

April 12, 2021

Rob Feckner
Performance, Compensation & Talent Management Committee Chair
California Public Employees' Retirement System
400 Q Street
Sacramento, California 95811

Dear Rob,

Re: Incentive Metrics Review for Fiscal Year 2021-2022

This memo is in response to your request for Global Governance Advisors ("GGA"), in its role as CalPERS' Board compensation consultant, to provide a review of the current metrics included within the CalPERS Annual Incentive program for 2020-2021 and provide insights on potential improvements for Fiscal Year 2021-2022. This opinion will include GGA's views on the relative weighting between Quantitative and Qualitative performance within the Annual Incentive formula, establishing Stretch goals, as well as how to think about costs when determining performance.

Background:

The current metrics used within the Annual Incentive program were first introduced as part of a new annual incentive plan for the 2016-2017 fiscal year with shared organizational metrics that aligned awards for all positions to the following performance areas:

- Fund Performance (both Total Fund and Asset-Class based)
- Enterprise Operational Effectiveness
- Investment Office CEM Results
- Customer Service
- Stakeholder Engagement

These metrics have continued to be used by CalPERS since then with higher performance expectations set for the Stakeholder Engagement metric in recent years and a decision in Fiscal Year 2019-2020 to move to measuring Fund performance entirely based on Total Fund performance with no weighting on Asset Class performance or Individual investment performance.

While the metrics have generally worked for CalPERS, there has been some question in recent years around the relative weighting between Quantitative and Qualitative performance within the Annual Incentive program as well as how to properly determine Stretch goals under the plan.

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Typical Performance Metrics Observed in the Pension Fund Industry:

In GGA's consulting experience working with countless pension funds of all sizes across North America, GGA observes the following performance metrics that are commonly found within Annual Incentive programs:

- Relative Total Fund Return vs. Market Benchmark (measured over one and/or rolling multi-year performance periods);
- Relative Asset Class Returns vs. Market Benchmark (measured over one and/or rolling multi-year performance periods);
- Execution against Strategic Plan Objectives (namely for the CEO); and
- Individual Performance Evaluation (typically Qualitative in nature).

In addition to these common metrics, many pension funds also report the use of:

- Customer Service (i.e. Member Services or Investment Office); and
- Stakeholder Engagement (as measured through surveys and feedback).

Other metrics that are less commonly found, but used in some cases include:

- Total Fund Costs;
- Internal Operational Metrics; and
- Environment-Related Metrics.

Detailed analysis of the incentive metrics used at various North American pension funds within CalPERS peer group is provided in **Appendix A**.

Overall, the performance metrics used by CalPERS cover many important areas at the Corporate level by focusing on Investment performance (both from a returns and cost perspective) as well as Customer Service and Stakeholder Engagement which are important areas of performance on the Pension Administration side of CalPERS. The specific areas measured for Customer Service and Stakeholder Engagement around Benefit Payment Timeliness, Customer Satisfaction, as well as meeting the needs of CalPERS' stakeholders and keeping them informed also align with what GGA observes at other North American pension funds. The incorporation of a measure of Operational Effectiveness through the Overhead Operating Costs as a Percentage of Total Operating Costs measure is a market leading practice and provides a way of measuring how the fund is managing its non-investment costs as well.

That said, the biggest gap that GGA observes at CalPERS is the lack of weighting on Asset Class investment performance within the Annual Incentive formula for investment professionals working within a specific asset class. While GGA understands that this change was made in 2019-2020 in the spirit of breaking down silos within the Investment office and focusing all investment staff towards meeting the Total Fund performance expectations of CalPERS, it is misaligned with the majority of the competitive marketplace. The reason for this is the greater line-of-sight and control that an investment professional working within a specific asset class has over the performance of that asset class, which a pension fund wants to reward for when performance is high and penalize when performance is low. With all investment professionals rewarded solely on Total Fund performance, there is less ability to differentiate between higher

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and lower performers or reward certain asset classes who have demonstrated stronger results over a given time period.

It is important to note that Total Fund performance is still incorporated within the Annual Incentive formula, albeit at a smaller weighting than Asset Class performance for investment professionals working in specific asset classes. This still encourages all investment professionals to work together to achieve Total Fund objectives as a sizeable portion of their Annual Incentive is still tied to Total Fund results. Positions such as CEO, CIO, Deputy CIO and other executive roles with more oversight over Total Fund operations are typically not measured by Asset Class performance with investment performance measured solely on Total Fund performance within the Annual Incentive formula.

Pension funds that have adopted a Long-Term Incentive Plan (“LTIP”) base 100% of the future payout under that plan to forward-looking Total Fund investment performance over the long run (typically 3-4 years in length) for all LTIP-eligible participants. This has the effect of trying to break down any internal silos by aligning all investment and executive staff towards achieving Total Fund performance expectations over the longer-term in order to earn a meaningful LTIP payout at the end of each performance period.

A comparison of CalPERS’ current weighting between Total Fund and Asset Class investment performance within its Annual Incentive program for investment professionals working in specific asset classes against the broader pension fund marketplace is provided below.

Comparison of CalPERS to Marketplace – Total Fund vs. Asset Class Investment Performance

CalPERS		Pension Fund Marketplace	
Total Fund Performance	Asset Class Performance	Total Fund Performance	Asset Class Performance
100%	0%	33%-40%	60%-67%

As demonstrated above, CalPERS is overweighted on Total Fund performance within its Annual Incentive formula for Asset Class investment professionals and should consider tying a meaningful portion of the Annual Incentive for Asset Class professionals to the performance of their asset class.

Weighting between Quantitative & Qualitative Performance within Annual Incentive:

GGA notes the concern in recent years at CalPERS that too much weighting is placed on Qualitative performance which is tougher to measure and reward realized performance. It also can open the fund up to criticism and increased levels of scrutiny due to the subjective nature of determining performance.

GGA reviewed the current weighting between Quantitative and Qualitative performance for Annual Incentive-eligible staff at CalPERS and notes the following high-level observations starting on the following page:

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Quantitative vs. Qualitative Performance at CalPERS - Observations

Participant/Group	Observation
CEO	Quantitative weighting is competitive
CIO	Quantitative weighting is below market
COIO	Quantitative weighting is below market
All Investment Management Positions	Quantitative weighting is below market
General Counsel	Quantitative weighting is competitive
Chief Actuary	Quantitative weighting is competitive
CFO	Quantitative weighting is competitive
Chief Compliance Officer	Quantitative weighting is competitive
Chief Operating Officer	Quantitative weighting is competitive
Chief Health Director	Quantitative weighting is competitive
CEA- Related Roles	Quantitative weighting is competitive
All Division Chiefs	Quantitative weighting is below market

The biggest area identified for improvement is in Investment positions where market practice is to place 70% to 75% weighting on Quantitative performance within the Annual Incentive formula with no more than 25% to 30% weighting allocated to Qualitative performance of the individual in their role. GGA would also expect All Division Heads to have a similar weighting between Quantitative and Qualitative performance as other executive roles such as the Chief Operating Officer, Chief Financial Officer, or Chief Compliance Officer. These roles tend to have a higher weighting placed on Qualitative performance, because it is harder to quantify the work that incumbents in these roles do, so it requires a more subjective view of their overall performance.

While generally the weighting on Quantitative performance is competitive for non-investment roles, GGA notes that many of these roles have no weighting on Total Fund investment performance against benchmark. While GGA agrees that from a risk mitigation standpoint, tying too much of their Incentive to areas such as Total Fund performance where they have less control over and may be incented to “look the other way” in order to drive higher investment results and a higher Incentive payout, market practice is to at least apply some weighting (15% to 25%) on Total Fund performance. This encourages greater teamwork, less silos between Investment and Non-Investment staff, and aligns all Incentive-eligible staff to Total Fund results for a portion of their Incentive payout. It also helps maintain a meaningful overall weighting on Quantitative performance within the Annual Incentive formula, making the results less subjective and easier to defend if challenged by plan stakeholders, media, or the general public.

A more detailed breakdown of the weighing on Quantitative vs. Qualitative performance against typical market practice is provided in **Appendix B**. Specific analysis of how CalPERS compares to equivalent roles within CalSTRS is also provided in **Appendix C**.

Setting Stretch Goals:

The setting of “stretch” goals is a common issue that comes up in pension funds, as well as within many other types of organization across the public and private sectors. In GGA’s experience, set performance expectations should be challenging, but reasonable. This means they should not be viewed as impossible to achieve when developed. That said, expectations

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should not be set so easily that Maximum performance is achieved consistently year-over-year. A good rule of thumb for any organization to use is to follow the guidelines GGA outlines below:

- Threshold Performance: Should be achieved 80% of the time (i.e. in 8 out of 10 years)
- Target Performance: Should be achieved 60% of the time (i.e. in 6 out of 10 years)
- Maximum Performance: Should be achieved 20% of the time (i.e. in 2 out of 10 years)

Historical lookback analysis at performance over the past 5 to 10 years in each measured performance area is one good way of checking on the reasonableness of performance expectations. Another good source of data can be an organization's identified peers. While no two organizations are the same, if no peer has been able to achieve the level of performance expected by your organization, this can at least act as a "reality check" on your expectations. Understanding the volatility of your performance results can also be helpful when deciding on an appropriate spread between "Target" and "Stretch" performance. For performance areas with more volatility in results, a larger spread between "Target" and "Stretch" performance should be set to take into account the probability of larger swings in results. On the flip side, for areas where performance is less volatile, setting smaller spreads between "Target" and "Stretch" performance is reasonable.

GGA notes that based on its review, historical performance in both Customer Service and Stakeholder Engagement has tended to be at the High end of the performance scale resulting in Maximum performance multipliers for most of the last four years. While performance expectations have been increased for Stakeholder Engagement in recent years, GGA encourages CalPERS to review historical performance in both areas and determine whether higher performance expectations are warranted moving forward. Total Fund investment performance allows for a partial payout in the case of negative value-added return results when compared to a benchmark index. In GGA's view this is not aligned with market practice and should also be reviewed moving forward.

Determining Appropriate Costs:

GGA does not have any material concerns regarding how CalPERS currently calculates investments costs for inclusion in the Annual Incentive formula given that CEM related costs are assumed to follow a standard methodology when compared to other pension fund peers over a 5-year period. In terms of measuring Operational Effectiveness costs, while GGA does not have any material concerns, we do note that adjustments appear to be made to the calculation to exclude Board and Third-Party Administrator Costs. In GGA's view, CalPERS should try to use the "truest" figures possible and try not to include too many adjustments to reported results as that could open CalPERS up to potential criticism that results are being adjusted to benefit Annual Incentive participants. Looking back historically at how different the results would be when including Board and Third-Party Administrator Costs and amending the required performance levels, if needed, would provide a "truer" measure of year-to-year Operational Effectiveness .

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GGA Recommendations for Consideration:

Based on its analysis, GGA feels that CalPERS' Annual Incentive metrics are not broken and that only small tweaks are required moving forward. GGA outlines the following recommendations for CalPERS' consideration:

1. For investment staff working in specific asset classes, add an Asset Class investment performance weighting within the Annual Incentive formula. This weighting should make-up approximately 40% to 50% of the Annual Incentive formula.
2. For investment staff, increase the weighting on Quantitative performance to between 70% and 75% of the Annual Incentive formula, an increase from the current 60% weighting.
3. For all Division Chiefs falling under the 20098 compensation program, increase the weighting on Quantitative performance to 50% to match other executive functional roles such as Chief Operating Officer, CFO and Chief Compliance Officer. For Division Chiefs under the CEA compensation program, keep weightings "as is".
4. For most non-investment executives, consider placing some weighting on Total Fund investment performance (no higher than 15%) to align closer with the CEO and all other Annual Incentive-eligible staff.
5. Review historical performance, specifically in Customer Service, Stakeholder Engagement and Total Fund performance, and determine whether any adjustments to performance expectations are warranted to remain in-line with the current market.
6. Review historical performance in Operational Effectiveness by including Board and Third-Party Administrator Costs in the calculation and consider whether to include these costs on a go-forward basis.

GGA has highlighted further details on Recommendations #1 to 4, by Annual Incentive program participant/group, in **Appendix D** for ease of review and understanding.

Rob, we trust that this letter addresses your concerns on this matter. If you have any questions on the contents within this letter, please let us know.

Sincerely,

Global Governance Advisors



Peter Landers
Partner



Brad Kelly
Partner

cc: Karen Van Amerongen, CalPERS
cc: Luis Navas, Global Governance Advisors

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Appendix A: Incentive Metrics Used within Identified CalPERS Pension Fund Peers

- GGA notes that many of CalPERS U.S.-based pension fund peers do not provide adequate disclosure on the design of their Incentive programs and therefore information for these funds has been omitted from the table below.

Company	Areas of Performance Considered								
	Total Fund	Asset Class	Personal Performance	Total Fund Costs	Customer Service	Stakeholder Engagement	Operational	Strategic Execution	Other
CalPERS	√	√	√	√	√	√			
(1) CalSTRS	√	√	√					√	
CPPIB	√	√	√				√		√
Caisse	√	√	√						√
Texas Teachers	√	√	√		√			√	
OTPP	√	√	√		√		√	√	√
(2) OMERS	√	√	√	√				√	√
Prevalence - Of Those Disclosing	100%	100%	100%	17%	33%	0%	33%	67%	67%

"*" Indicates that information not disclosed.

Notes:

- (1) Customer Service and Stakeholder Engagement are considered indirectly as part of Strategic Execution and do not have specific weightings allocated.
- (2) Total Fund Costs considered when evaluating CEO's personal performance.

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Appendix A: Incentive Metrics Used within Identified CalPERS Pension Fund Peers ^{cont'd.}

Performance Area	CalPERS Metric Used	Examples of Performance Metrics
Total Fund	<ul style="list-style-type: none"> - Total Fund Return Relative to Benchmark - Total Fund Return Relative to CEM US Benchmark 	<ul style="list-style-type: none"> - Total Fund Return Relative to Benchmark - Absolute Total Fund Return - Total Fund Volatility
Asset Class	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> - Asset Class Return Relative to Benchmark Index - Absolute Asset Class Return
Total Fund Costs	<ul style="list-style-type: none"> - Total Fund Costs Relative to CEM US Benchmark 	<ul style="list-style-type: none"> - Managing Cost Effectiveness of Total Fund
Customer Service	<ul style="list-style-type: none"> - Benefit Payment Timeliness - Customer Satisfaction 	<ul style="list-style-type: none"> - Customer Satisfaction with Business Processes - Peer Service Level Comparison Relative to CEM Results - Service Excellence Index - Comprehensive Annual Review of Performance Factors Relating to the Business & Operational Management of the Investment Branch - Survey of the CIO, Deputy CIO & Investments Staff Rating of Implementation Success & Customer Service
Stakeholder Engagement	<ul style="list-style-type: none"> - Score against Annual Engagement Survey 	<ul style="list-style-type: none"> - Employee Engagement Survey & Employee Turnover - Comprehensive Annual Review of Performance Factors Relating to Investment Office Engagement Strategy & Outreach of the Investment Branch

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Appendix A: Incentive Metrics Used within Identified CalPERS Pension Fund Peers ^{cont'd.}

Performance Area	CalPERS Metric Used	Examples of Performance Metrics
Operational	<ul style="list-style-type: none"> - Total Overhead Operating Costs as % of Total Operating Costs 	<ul style="list-style-type: none"> - Productivity Relative to CEM Results - Integrated technology, data and knowledge advantage initiative
Strategic Execution	<ul style="list-style-type: none"> - Business Objectives 	<ul style="list-style-type: none"> - Performance against Organizational Leadership Priorities - Board Evaluation of Status of Strategic Plan & Objectives - Annual Strategic Execution - Board or CEO Evaluation of Strategic Plan Performance
Personal Performance	<ul style="list-style-type: none"> - Leadership 	<ul style="list-style-type: none"> - Individual performance against personal objectives - Developing subordinate staff and recruit/retain talent - 360 Leadership Score - Contribution to Short & Long-Term Areas of Focus - Comprehensive Review of Personal Performance Factors
Other	<ul style="list-style-type: none"> - 	<ul style="list-style-type: none"> - Developing organizational structure, systems and processes - Relationships with Board, Committees, Direct Reports - Increase Support of Local Companies & Economy - Board Risk Adjustment Factor - Adopting Best-in-Class Climate-Related Financial Disclosure - Increasing Low-Carbon Assets - Reduce Carbon Intensity of Portfolio - Increase Renewable Energy & Sustainability Investment

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Appendix B: Quantitative vs. Qualitative Weighting at CalPERS Compared to Typical Market Practice (by Participant/Group)

Participant/Group	CalPERS		Pension Fund Marketplace	
	Quantitative	Qualitative	Quantitative	Qualitative
CEO	75%	25%	70%-80%	20%-30%
CIO	60%	40%	70%-75%	25%-30%
Deputy CIO	60%	40%	70%-75%	25%-30%
COIO	60%	40%	70%-75%	25%-30%
All Investment Management Positions	60%	40%	70%-75%	25%-30%
General Counsel	50%	50%	50%-60%	40%-50%
Chief Actuary	50%	50%	50%-60%	40%-50%
CFO	50%	50%	50%-60%	40%-50%
Chief Compliance Officer	50%	50%	50%-60%	40%-50%
Chief Operating Officer	50%	50%	50%-60%	40%-50%
Chief Health Director	50%	50%	50%-60%	40%-50%
CEA-Related Roles	50%	50%	50%-60%	40%-50%
All Division Chiefs	40%	60%	50%-60%	40%-50%

GGA notes the following points relating to the table above:

- For senior non-investment roles at CalPERS, the weighting on Quantitative performance within the Incentive program is on the lower end, but still within market norms.
- The weighting on Quantitative performance for All Divisions Chiefs is slightly below the typical market practice.
- Investment-related roles at CalPERS tend to have less weighting on Quantitative performance than what is observed in the market.

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Appendix C: Quantitative vs. Qualitative Weighting at CalPERS Compared to CalSTRS (by Participant/Group)

Participant/Group	CalPERS		CalSTRS	
	Quantitative	Qualitative	Quantitative	Qualitative
CEO	75%	25%	30%	70%
CIO	60%	40%	75%	25%
Deputy CIO	60%	40%	80%	20%
COIO	60%	40%	20%	80%
Investment Management – Asset Classes	60%	40%	80%	20%
Investment Management – Strategy & Risk	60%	40%	55%	45%
Investment Management – Corp. Gov.	60%	40%	70%	30%
Investment Management – Risk	60%	40%	50%	50%
Investment Management – Innovation	60%	40%	60%	40%
Investment Management – Engagement	60%	40%	30%	70%
Project Management/Customer Service	60%	40%	50%	50%
General Counsel	50%	50%	n/a	n/a
Chief Actuary	50%	50%	0%	100%
CFO	50%	50%	20%	80%
Chief Operating Officer	50%	50%	15%	85%

GGA notes the following points relating to the table above:

- Certain roles at CalPERS are not comparable at CalSTRS and have therefore been excluded from the table.
- For senior non-investment roles at CalPERS, while similar areas of performance are considered as part of determining Incentives, it is done so using more Quantitative metrics than at CalSTRS.
- Investment-related roles at CalPERS tend to have less weighting on Quantitative performance than Qualitative performance when compared to similar roles at CalSTRS, with the exception of Engagement and Strategy & Risk roles.
- CalSTRS’ General Counsel position is currently not eligible to receive an Incentive payout.
- CalSTRS’ Chief Actuary position is currently evaluated solely on Qualitative performance in their role.

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Appendix D: GGA’s Detailed Recommendations for Consideration (by Participant/Group)

- Areas highlighted in **GREEN** represent a proposed increase in weighting from Fiscal Year 2020-2021.
- Areas highlighted in **RED** represent a proposed decrease in weighting from Fiscal Year 2020-2021.

Participant/Group		Quantitative					Qualitative		
		Total Fund	Asset Class	Enterprise Operational Effectiveness	INVO CEM	Customer Service	Stakeholder Engagement	Leadership	Business Objectives
CEO	Proposed	15%	*	20%	10%	15%	15%	25%	*
	Current	15%	*	20%	10%	15%	15%	25%	*
CIO	Proposed	65%	*	*	10%	*	*	12.5%	12.5%
	Current	50%	*	*	10%	*	*	20%	20%
Deputy CIO	Proposed	65%	*	*	10%	*	*	12.5%	12.5%
	Current	50%	*	*	10%	*	*	20%	20%
All Investment Management Positions	Proposed	20%	45%	*	10%	*	*	12.5%	12.5%
	Current	50%	*	*	10%	*	*	20%	20%
General Counsel	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Actuary	Proposed	*	*	20%	10%	10%	10%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Financial Officer	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Compliance Officer	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Operating Officer	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Chief Health Director	Proposed	*	*	20%	10%	10%	10%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
CEO CSS & DEO CSR	Proposed	*	*	20%	10%	10%	10%	20%	30%
	Current	*	*	20%	10%	10%	10%	20%	30%
Division Chiefs – 20098	Proposed	15%	*	15%	10%	5%	5%	20%	30%
	Current	*	*	20%	*	10%	10%	20%	40%
Division Chiefs – CEA	Proposed	*	*	20%	*	10%	10%	20%	40%
	Current	*	*	20%	*	10%	10%	20%	40%