CalPERS' Executive Compensation Analysis Framework

April 2021

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We developed our executive compensation analysis framework after conducting extensive research starting in July 2017. Our research considerations included findings from academic and practitioner research, and multiple discussions with global asset owners and managers, compensation consultants, and proxy advisory firms.

We implemented the first version of our framework in January 2018, our proprietary 5-year quantitative pay-for-performance, or P4P, model in March 2019, and the CalPERS P4P Scorecard in August 2019.

We will continue to refine our executive compensation framework as we gain new insights from our engagements with market participants. Our executive compensation analysis framework should be read in conjunction with the Executive, Director, and Employee Compensation section of our Governance & Sustainability Principles, pages 23 to 26, and Frequently Asked Questions, to provide a comprehensive view of our compensation philosophy.

Our executive compensation analysis framework comprises two complementary components:

- Our proprietary 5-year quantitative P4P model
- Qualitative analysis of the design, structure, and practice of compensation plans

The three main objectives of our executive compensation analysis framework are:

- To assess whether pay is aligned with performance as measured by total shareholder return (TSR) over a 5-year cumulative period
- To determine whether pay is reasonable relative to peers after taking into account performance
- To evaluate whether the design, structure, and practice of compensation plans promotes long-term shareholder value creation at an acceptable level of risk

Quantitative Analysis

We use our proprietary 5-year quantitative P4P model developed in collaboration with Equilar to perform the quantitative analysis of pay and performance alignment.

CalPERS P4P Scorecard

The CalPERS P4P Scorecard shows the output of our 5-year quantitative P4P model. Below is an example of the CalPERS P4P Scorecard.

5-Year Metrics	Values	Russell 3000 Percentile
P4P™ Score		
Realizable Pay	-70	3rd
Grant Date Fair Value	-74	4th
Financial Outcomes Spread (Shareholder - CEO)	-75.1%	2nd
Shareholder Financial Outcome (TSR)	-47.8%	10th
CEO Financial Outcome	27.4%	67th

P4P Score:

Our P4P scores are calculated using Equilar's patented P4P formula and our realizable pay and grant date target pay methodologies. Within our model, we define realizable pay as 5-year CEO cumulative realizable pay, or potential earnable pay, and performance as 5-year cumulative total shareholder return (TSR). Our realizable pay methodology uses each company's latest fiscal year-end to measure the current market value, or mark-to-market, of the cumulative CEO pay granted over each of the previous 5 years, known as grant date target pay.

Realizable pay, unlike grant date target pay, varies with performance and does not remain static. Realizable pay analysis helps us see how pay scales with performance as we assess the alignment of pay and performance. Grant date target pay analysis allows us to assess whether target pay is being set at a reasonable level relative to peers after taking into account a company's historical performance relative to its peers. As an example, a company that sets target pay at the 50th percentile of peers while its historical performance is at the 25th percentile of the same peers would be considered to be setting target pay outside of what appears justified by its historical performance.

We use TSR to measure performance because TSR reflects what we experience as investors. We invest in companies to earn returns, and we believe that over the long-term, the performance of a company's stock mirrors the performance of its underlying business.

Our P4P scores assess a company's CEO pay relative to peers given the company's relative performance against the same peers over a 5-year period. A negative score means that the company's weighted pay score is higher than its weighted performance score. We interpret a negative score to mean that the level of pay may be too high relative to the performance shareholders receive; that is, we are paying a premium without receiving comparable superior performance. It is important to note that a positive score on its own is not sufficient to adequately address the three objectives of our executive compensation analysis outlined earlier. As such, we also analyze the CEO and Shareholder Financial Outcomes.

CEO and Shareholder Financial Outcomes Analysis:

We developed the financial outcomes analysis to enable us to compare the financial experiences of the CEO to those of shareholders, which ideally should be aligned and comparable. We are assessing whether pay is aligned with performance, and whether leverage is embedded in the compensation plan.

A compensation plan with high leverage may incentivize the CEO to take excessive risks that are not consistent with long-term value creation for the company and shareholders.

Shareholder Financial Outcome is the company's 5-year cumulative TSR.

CEO Financial Outcome is the mark-to-market change in the 5-year CEO cumulative grant date target pay as of the company's latest fiscal year end. Mathematically, the calculation is:

$$\left[\frac{5 - yr\ CEO\ Cumulative\ Realizable\ Pay}{5 - yr\ CEO\ Cumulative\ Grant\ Date\ Target\ Pay} - 1\right] \times 100$$

Financial Outcomes Spread is the Shareholder Financial Outcome minus the CEO Financial Outcome. The spread reflects how much better or worse off the financial experience of shareholders is relative to that of the CEO. It is meant to capture the degree of alignment between the CEO pay and shareholder interests.

Using the financial outcomes analysis, we can identify which compensation elements are driving the disconnect between the financial outcomes of the CEO and shareholders. The CEO financial outcome should primarily be driven by long-term equity awards as opposed to short-term incentive awards.

A CEO financial outcome that is driven by short-term incentives indicates that the compensation plan is not aligned with long-term shareholder value creation. Furthermore, pay and performance may be misaligned if the change in the value of equity held by the CEO is materially different from the change in the TSR experienced by shareholders.

For example, using the numbers from our scorecard above, the CEO financial outcome of 27.4% indicates that the 5-year CEO cumulative grant date target pay gained 27.4% on a mark-to-market basis. On the other hand, shareholders lost 47.8% in TSR over the same period. The financial outcomes spread of negative 75.1% indicates that the financial experience of shareholders is significantly worse than that of the CEO. The fact that the CEO financial outcome is significantly different and directionally inconsistent with shareholder financial outcome implies that pay and performance are not aligned.

Our 5-year P4P scorecard is available to anyone with access to the Equilar Insight platform.

Qualitative Analysis

Our qualitative analysis centers around the design, structure, and practice of compensation plans. We review qualitative pay features in aggregate before determining whether the compensation plan aligns with the interest of long-term shareholders.

One or more problematic pay features may result in a vote against the compensation plan. Some problematic pay features may include, but are not limited to:

- Short vesting periods and insufficient holding periods for long-term equity awards*
- Short performance periods for long-term incentive awards
- Use of similar metrics for short-term and long-term incentive plans
- Use of adjusted metrics or non-GAAP metrics on compensation plans without sufficient justification and prominent disclosure of the reconciliation with GAAP metrics. We believe that the regulatory requirement for companies to report their earnings based on Generally Accepted Accounting Principles (GAAP) accounting is appropriate for consistency and comparability
- Lack of policy prohibiting the use of derivative instruments which work to eliminate executives' underlying equity exposure. We believe hedging and stock pledging undermine the alignment of the interests of the executives with long-term shareholders and should be prohibited

- Single-trigger change-in-control payments. We believe that any provisions providing for compensation following change-in-control events should be "double-triggered," that is, such provisions should stipulate that compensation is payable only: (a) after a control change takes place, and (b) if a covered executive's job is terminated or downgraded because of the control change
- Excessive severance provisions and excise tax gross-ups. We believe excise tax gross-ups should not be permitted in compensation programs; executives should be responsible for paying their own excise taxes
- Lack of a comprehensive clawback policy. We believe that companies should develop and disclose policies to recoup compensation made to executives during periods of fraudulent activity, inadequate oversight, misconduct including harassment of any kind such as sexual harassment, or gross negligence, which impacted or is reasonably expected to impact financial results or cause reputational harm
- Discretionary pay, one-time awards, and guaranteed bonus without sufficient justification
- Lack of comprehensive disclosure of the incentive plan structure and features which prevents shareholders from being able to prospectively assess how pay scales with performance, and retroactively assess pay outcomes given the performance outcomes

*We consider long-term to be at least five years. In practice, we typically accept 3-year cliff vesting schedules with an additional 2-year holding requirement as being equivalent to a 5-year vesting period. In general, we are not supportive of equity awards with ratable vesting structures. Furthermore, CalPERS will most likely vote against compensation plans where a significant portion of total equity awards vest in less than three years and/or includes ratable vesting, unless an additional holding period is in place. To discourage short-term focus ahead of separation, we also prefer longer postseparation holding periods (i.e. two years).

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