximum Performance = Expected Rate of Return x 120%	8.4%
Target Performance = Expected Rate of Return in Year 1	7.0%
(No Threshold Performance Level)	N/A

- Performance will be measured as the compound annual growth rate (“CAGR”) of Total Fund returns over the five-year performance period
- Target performance for each five-year period is based on the Expected Rate of Return in the first year of the given period

Option A – Payout Multiplier

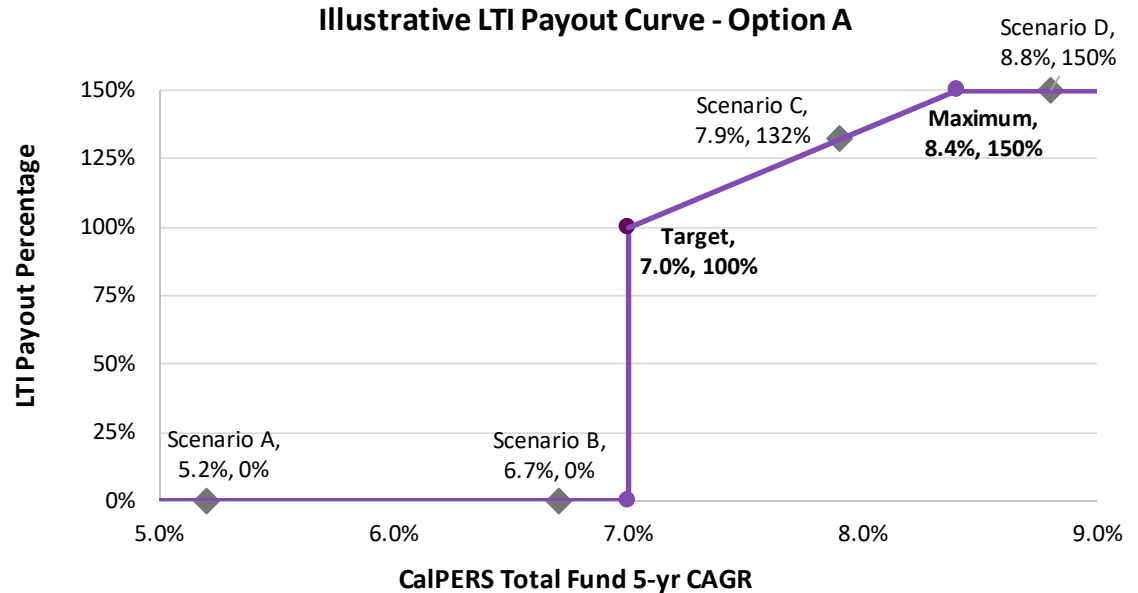
Performance Level	5-Year Total Fund Return Level	Payout Multiplier
Maximum Performance ¹	8.40%	1.5 (or 150%)
<i>Performance between target and maximum</i>	--	<i>Interpolated</i>
Target ("Goal") Performance ²	7.00%	1.0 (or 100%)

¹ Multiplier capped at 1.5 for returns above maximum

² No payouts will occur for returns below target

Option A – Payout Curve

- The graph to the right shows the proposed performance and payout levels
- Hypothetical scenarios have been included to illustrate potential performance and payout outcomes
- Data labels list returns first and corresponding payout level second



Option A – Illustrative Example

- The tables on the following slides provide an illustrative example of the proposed LTIP mechanics:

Step 1 – Initial LTIP award value for a Hypothetical Investment Manager

CalPERS Fiscal Year	Base Salary	Annual Incentive Information (% of Salary)		Initial LTIP Value <i>(Lower of Target and Actual Annual Incentive)</i>		
		Target	Actual	Award #	% of Salary	\$ Value
'19 – '20	\$190,000	40%	35%	#1	35%	\$66,500
'20 – '21	\$200,000	40%	45%	#2	40%	\$80,000
'21 – '22	\$210,000	40%	50%	#3	40%	\$84,000

Option A – Illustrative Example (continued)

Step 2 – Calculate Payouts (returns listed below are hypothetical and shown for illustrative purposes; our example assumes an expected rate of return of 7.0% for each period)

Award #	CalPERS Fiscal Year – Hypothetical Total Fund Returns								Payout Result		
	'19 – '20	'20 – '21	'21 – '22	'22 – '23	'23 – '24	'24 – '25	'25 – '26	'26 – '27	CAGR ¹	Payout	
#1	13.5%	11.3%	9.6%	6.8%	6.1%	Award #1 Payout			9.43%	1.50 or 150%	
#2		11.3%	9.6%	6.8%	6.1%	4.3%	Award #2 Payout		7.59%	1.21 or 121%	
#3			9.6%	6.8%	6.1%	4.3%	2.0%	Award #3 Payout		5.73%	0.0 or 0%

¹ CAGR – Compound Annual Growth Rate

Option A – Illustrative Example (continued)

Step 3 – Calculate LTIP Payout

LTIP Award Info		Initial LTIP Award Value		Total Fund Performance		Final LTIP Payout
Award #	Fiscal Years	% of Sal.	\$ Value	CAGR	Payout	
#1	'19 – '24	35%	\$66,500	9.43%	1.50 or 150%	\$99,750
#2	'20 – '25	40%	\$80,000	7.59%	1.21 or 121%	\$96,800
#3	'21 – '26	40%	\$84,000	5.73%	0.0 or 0%	\$0

LTIP Performance Design – Option B



Option B – Performance Levels

The table below shows proposed performance levels for Total Fund returns over five years:

Performance Level	Total Fund Returns
Maximum Performance = Expected Rate of Return x 120%	8.4%
Target Performance = Expected Rate of Return in Year 1	7.0%
Threshold Performance = Expected Rate of Return x 80%	5.6%

- Performance will be measured as the compound annual growth rate (“CAGR”) of Total Fund returns over the five-year performance period
- Target performance for each five-year period is based on the Expected Rate of Return in the first year of the given period

Option B – Payout Multiplier

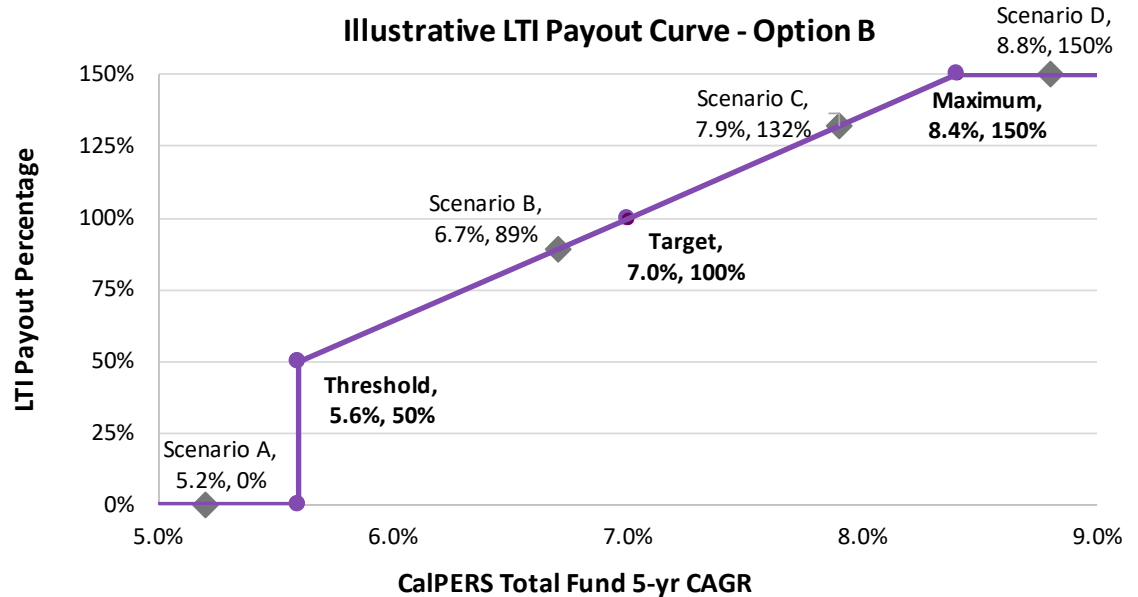
Performance Level	5-Year Total Fund Return Level	Payout Multiplier
Maximum Performance ¹	8.40%	1.5 (or 150%)
<i>Performance between target and maximum</i>	--	<i>Interpolated</i>
Target ("Goal") Performance	7.00%	1.0 (or 100%)
<i>Performance between target and minimum</i>	--	<i>Interpolated</i>
Threshold Performance ²	5.60%	0.5 (or 50%)

¹ Multiplier capped at 1.5 for returns above maximum

² No payouts will occur for returns below threshold

Option B – Payout Curve

- The graph to the right shows the proposed performance and payout levels
- Hypothetical scenarios have been included to illustrate potential performance and payout outcomes
- Data labels list returns first and corresponding payout level second



Option B – Illustrative Example

- The tables on the following slides provide an illustrative example of the proposed LTIP mechanics:

Step 1 – Initial LTIP award value for a Hypothetical Investment Manager

CalPERS Fiscal Year	Base Salary	Annual Incentive Information (% of Salary)		Initial LTIP Value <i>(Lower of Target and Actual Annual Incentive)</i>		
		Target	Actual	Award #	% of Salary	\$ Value
'19 – '20	\$190,000	40%	35%	#1	35%	\$66,500
'20 – '21	\$200,000	40%	45%	#2	40%	\$80,000
'21 – '22	\$210,000	40%	50%	#3	40%	\$84,000

Option B – Illustrative Example (continued)

Step 2 – Calculate Payouts (returns listed below are hypothetical and shown for illustrative purposes; our example assumes an expected rate of return of 7.0% for each period)

Award #	CalPERS Fiscal Year – Hypothetical Total Fund Returns							Payout Result			
	'19 – '20	'20 – '21	'21 – '22	'22 – '23	'23 – '24	'24 – '25	'25 – '26	'26 – '27	CAGR ¹	Payout	
#1	13.5%	11.3%	9.6%	6.8%	6.1%	Award #1 Payout			9.43%	1.50 or 150%	
#2		11.3%	9.6%	6.8%	6.1%	4.3%	Award #2 Payout		7.59%	1.21 or 121%	
#3			9.6%	6.8%	6.1%	4.3%	2.0%	Award #3 Payout		5.73%	0.55 or 55%

¹ CAGR – Compound Annual Growth Rate

Option B – Illustrative Example (continued)

Step 3 – Calculate LTIP Payout

LTIP Award Info		Initial LTIP Award Value		Total Fund Performance		Final LTIP Payout
Award #	Fiscal Years	% of Sal.	\$ Value	CAGR	Payout	
#1	'19 – '24	35%	\$66,500	9.43%	1.50 or 150%	\$99,750
#2	'20 – '25	40%	\$80,000	7.59%	1.21 or 121%	\$96,800
#3	'21 – '26	40%	\$84,000	5.73%	0.55 or 55%	\$46,200

LTIP Performance Design – Option C



Option C – Performance Levels

The table below shows proposed performance levels for Total Fund returns over five years:

Performance Level	Total Fund Returns
Maximum Performance = Expected Rate of Return x 120%	8.4%
Target Performance = Expected Rate of Return in Year 1	7.0%
Threshold Performance = Expected Rate of Return x 80%	6.1%

- Performance will be measured as the compound annual growth rate (“CAGR”) of Total Fund returns over the five-year performance period
- Target performance for each five-year period is based on the Expected Rate of Return in the first year of the given period

Option C – Payout Multiplier

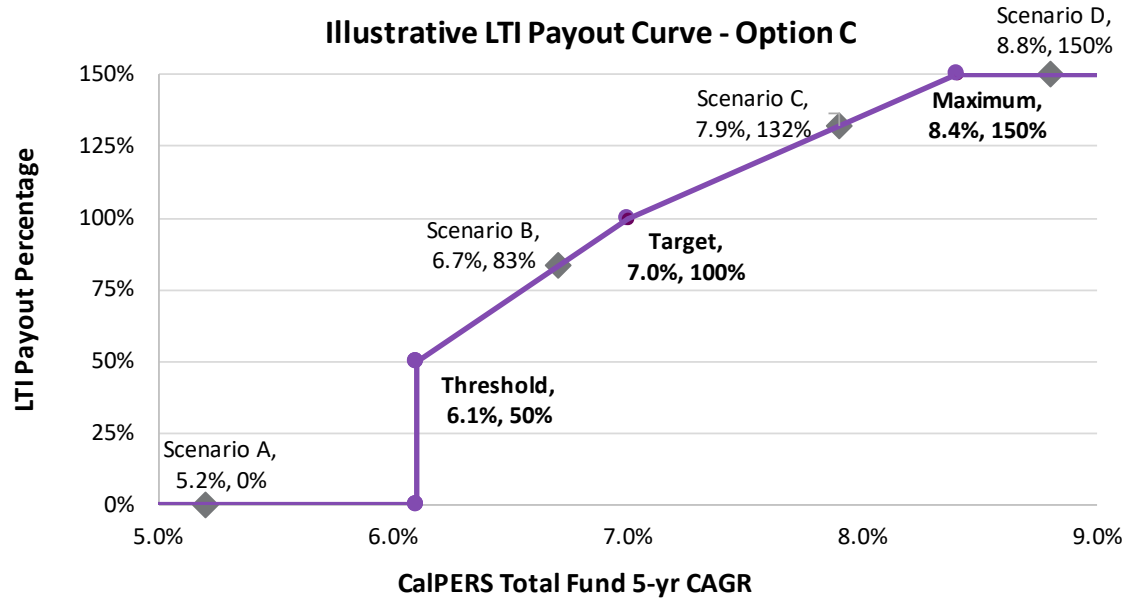
Performance Level	5-Year Total Fund Return Level	Payout Multiplier
Maximum Performance ¹	8.40%	1.5 (or 150%)
<i>Performance between target and maximum</i>	--	<i>Interpolated</i>
Target ("Goal") Performance	7.00%	1.0 (or 100%)
<i>Performance between target and minimum</i>	--	<i>Interpolated</i>
Threshold Performance ²	6.10%	0.5 (or 50%)

¹ Multiplier capped at 1.5 for returns above maximum

² No payouts will occur for returns below threshold

Option C – Payout Curve

- The graph to the right shows the proposed performance and payout levels
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Option C – Illustrative Example

- The tables on the following slides provide an illustrative example of the proposed LTIP mechanics:

Step 1 – Initial LTIP award value for a Hypothetical Investment Manager

CalPERS Fiscal Year	Base Salary	Annual Incentive Information (% of Salary)		Initial LTIP Value <i>(Lower of Target and Actual Annual Incentive)</i>		
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'21 – '22	\$210,000	40%	50%	#3	40%	\$84,000

Option C – Illustrative Example (continued)

Step 2 – Calculate Payouts (returns listed below are hypothetical and shown for illustrative purposes; our example assumes an expected rate of return of 7.0% for each period)

Award #	CalPERS Fiscal Year – Hypothetical Total Fund Returns							Payout Result			
	'19 – '20	'20 – '21	'21 – '22	'22 – '23	'23 – '24	'24 – '25	'25 – '26	'26 – '27	CAGR ¹	Payout	
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¹ CAGR – Compound Annual Growth Rate

Option C – Illustrative Example (continued)

Step 3 – Calculate LTIP Payout

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Award #	Fiscal Years	% of Sal.	\$ Value	CAGR	Payout	
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#3	'21 – '26	40%	\$84,000	5.73%	0.0 or 0%	\$0

Other LTIP Design Considerations



LTIP Design Recommendations – Other Considerations

Design Area	Overview and GT Commentary
Existing Policy Provisions	<ul style="list-style-type: none"> ▪ GT recommends certain existing policy provisions related to annual incentives apply to LTIP, with certain alterations to address the nuances of the LTIP. Key provisions requiring revision may include those related to the topics below: <ul style="list-style-type: none"> – LTIP Eligibility – Pro-rata Awards – Action Upon Unsatisfactory Performance ▪ In addition, other conforming Policy revisions may be necessary to ensure the Policy reflects any decision regarding LTIP made by the Committee.
LTIP: CIO and CEO Positions	<ul style="list-style-type: none"> ▪ To promote a unified focus across the investment office, GT recommends the CEO and CIO position eventually participate in the LTIP plan. The Committee may want to consider this at a future meeting.