AGENDA ITEM DETAILS

Subject: Consideration of Annual Review of ERS Incentive Compensation Plan

The Board of Trustees (Board) first approved the ERS Incentive Compensation Plan (Plan or ICP) on December 13, 2006. The Board reviews and approves the Plan document for the upcoming plan year annually in a public meeting before the start of that plan year. The Board approved the Plan document for Plan Year 2024 on August 23, 2023. This annual process periodically includes updates to conform the Plan to the current labor market and compensation plan standards. Any proposed updates are laid out by staff at the May meeting for the Board to review and consider. Final approval of the Plan document for Plan Year 2025 will be considered at the August 2024 Board meeting.

PROPOSED ICP CHANGES FOR PLAN YEAR 2025:

Proposed Methodology Change for Maximum Performance Goals

Section 2.30 of the Plan document currently specifies that the Maximum Performance Goal (MPG) for each publicly traded asset class is the expected Information Ratio listed in the Risk Budget for that asset class in the Investment Policy Statement (IPS). The MPG for the overall Trust, however, specifies that it shall be measured based on an Excess Return target.

For reference; Information Ratio, Tracking Error, and Excess Return are defined as follows in the ICP Document:

> “Information Ratio” - a measure of the Excess Return of a composite or portfolio over a Benchmark given the level of risk permitted by the Board, as documented in the Risk Budget in Chapter V, Table 4, of the Investment Policy. The Information Ratio is calculated as: (actual return – benchmark return) / (Tracking Error).
>
> “Tracking Error” - a statistical measure of the divergence between the returns of a portfolio and those of its benchmark, which is typically calculated as the standard deviation of excess returns over a historical period.
>
> “Excess Return” - actual return after subtracting the return of the applicable Benchmark. Excess Return may be positive or negative.

To provide consistency between how awards are calculated for the Trust overall and the publicly traded asset classes, staff recommends that the MPG for each publicly traded asset class be based on Excess Return targets for Plan Year 2025 and beyond. Excess Return target aligns more closely with the implementation objective established in the IPS to obtain returns in excess of the assigned benchmark.

In most asset classes and for most participants, the MPGs would increase and therefore become more challenging to achieve. In the cases of Rates and Cash, the MPGs would decrease for the two ICP participants that have award goals related to Rates and Cash. This approach aligns with the objective of these two asset classes, which primarily exist to provide liquidity and risk mitigation to the Trust.

The following table illustrates how the MPGs would change if the staff recommendation were to be approved by the Board along with the updates to the IPS that will be proposed in a separate agenda item:

	Proposed Maximum Performance Goal (basis points)	
Plan Years:	**2024 and prior**	**2025 and beyond**
Basis:	**Expected Information Ratio**	**Excess Return Target**
Public Equity	**25**	**50**
Public Credit	**35**	**50**
Public Real Estate	**30**	**50**
Special Situations	**25**	**50**
Hedge Funds	**25**	**50**
Rates	**20**	**10**
Cash	**20**	**5**

<u>Proposed Change to Appendix A</u>

Appendix A currently specifies the Maximum Incentive Award Percentage for Investment Attorneys to be 65%. Based on recent compensation studies conducted by staff, which included comparisons against both external and internal compensation data, staff recommends establishing the following series for Investment Attorneys on Appendix A:

Plan Groups	Maximum Incentive Award Percentages
Deputy General Counsel (Investment Attorney)	**90%**
Senior Investment Attorney	**80%**
Investment Attorney	**70%**

<u>Other Changes</u>

In addition to the methodology change proposed above, staff is proposing some other changes to the Plan document to provide greater clarity and to align with current processes and practices.

Exhibit A, included with this agenda item, details all of the updates proposed by staff for the Plan Year 2025.

This agenda item is presented for discussion and informational purposes only. No action is necessary at this time.

ERS INCENTIVE COMPENSATION PLAN BACKGROUND:

The ICP communicates strategic performance priorities to participating employees. It is designed to incentivize the prudent achievement of sustained levels of high investment performance without undue risk, promote teamwork among employees, support the agency's strategic and operational goals, and attract and retain key employees.

As an incentive for participating employees to work toward ERS' success, the Plan compensates qualifying employees based on ERS' overall Trust fund performance, their assigned asset class performance, and their own individual contributions to performance.

ERS measures performance based on one-, three- and five-year performance periods within risk parameters set by the Board. Both total Trust and individual portfolio performance are considered. Participating employees earn incentive compensation if performance exceeds the assigned benchmarks. Benchmarks are set for the total Trust and individual asset classes and documented in the investment policy, unless otherwise stated in the Plan document.

ERS evaluates participating employees on both quantitative and qualitative metrics. Qualitative metrics include areas such as leadership, teamwork, communication, and innovation. The senior leadership of the investments team have developed a rating methodology to determine qualitative ranking scores for investment employees.

Earned incentive compensation is generally paid to employees over a three-year period. The payout is 50% in the first year and 25% for the following two years, as long as the employee remains employed in good standing for three years from the date the incentive compensation award was earned. This approach is intended to serve as an effective retention tool.

Employees can *earn* incentive compensation awards in plan years when the overall Trust performance is negative. However, incentive compensation awards cannot be *paid* during plan years when total fund performance is not positive. Incentive compensation awards are calculated based on a weighted average annual salary.

All payments are subject to claw back under certain circumstances. For example, an employee paid in error must reimburse ERS the amount of the payment, even if he or she no longer works for ERS. Similarly, if an award was incorrectly calculated and a participant was underpaid, the Executive Director may approve a supplemental payment to make up the difference between the earned amount and the previously paid amount. These two Plan provisions help ensure the goal of 100% accuracy in payment of awards.

ERS has established a robust governance process for the ICP, which includes a standing process team with clearly defined roles, as well as, an annual validation of the awards and payments by an independent third-party consulting firm. In addition, the State Auditor's Office currently performs an audit of ERS's ICP on an every-other-year schedule.

Human Resources (HR), in conjunction with executive management and other key stakeholders, annually reviews the Plan and related processes to make recommendations to the Board. ERS staff presents a draft Plan document to the Board each year at the May Board meeting for review and discussion.

Final Plan approval will be on the agenda of the August Board meeting.

ATTACHMENTS:

1. Exhibit A – Proposed Plan Year 2025 ICP Document Draft
2. Slides – Annual Review of the ERS Incentive Compensation Plan