



To: CalPERS Performance, Compensation and Talent Management Committee

From: Eric Gonzaga, Eric Myszka, and Rob Storrick, Grant Thornton LLP

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Re: Recommended Compensation for the Chief Investment Officer Role

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Introduction

As detailed in Agenda Item 6a, CalPERS' CIO is the only position in the investment office that does not participate in the long-term incentive (LTI) plan. Accordingly, Grant Thornton is recommending the CIO position participate in the LTI plan to (1) better align with CalPERS' current compensation plans and competitive market practices, (2) encourage long-term retention in the CIO role, and (3) incentivize sustained investment performance over the length of the LTI plan.

Recommendation

The table below details Grant Thornton's recommendation for CIO compensation ranges and incentive levels; note that we have also listed market data which was presented in June 2018 when the Board adopted revised salary and incentive ranges for the CIO position to provide a comparison to competitive market levels:

Table A

	CalPERS Today	GT Recommendation	Market Data ¹
Base Pay Range	\$424,500 - \$707,500 (midpoint \$566,000)	\$424,500 - \$707,500 (midpoint \$566,000)	\$470,000 - \$566,000 (midpoint \$495,000)
Annual Incentive Range (% of salary)	0-150% (target 100%)	0-120% (target 80%)	--
LTI Range (% of salary)	--	80% - 120% ²	--
Min Potential / P25 (Min Salary + Target Incentive + Target LTI)	\$849,000	\$1,103,700	\$948,000
Mid Potential / P50 (Mid Salary + Target Incentive + Target LTI)	\$1,132,000	\$1,471,600	\$1,509,000
Max Potential / P75 (Max Salary + Max Incentive + Max LTI)	\$1,768,750	\$2,405,500	\$2,107,000

In summary, Grant Thornton is making the following recommendations for the CIO's go-forward compensation:

- Maintain the existing salary range;
- Reduce the current annual incentive range of 0% to 150% of salary (100% target) to 0% to 120% of salary (80% of target);
- Introduce a long-term incentive award with a target amount of 80% of salary. The initial long-term incentive award may be less than 80% of salary if the actual annual incentive award received in year 1 is less than target. Additionally, the LTI award can payout at 150% of the initial award level if maximum performance is achieved.

Appendix A provides a visual display of the CIO's current compensation and Grant Thornton's recommendation against the competitive market data.

¹ McLagan originally presented market data for the CIO role in 2015; the data presented in 2018 was aged to then-current 2018 levels based on conservative annual adjustments. Note that market compensation levels do not include long-term incentives.

² If actual annual incentives paid is lower than the LTI target in any one year, then the initial long-term incentive value for that year will be capped at the actual annual incentive payment. LTI payments may be paid out at 150% of the initial LTI value if maximum performance levels are reached (maximum performance = compound annual growth rate returns of at least 8.4% over the five-year performance period).

Commentary – Internal Positioning

Grant Thornton's recommendation to maintain the current salary range would keep the CIO role with the highest salary range in the investment office. The proposed annual incentive range of 0% to 120% of salary (80% of target) and a long-term incentive target of 80% of salary would be equal to the Deputy Chief Investment Officer and would be the highest levels in the investment office for each respective incentive plan.

Given that the CIO is the highest ranked position in the investment office, we believe it would be appropriate (and a matter of best practice) to adopt annual and long-term incentive plan ranges that would position the CIO as the role with the highest target total compensation package in the investment office.

Commentary – External Positioning

The midpoint of the existing base salary range, \$566,000, is equal the market 75th percentile provided by McLagan. The recommended target total compensation (i.e., midpoint salary and target annual and long-term incentives) of \$1,471,600 is 2% below the market median of total cash, which aligns with CalPERS' stated compensation philosophy to set target total compensation between the 50th and 75th percentiles of market total cash.

The maximum potential compensation (i.e., maximum salary and maximum annual and long-term incentives) of \$2,405,500 would be positioned 14% above the market 75th percentile. Grant Thornton does not have concerns about this potential, since such high compensation will only be received if CalPERS' performance far exceeds the performance of its peers and the overall market.

There are two other factors that further support our CIO compensation recommendation :

- The market data for the CIO role was last presented in 2015 and aged to then-current day levels in 2018. Based on our knowledge of comparable public pension funds and peer financial services organizations, we recognize that actual market levels have increased in the last five years and that if another benchmarking study were completed today, that competitive market levels would likely be higher than the values presented above.
- CalPERS traditionally only considers market total cash levels (i.e., salary + annual bonuses) when benchmarking total compensation in the investment office. Long-term incentives, which are excluded from the market data, typically represent a significant portion of compensation at peer organizations. If these were to be included in the market data, the CIO's maximum compensation would be positioned much lower relative to the market data.

Conclusion

Grant Thornton recommends that CalPERS adjust the CIO's compensation levels and ranges to include an LTI award. As shown in Table A, the recommended salary, annual incentive, and long-term incentive ranges approximate the market median for total cash, which is aligned with CalPERS adopted compensation philosophy. Lastly, the inclusion of the CIO in the LTI plan would further unite the investment office and ensure a shared investment focus over the duration of the five-year performance period. Given that the CIO position is currently vacant, it is Grant Thornton's opinion that the inclusion of the LTI plan in the CIO's compensation package would assist the Board in recruiting and hiring the most talented potential applicants.

CAVEATS

This memorandum address certain U.S. Federal income tax issues only and does not address state, local or other foreign tax issues. Our discussion is based on the Internal Revenue Code of 1986, as amended, the Treasury Regulations promulgated thereunder, and other relevant authorities. These authorities are all subject to change, and such change could have retroactive effect. Any such changes could thus have effect on the validity of our conclusions. Unless specifically requested, we will not update this Memorandum for subsequent changes or modifications to these authorities. Further, this memorandum is based on interpretation of these authorities; another knowledgeable party (such as the IRS or court hearing the same facts) might reach different conclusions.

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.

DISCLOSURE PURSUANT TO IRS CIRCULAR 230

The information contained in this document is not a tax opinion. This document was not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on any taxpayer.

Appendix A – Comparison of CIO’s Current and Proposed Compensation Ranges Against Competitive Market Data

Note: compensation levels are listed in \$000s

