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GOVERNANCE  
ADVISORS

# Opinion Letter

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## Annual Incentive Plan Metrics & Additional Considerations

Prepared for:

Performance, Compensation & Talent  
Management Committee

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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 proposed annual incentive plan metrics for Fiscal Year 2025-2026.

## 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
- Enterprise Operational Effectiveness (“EOE”)
- Investment Office CEM Results
- Customer Service
- Stakeholder Engagement

CalPERS continues to use these metrics but, in recent years, has proactively reviewed and updated the performance expectations for all metrics to ensure performance levels remain challenging, yet fair to both incentive participants and CalPERS members. The performance metrics used within the incentive plan have generally worked for CalPERS, and GGA has not had any concern with their placement and use within the annual incentive program.

Administratively, there have been some questions around how to integrate 5-year Total Fund value add performance into the annual incentive plan for newly hired professionals or professionals promoted into a position where 5-year Total Fund value add performance is included in their annual incentive, which GGA has addressed within this letter.

GGA understands that the Board is currently working with the recently hired Chief Investment Officer to determine whether to adopt a Total Portfolio Approach (“TPA”) as it relates to how CalPERS invests its assets on behalf of its members. If its adoption is approved, moving to a TPA will likely have an impact on how CalPERS designs its incentive plan, however the TPA implementation is not expected to commence until at least Fiscal Year 2026-2027. GGA will conduct further analysis and back-testing of any material changes required to align to a new TPA, where required, during Fiscal Year 2025-2026. Given these potential anticipated changes, GGA does not recommend making any substantive changes to the current incentive program and therefore, recommends at this time the current metrics remain in place for the upcoming year. That said, based on back testing and stress testing of historical Total Fund and Enterprise Operational Effectiveness performance, adjustments to the performance hurdles for these metrics are recommended by GGA for the upcoming fiscal year.

## Summary of GGA’s Assessment

GGA reviewed the proposed annual incentive metrics for Fiscal Year 2025-2026 and believes that the metric performance areas still meet the needs of CalPERS at this time. They align to

CalPERS mission and strategic plan while continuing to encourage teamwork by tying CalPERS management to a consistent set of metrics.

While GGA is comfortable with the proposed annual incentive metrics, upon further historical analysis, GGA recommends adjustments for the upcoming fiscal year to the performance expectations for both Total Fund and EOE performance to align closer with Ideal probabilities of attainment as follows:

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

By looking to generally align with these probabilities of attainment over time, performance hurdles are set at a challenging, yet fair and reasonable level for plan participants while ultimately still ensuring a high level of performance for CalPERS stakeholders.

In terms of the integration of Investment performance into the Annual Incentive calculation, GGA recommends that Total Fund investment performance be measured on a 5-year backward-looking rolling basis. This means that affected incumbents will not have Total Fund investment performance phased-in over a 5-year period, but instead will be impacted by the 5-year Total Fund investment return performance achieved over the last 5 years and on a 5-year rolling basis each year thereafter. This approach can be justified by market precedence and will keep the Annual Incentive Plan simpler to administer for CalPERS' Human Resources department. It will also reward any affected incumbents the same as all other Annual Incentive-eligible team members so there is consistency in treatment under the plan.

Separate from the items addressed above, GGA recommends that GGA work with the Board to review potential changes required to CalPERS' incentive program (both Annual and Long-Term) in the event a TPA approach to investing is approved. This review will consider how a move to a TPA approach to investing will impact CalPERS' strategic plan and how the Board and staff look at performance. The goal will be to align CalPERS' incentive program with its desired performance outcomes under this new approach. This will include Total Fund performance, but also other key operational and engagement areas of performance outside of investment activities.

Provided below are details surrounding GGA's exact recommendations for the proposed annual incentive metrics for Fiscal Year 2025-2026.

## CalPERS' Performance Metric Review Details:

### Metric #1: Total Fund Performance

#### PROPOSED CHANGES FOR FISCAL YEAR 2025-2026

This metric is based on fund performance against the policy benchmark for the five-year period of July 1, 2021 through June 30, 2026. Payout ratio for intermediate results will be determined by interpolation.

#### Past 2024-2025 Metrics

Performance (bps)	Payout Ratio
+10	1.50 (150%)
+5	1.00 (100%)
0	0.00 (0%)



#### Proposed 2025-2026 Metrics

Performance (bps)	Payout Ratio
+20	1.50 (150%)
+10	1.00 (100%)
0	0.00 (0%)

The historical analysis utilized by GGA to recommend the adjustments highlighted above is outlined in **Appendix A**. The most material change to the performance hurdles is the higher level of performance required to earn a Target or higher payout.

Ultimately, the recommended adjustments are intended to align CalPERS closer with recognized probability levels in recent years, incent the generation of more alpha in the portfolio and make the performance expectations challenging, yet fair for eligible CalPERS team members while ensuring value is provided to CalPERS members. The upward adjustment in performance expectations also aligns CalPERS closer to typical market expectations (albeit still lower) in terms of outperformance relative to benchmark.

5-year rolling investment performance is to be included immediately in the Annual Incentive calculation as opposed to phased-in over time for the reasons stated above.

## Metric #2: Enterprise Operational Effectiveness (“EOE”)

### PROPOSED CHANGES FOR FISCAL YEAR 2025-2026

This metric for 2025-26 is defined as Overhead Operating Costs as a percentage of Total Operating Costs (“OOC”) and is measured based on year-over-year improvement.

- Total Overhead Operating Costs (“OOC”) identify all administrative costs not mapped directly to Product and Service Delivery Operating Costs (“PSDOC”); and excludes Board and Third-Party Administrator Costs
- $OOC = OOC / (OOC + PSDOC)$

#### Past 2024-2025 Metrics

Score	Payout Ratio
< -1.05%	1.50 (150%)
-1.05% to < -0.55%	1.25 (125%)
-0.55% to 0.0%	1.00 (100%)
> 0.0% to 0.55%	0.75 (75%)
> 0.55% to 1.05%	0.50 (50%)
> 1.05%	0.00 (0%)



#### Proposed 2025-2026 Metrics

Score	Payout Ratio
< -0.80%	1.50 (150%)
-0.80% to < -0.40%	1.25 (125%)
-0.40% to 0.0%	1.00 (100%)
> 0.0% to 0.40%	0.75 (75%)
> 0.40% to 0.80%	0.50 (50%)
> 0.80%	0.00 (0%)



The historical analysis utilized by GGA to recommend the adjustments highlighted above is outlined in **Appendix A**. The most material changes to the performance hurdles are the higher level of performance required to start earning a payout for Enterprise Operational Effectiveness and the lower level of performance required to earn a Maximum payout for this metric (i.e., a narrowing of the performance range).

Ultimately, the recommended adjustments are intended to align CalPERS closer with recognized probability levels in recent years and make the performance expectations challenging, yet fair for eligible CalPERS team members while ensuring the provision of value to CalPERS members.

### Metric #3: Investment Office CEM

#### NO CHANGE FOR FISCAL YEAR 2025-2026

This metric for Fiscal Year 2025-2026 is determined by CalPERS annual participation in the CEM benchmarking survey and shows how CalPERS' investment costs and return performance compares to a customized peer group over a five-year period.

Score	Payout Ratio
Outperforms US Benchmark on Net Value Added (Returns) <u>and</u> Cost by 0.1% and 8 bps, respectively	1.50 (150%)
Outperforms US Benchmark on Returns <u>and</u> Cost by .05% and 4 bps, respectively	1.00 (100%)
Outperforms US Benchmark on Cost <u>or</u> Outperforms US Benchmark on Returns	0.50 (50%)
Underperforms US Benchmark on Returns <u>and</u> Cost	0.00 (0%)

### Metric #4: Customer Service

#### NO CHANGE FOR FISCAL YEAR 2025-2026

This metric for Fiscal Year 2025-2026 is based on two Service Dimensions:

- Benefit Payment Timeliness: Percentage of benefit payments issued to our customers within established service levels
- Customer Satisfaction: Customer service with CalPERS services as measured by surveys and other methods

Score	Payout Ratio
≥ 97%	1.50 (150%)
96% to < 97%	1.25 (125%)
95.5% to < 96%	1.00 (100%)
95% to < 95.5%	0.75 (75%)
94% to < 95%	0.50 (50%)
< 94%	0.0 0.00 (0%)

## Metric #5: Stakeholder Engagement

### NO CHANGE FOR FISCAL YEAR 2025-2026

This metric for Fiscal Year 2025-2026 is based on results of the following three Stakeholder Engagement Survey questions:

- Is CalPERS sensitive to the needs of its members?
- Is CalPERS doing a good job of keeping in touch with its members and keeping them informed?
- CalPERS is effective in communicating and engaging with stakeholders (rate on scale from one to ten).

Score	Payout Ratio
≥ 80.5%	1.50 (150%)
80% to < 80.5%	1.25 (125%)
79.75% to < 80%	1.00 (100%)
79.5% to < 79.75%	0.75 (75%)
79% to < 79.5%	0.50 (50%)
< 79%	0.00 (0%)

We trust that this letter addresses your concerns on this matter and look forward to discussing it in more detail at the June PCTM meeting. If you have any questions on the contents of this letter, please let us know.

Sincerely,

### Global Governance Advisors



Peter Landers  
Senior Partner



Brad Kelly  
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cc: Brittany Emmons, CalPERS

## Appendix A:

### Historic Probability Assessment and Metrics Adjustment Recommendations

#### Background:

As part of our ongoing compensation advisory work, GGA conducted a historical probability assessment for the Total Fund Value Add and Enterprise Operational Effectiveness (“EOE”) performance metrics used under the plan.

GGA provided a historical analysis against current performance hurdles at the previous April PCTM meeting.

In GGA’s view, it is important to regularly review the rigor and fairness of the expectations set for performance metrics under the annual incentive plan to ensure they continue to be challenging to incentive plan participants, as well as fair to CalPERS members. This is done through analyzing historical performance results to ensure Minimum expectations are not set too easily and that Maximum expectations are not set at an unrealistic level that can never be achieved.

As a result, this appendix contains a probability assessment and rationale for any changes suggested by GGA for the following two metrics:

1. Total Fund Value Add
2. Enterprise Operational Effectiveness

#### Related Historic Data:

The tables that follow shows the related historic data (where possible) from Fiscal Year 2014-2015 to Fiscal Year 2023-2024 provided to GGA by CalPERS.

Total Fund Performance					Enterprise Operational Effectiveness		
Fiscal Year	5-Year Portfolio Return	5-Year Benchmark Return	Outperformance	Outperformance (Bps)	Fiscal Year	Achievement	Variance
2023-24	6.64%	6.58%	0.06%	6	2023-24	63.27%	0.67%
2022-23	6.13%	5.95%	0.18%	18	2022-23	62.53%	-0.38%
2021-22	6.68%	6.56%	0.12%	12	2021-22	62.47%	-1.09%
2020-21	10.35%	10.47%	-0.13%	-13	2020-21	62.79%	-1.00%
2019-20	6.29%	6.43%	-0.13%	-13	2019-20	63.47%	-0.65%
2018-19	5.82%	6.05%	-0.23%	-23	2018-19	64.43%	0.44%
2017-18	8.05%	8.12%	-0.07%	-7	2017-18	34.40%	0.83%
2016-17	8.83%	8.60%	0.23%	23	2016-17	34.72%	1.74%
2015-16	6.76%	6.64%	0.13%	13			
2014-15	10.73%	10.39%	0.34%	34			



## Total Fund Value Add Performance – Historical Analysis against Proposed Performance Hurdles

Using the same historic data and adjusting performance hurdles by increasing the performance expectations to achieve a Target or higher payout results in the following:

Total Fund Performance				
Year	5-Year Performance BPS	Proposed Incentive Performance Hurdles		
		Threshold	Target	Maximum
2023-24	6	0.00	10.00	20.00
2022-23	18	0.00	10.00	20.00
2021-22	12	0.00	10.00	20.00
2020-21	-13	0.00	10.00	20.00
2019-20	-13	0.00	10.00	20.00
2018-19	-23	0.00	10.00	20.00
2017-18	-7	0.00	10.00	20.00
2016-17	23	0.00	10.00	20.00
2015-16	13	0.00	10.00	20.00
2014-15	34	0.00	10.00	20.00
75th Percentile	17	Historical Annual Probability of Attainment		
50th Percentile	9			
25th Percentile	-11	Threshold	Target	Maximum
		60.00%	50.00%	20.00%

## Total Fund Value Add Performance – Effect of Proposed Changes

The following table outlines how GGA's proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Current	60%	50%	50%
Ideal	80%	60%	20%
Proposed	60%	50%	20%

## Enterprise Operational Effectiveness – Historical Analysis against Updated Performance Hurdles

Using the same historic data and adjusting performance hurdles by narrowing the performance ranges results in the following assessment:

Enterprise Operational Effectiveness				
Year	Annual Performance (%)	Proposed Incentive Performance Hurdles		
		Threshold	Target	Maximum
2023-24	0.67%	0.80%	0.00%	-0.80%
2022-23	-0.38%	0.80%	0.00%	-0.80%
2021-22	-1.09%	0.80%	0.00%	-0.80%
2020-21	-1.00%	0.80%	0.00%	-0.80%
2019-20	-0.65%	0.80%	0.00%	-0.80%
2018-19	0.44%	0.80%	0.00%	-0.80%
2017-18	0.83%	0.80%	0.00%	-0.80%
2016-17	1.74%	0.80%	0.00%	-0.80%
75th Percentile	0.71%	Historical Annual Probability of Attainment		
50th Percentile	0.03%	Threshold	Target	Maximum
25th Percentile	-0.74%	75.00%	50.00%	25.00%

## Enterprise Operational Effectiveness – Effect of Proposed Changes

The following table outlines how GGA's proposed changes would affect the overall attainment probabilities, moving them closer to the Ideal attainment levels:

	Attainment Probability		
	Threshold	Target	Maximum
Current	87.5%	50%	12.5%
Ideal	80%	60%	20%
Proposed	75%	50%	25%