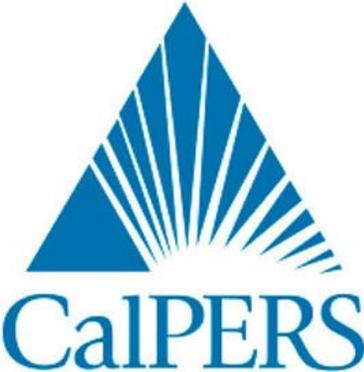




GLOBAL  
GOVERNANCE  
ADVISORS

# Compensation Governance Best Practices



California  
Public Employee  
Retirement  
System

# Outline

## Contents of Today’s Education Session

**PERFORMANCE REVIEW BEST PRACTICES..... 3**

**COMPENSATION BENCHMARKING BEST PRACTICES.. . . . . 16**

**RELATIVE VALUE ADD BENCHMARKS..... 22**

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**PROACTIVE COMMUNICATION STRATEGIES..... 34**



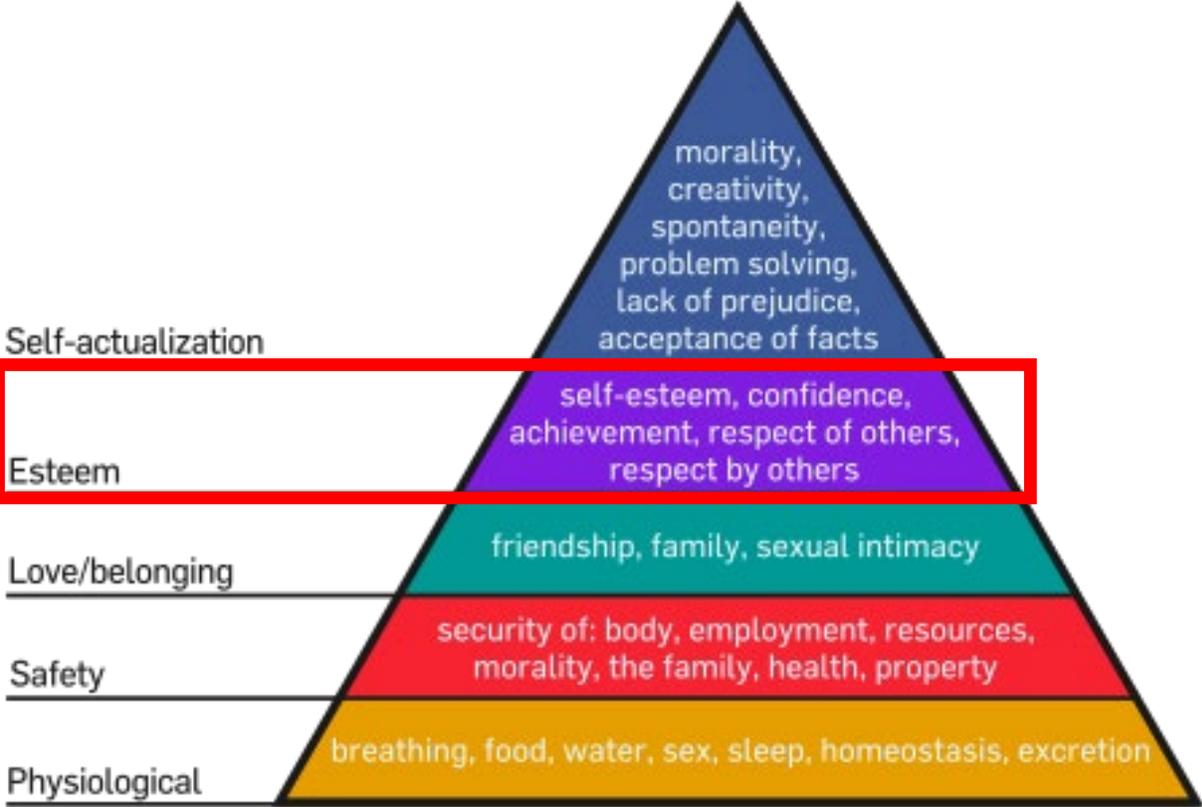
# PERFORMANCE REVIEW BEST PRACTICES



# Address What Employees Want



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Abraham Maslow's Hierarchy of Needs, 1943

# Why Do Performance Plans Fail?



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## Poor Design



## Poor Execution



# Positive Incentive (At Risk Pay) Plans



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## Effective Plans:

- Are clear on expectations and process
- Promote buy-In
- Based on influence
- Assess attainability
- Rely on strong communication
- Are simple
- Are renewable
- Are affordable



# Performance Objectives & Targets



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- Objectives and targets in a balanced scorecard can be tested against the mnemonic **SMARTER**:

**S**pecific  
**M**easurable  
**A**ttainable  
**R**elevant  
**T**ime-Bound  
**E**thical  
**R**isk Weighted

(Source – Global Governance Advisors)



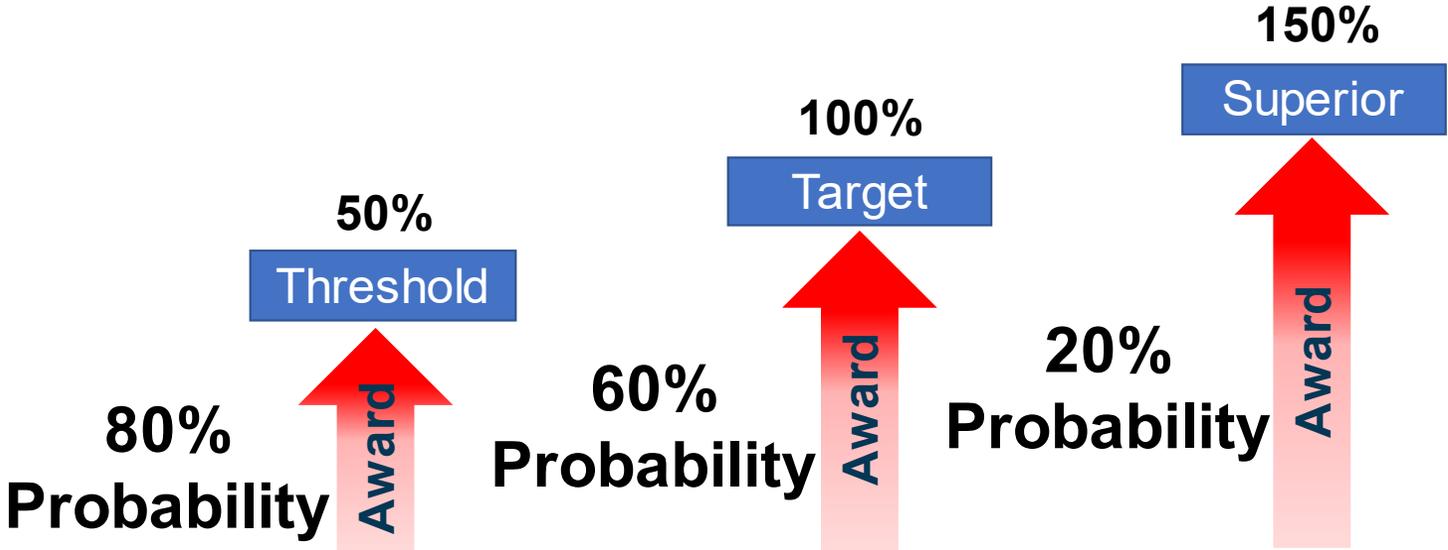
# Balanced Scorecards Help Focus



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## An approved table that outlines agreed:

- Performance targets
- Measures
- Weighting
- Award amounts related to performance levels:



# Good Rule of Thumb...

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Threshold (Minimum) Performance:  
Achieved 8 out of 10 years

Target Performance:  
Achieved 6 out of 10 years

Superior (Maximum) Performance:  
Achieved 2 out of 10 years

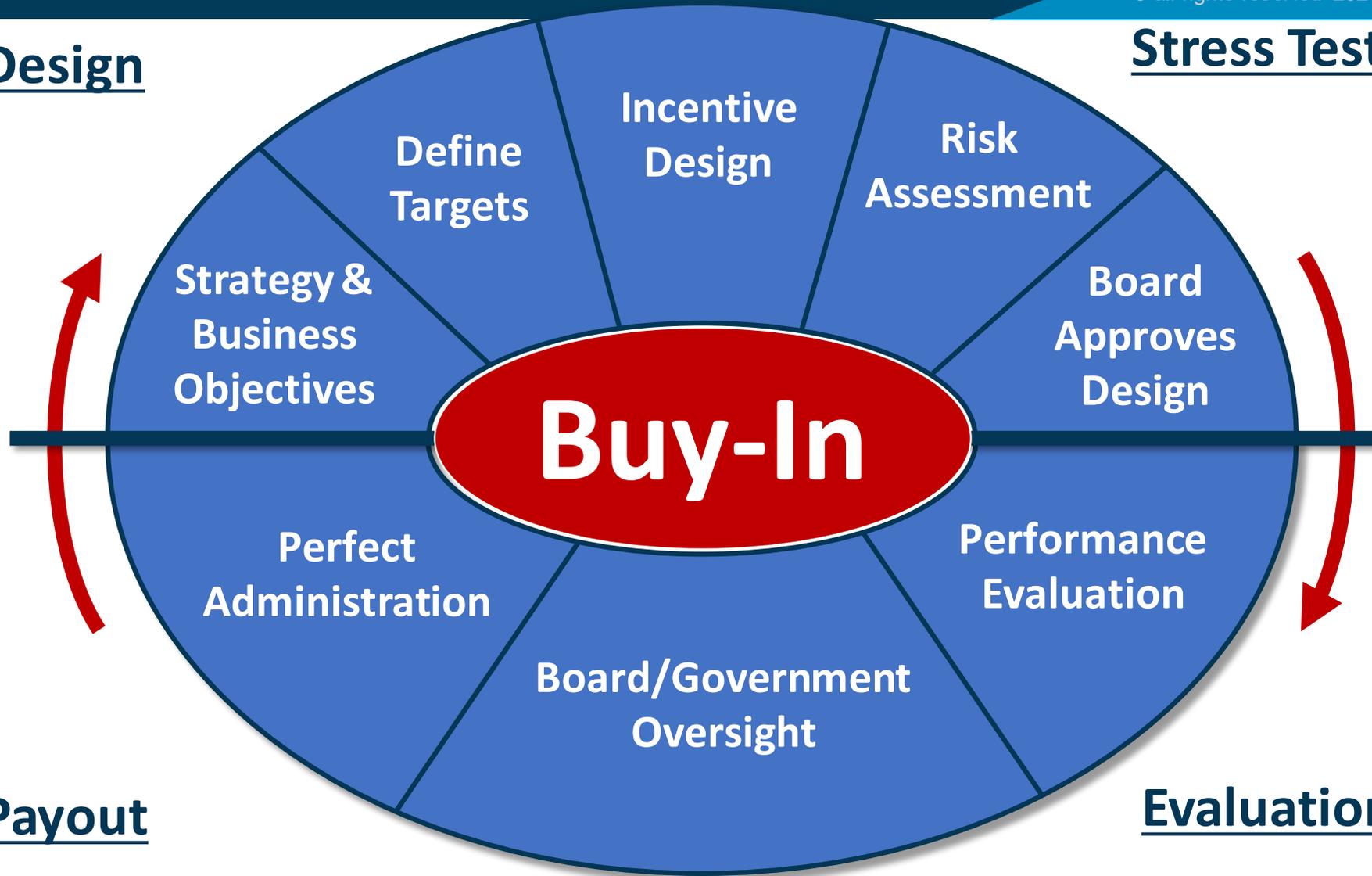
# Process is Important – Buy-In is Key



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Design

Stress Test



# Strong Communication is Essential



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## Communication is a cornerstone

- A strong plan provides communication opportunities
  - Tools to share expectations and concerns
- Reinforcement of the strategic plan
- Understanding strengthens buy-in
- Sets stage for beneficial process
  - Objectives and goal setting
  - Mid-year assessment
  - Final (year-end) results
- Consistent follow through is important



# Communication Cycle



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## Initial Meeting

- Establish (SMARTER) objectives
  - Clarity of expectations
- Opportunity for input
- Negotiation strengthens accountability
- Identification of potential challenges



# Communication Cycle cont'd



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## Mid-Year Meeting

- Understanding of current performance
- Opportunity to communicate challenges
  - Discuss possible solutions
- Possible adjustment of objectives
  - Only if absolutely necessary
- Clarity on how success can be achieved



# EXPECTATIONS

## *Employee Engagement*

### Proactive participation is expected

- Ideas on personal objectives, targets & weightings
- Solutions to real problems
  - Based on realities
  - Team-oriented
- Should always know their current performance levels
- Ideas for (ongoing) improvement

# Communication Cycle cont'd



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## Year-End Meeting

- Understanding of overall performance
- Opportunity to communicate challenges
  - Discuss possible solutions
- Opportunity to strategize
  - How can I achieve greater success in the upcoming year?



# COMPENSATION BENCHMARKING BEST PRACTICES

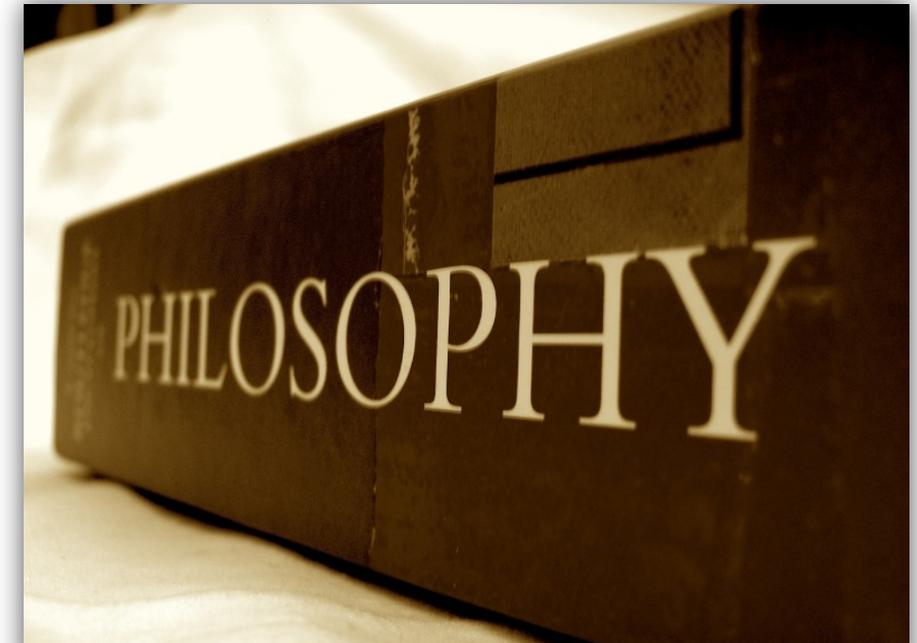
# The Foundation - Compensation Philosophy

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## Key Characteristics:

- Purpose & Objectives
- Elements of Compensation
- Compensation Mix
- Well-Defined Peer Group
  - Characteristics
- Positioning Relative to Peer Group
- Governance & Oversight of Program

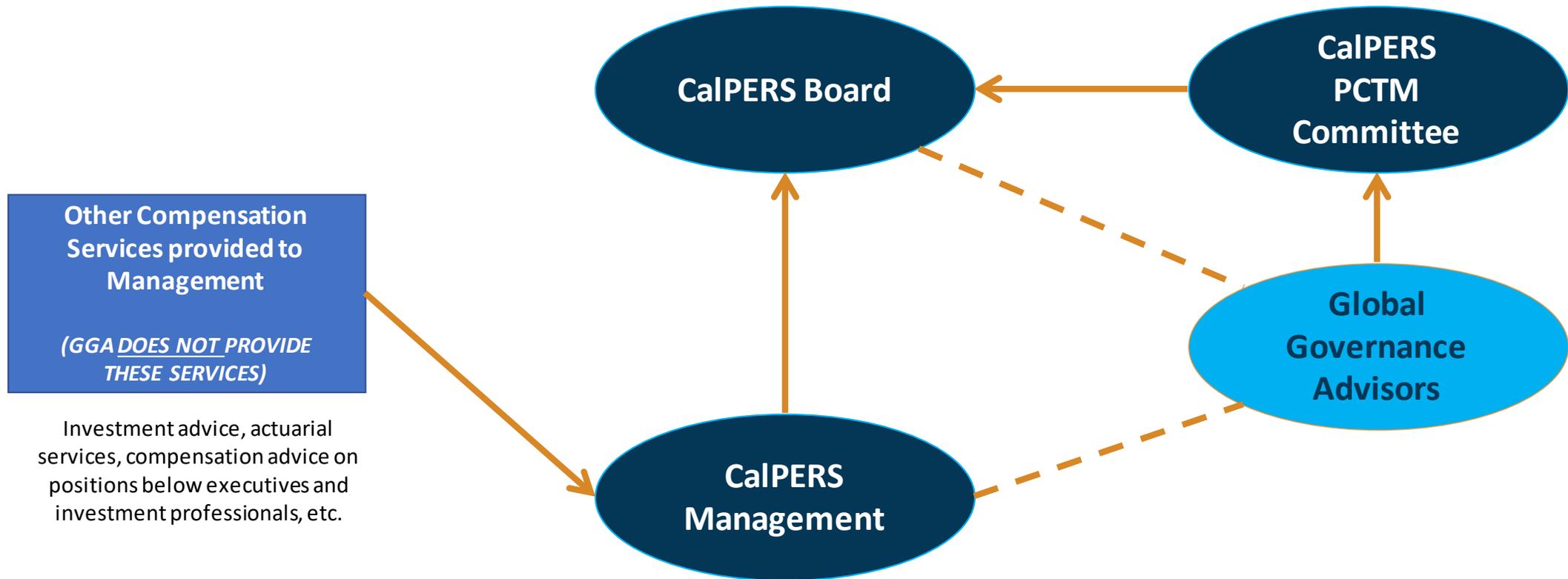


**NOTE: CalPERS should consider benchmarking against “Total Direct Compensation” now that its compensation mix includes LTIP.**

# GGA's Working Relationship Structure



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In carrying out our services, GGA works for the Board through the Performance, Compensation & Talent Management Committee and in collaboration with senior management.

# Types of Compensation Reviewed



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## Market review of executive compensation levels against a peer group relating to:

- Base salary
- Short-term incentive awards
- Long-term incentive awards
- Accumulated and realized LTIP grants
- Retirement benefits
- Perquisites



**Comp  
Advisor**

**Ongoing/  
In-house**

# Always use Similar Peers



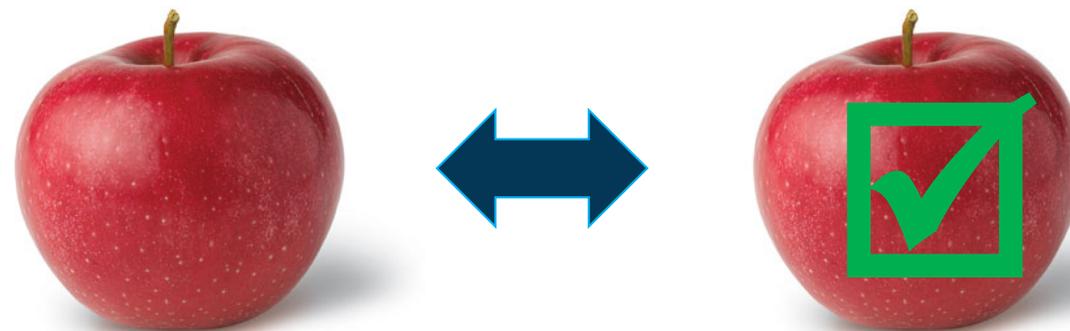
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## Peer group or market data should be comprised of organizations that are:

- Of similar size (e.g., assets, members, etc.)
- Similar sectors (e.g., investment, pensions, etc.)
- Similar region

## The positions should be:

- Similar in scope
- Similar responsibilities



*Overall, it is very important to know what your peers are doing.*

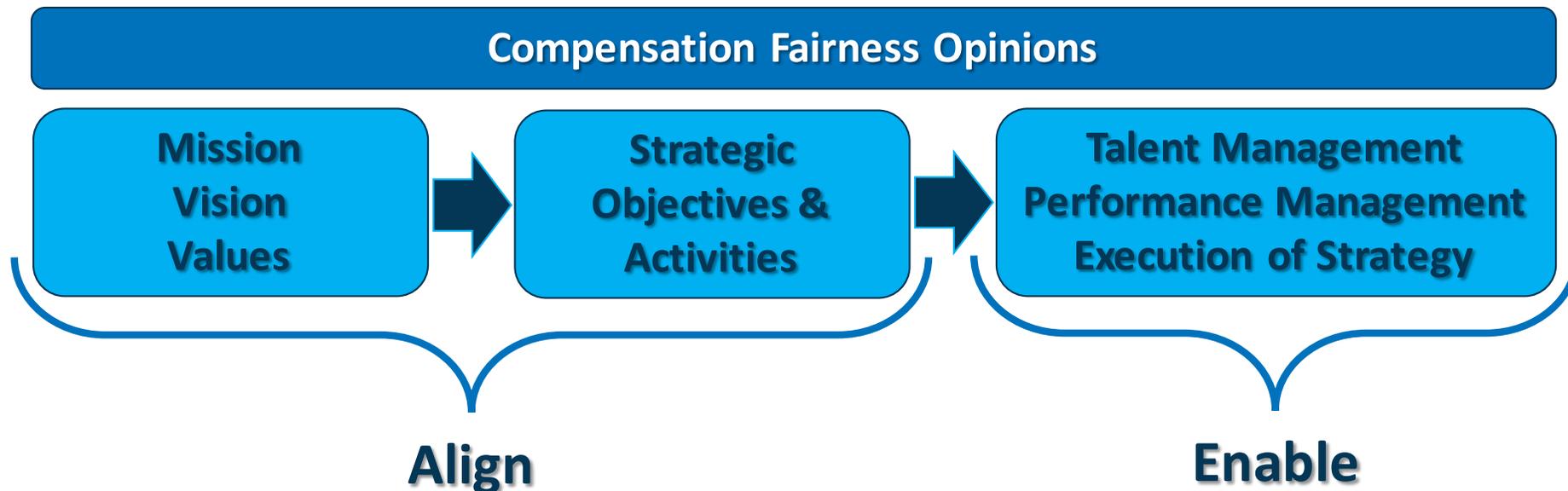
# Enhancing Organizational Effectiveness



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## Compensation Benchmarking

- Decisions should align with the mission, vision and values of the organization
- Help align and enable fund strategy and activities
- Improve attraction, retention and performance of staff



# RELATIVE VALUE ADD BENCHMARKS

# Purpose of Benchmarks



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- Define the broad investment opportunity set for Board and Staff
- Track broad capital market performance
- Align expected risk and return from Asset Allocation policy with execution of that policy
- Measure staff performance in executing policy
- Measure effectiveness of Asset Allocation policy with other alternative policies

**All these purposes would require different benchmark selection**

# Role of Independent Consultants

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## **Investment Consultants:**

- Review and recommend benchmarks (used for both investment policy and incentive compensation)
- Provide opinions on changes to benchmarks and parameters to incentive compensation

## **Compensation Consultants:**

- Review market practices as it relates to setting appropriate performance hurdles to achieve against benchmark for Incentive purposes
- Analyze the impact of changes in benchmarks on Incentive payout levels through historical lookback and forward-looking analysis
- Audit Incentive payouts in relation to performance against benchmarks on an annual basis

# High-Level Market Best Practices



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## Total Fund Benchmarks

Funds utilize a “policy benchmark” (target weights X actual benchmark performance) to assess Total Fund performance.

## Asset Class Benchmarks

Funds utilize well-recognized strategic class benchmarks that reflect reasonable/viable opportunity sets for each major class.

## Use of Customized Benchmarks

Funds utilize customized benchmarks that reflect unique policy decisions.

## Use of Same Benchmarks for Investment & Incentive Performance Evaluation

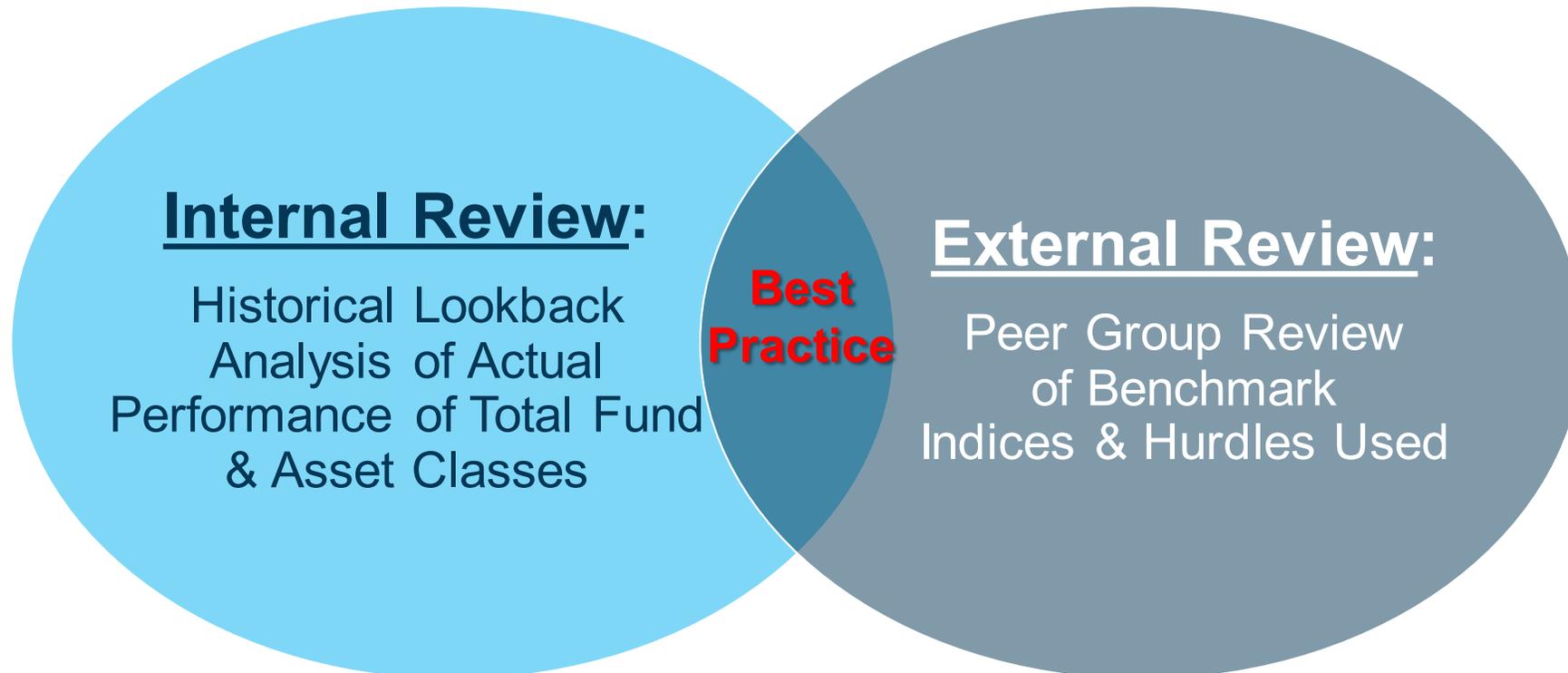
Funds generally use the same investment benchmarks for investment and incentive performance evaluations.

# High-Level Market Best Practices cont'd



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- Conducting Internal and External Reviews in conjunction with one another is another way to test the reasonableness of benchmark indices and hurdles.
  - This best practice helps to ensure there is pay-for-performance linkage and no “gaming” of payouts in addition to a fund’s normal benchmark review process.



# Selected U.S. Funds



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Investment performance is measured relative to appropriate pre-defined benchmarks in the asset allocation and benchmarks table, including applicable footnotes, in the Board’s Investment Policy Statement (“IPS”).



Incentive compensation must be earned and is paid only when portfolio and fund performance surpasses thresholds set by Trustees working with industry consultants.



The VRS Board of Trustees awarded the bonuses to investment professionals under an incentive pay plan based on the performance of the retirement system’s investments, measured in comparison with benchmarks of expected performance over three and five years.

# PENSION TRENDS

***What Needs To Change?***

***What Can We Improve?***

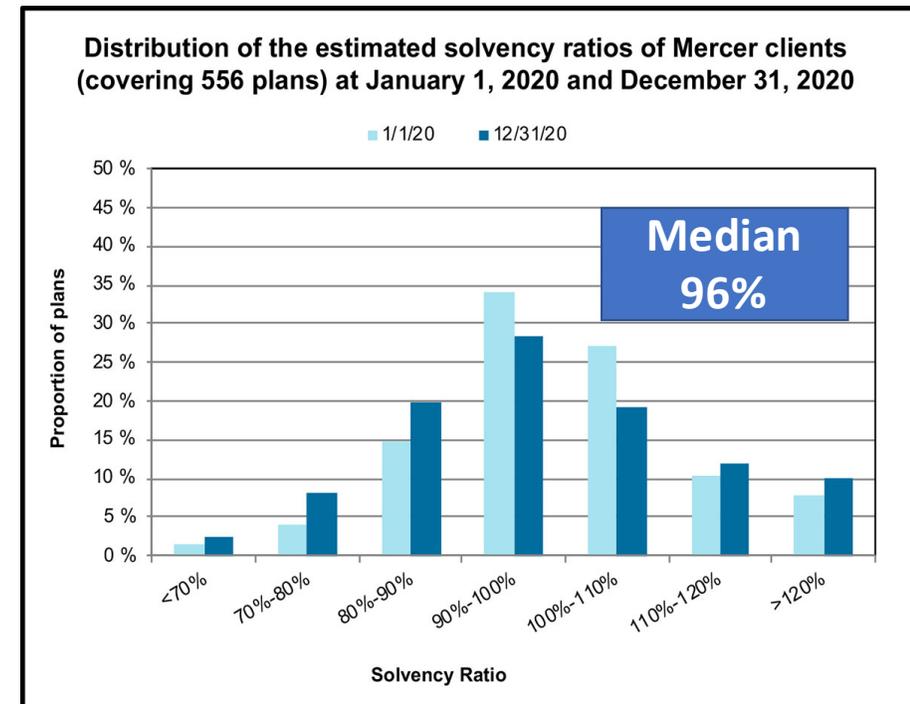
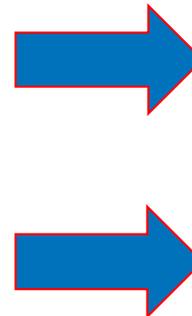
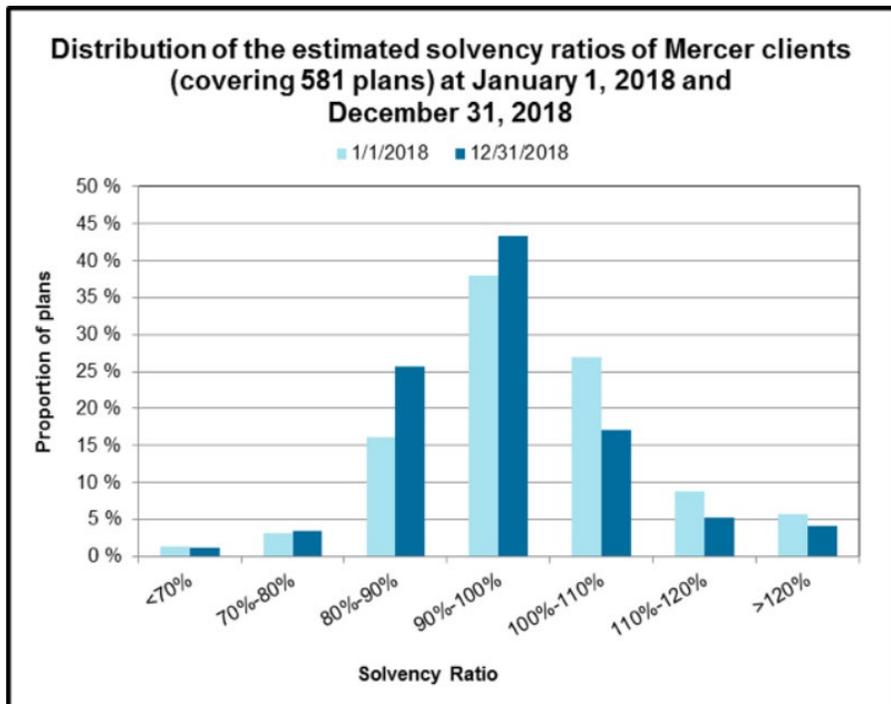
***Is There a Better Way?***

# Full Funding Is Possible



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## Mercer Pension Reports (Canadian Funds)



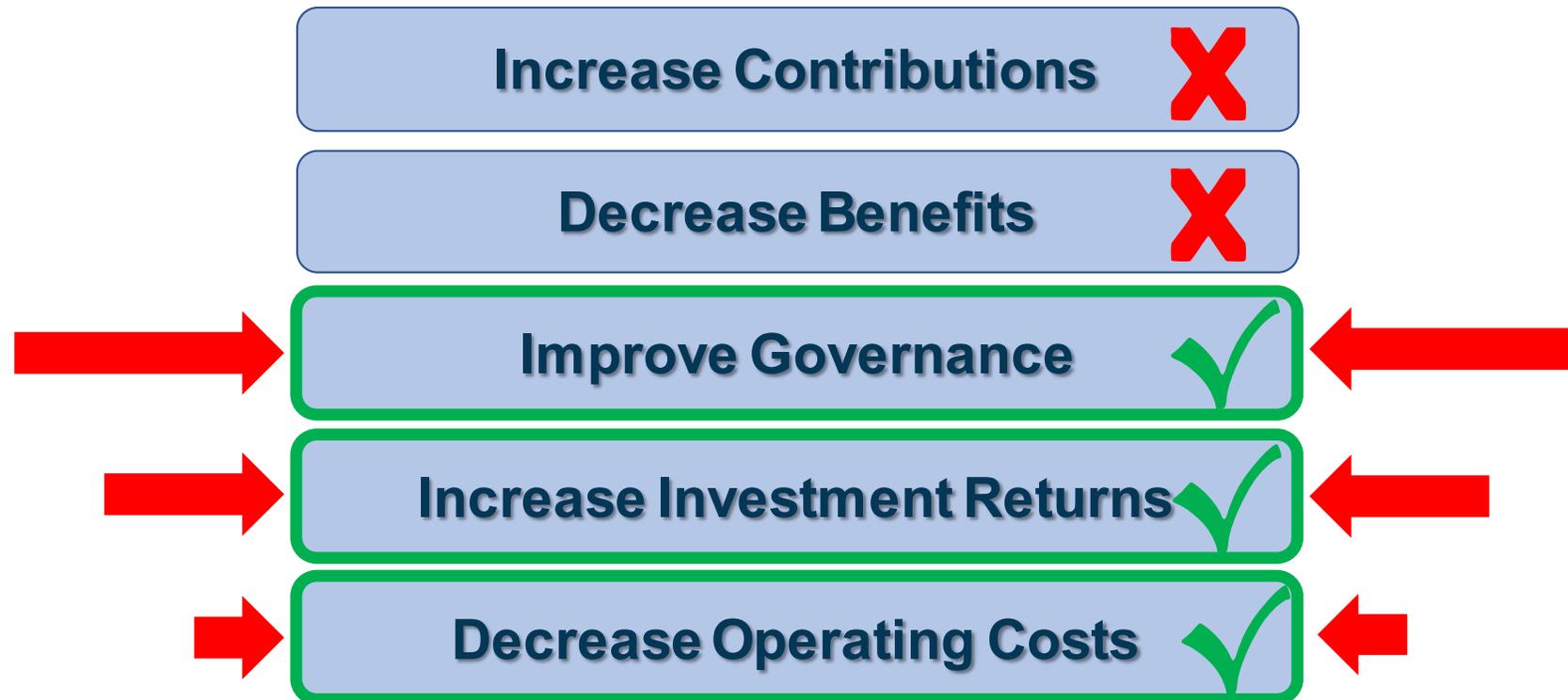
**Don't let politicians and critics tell you it isn't possible!**

# Why Consider Alternative Models?



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## How can you reduce your pension deficit?



# The Board's Role



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## Strong Governance Oversight is Key

- Strong financial oversight
  - Committed to strong financial policies and processes
- Enhanced board composition & skills
  - Strategically and actively seek out the skills they need
- Regular board evaluations
  - Ongoing commitment to governance improvement
- Clarity on board vs. management roles
  - More efficient use of resources
- High-performance cultures with competitive compensation
  - Establish highly competitive compensation opportunities
  - Large portions offered through “at risk” short- and long-term incentives
  - Strong focus on personal, team, and fund performance



**Poor governance  
can cost funds  
between 1% & 2%  
annually**

# Market Leading Funds Today

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- Recruiting top investment professionals and highly skilled Board members
  - Building internal asset management teams to replace costly external service providers
- Offer higher compensation opportunity levels to attract, motivate and retain top talent
  - Substantially lower external management fees more than offset this cost
- Teams are performing better as investors since the entire team is directly aligned with the mission and vision of the pension fund
  - Often incentivized through strong long-term incentive plans
- Global offices in New York, Hong Kong, Sydney, London, etc.

**The above changes have led to Pension Fund deficits being reduced or almost eliminated**

# PROACTIVE COMPENSATION COMMUNICATION STRATEGIES

# Proactive Management Is Key



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## Prevention:

- Address potential issues before they start
- Plan for response if they do occur

## Promote, Safeguard Culture & Reputation:

- Set “tone at top” and monitor
- Ensure openness and transparency with stakeholders

## Detailed Planning:

- Development of formal communication management plan



**Establishing a proactive education and response process helps prepare Trustees**

# Board's Role



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## Stay Informed on:

- Overarching compensation philosophy
- Compensation fairness and objective assessment process (Peers, markets, relative positioning, etc.)
- Overall compensation design
- Purpose of incentives and key objectives
- Performance achievements ( & associated material gains)
- Required disclosure & best practices
- Communication practices and board policy



**Always be armed with insightful and objective information and speak with one voice!**

# Communication Policies Outline...



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## A Process For all Trustees to Follow

- What to do if contacted by the media
- Who will be the designated spokesperson
- How will the key speaking points be established
- How will follow-up strategies

## Proactive Communication Disclosure:

- Determine what should be shared and how best to share it
- Ensure openness and transparency with stakeholders

## Annual Planning:

- Updating communication management plan



**Purpose is to promote and maintain open, accessible, timely, and transparent internal and external communications with the Fund's stakeholders and broader community.**

# Board Members Have a Clear Role



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- Success is based on clear roles and focused efforts
- Effective Boards remain focused on strong strategic direction and oversight

**The Board's role is to pull management out of the trees to see the forest.**

*– Pearl Zhu, Digitizing Boardrooms*

# Our Role As Your Board Advisors



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## As trusted advisors to your Fund, GGA will:

- Educate the CalPERS Board at every opportunity
- Ensure Trustees are informed on the objective and subjective rationale behind all our recommendations
- Guide the board through safe and defensible processes whenever dealing with compensation governance responsibilities

**We are committed to helping your Board fulfil its duties in ensuring that CalPERS remains sustainable, and maintains its pension promise to its members**



# Today's Presenters



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