

Review of Performance-Based Incentive (PBI) Policy

June 15, 2023

Aon McLagan



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Performance Based Incentive Compensation Plan

STRS Ohio

June 15, 2023



Executive Summary

McLagan found that the STRS Ohio incentive plan is generally aligned with competitive market practice. During the May board meeting, McLagan reviewed the following recommendations with the Board:

- Measure all investment performance net-of-fees. Currently, there is a mixed use of net and gross.
- ✓ Increase the minimum weighting to total fund performance from 10% to 20%.
- ✓ Simplify the plan by removing one-year measures from portfolio and asset class components (currently weighted at 2-10% of total incentive opportunity).
- "Clean up" the plan document by ensuring plan provisions are clear and precise. Additionally, consider moving administrative policies into a separate document.
- ✓ Adjusting the absolute return provision to be a linear gradient (e.g., haircut equal to 4x the negative return value, up to a 50% reduction).



1. Measure all investment performance net of external fees

All incentive goals except those based on Total Fund, real estate and alternative investments will be based on gross Relative Returns (before all investment management costs, both internal and external). Total Fund will be based on Net Relative Returns net of all investment management costs (internal and external) including carried interest and other fund expenses. Real estate and alternative investments will be based on Relative Returns net of all external management fees and costs including carried interest and other fund expenses as per industry convention but no costs deducted for internal management.

All incentive goals except those based on Total Fund, real estate and alternative investments will be based on gross Relative Returns (before investment management costs, both internal and external). Total Fund investment performance will be based on Net Relative Returns net of all investment management costs (internal and external) including carried interest and other fund expenses. Real estate and alternative Each asset class will be based on Relative Returns net of all external management fees and costs including carried interest and other fund expenses as per industry convention but no costs deducted for internal management.

Total Fund investment performance will be based on Net Relative Returns, net of all investment management costs (internal and external) including carried interest and other fund expenses. Each asset class will be based on Relative Returns net of all external management fees and costs including carried interest and other fund expenses as per industry convention but no costs deducted for internal management.



2. Increase Total Fund Minimum Weighting from 10% to 20%

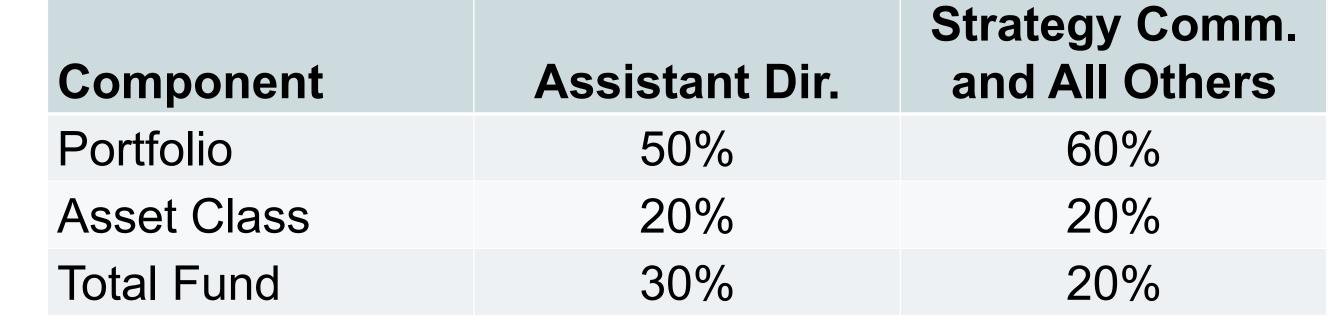
Current

Component	Assistant Dir.	Strategy Comm.	All Others
Portfolio	50%	60%	70%
Asset Class	20%	20%	20%
Total Fund	30%	20%	10%

Redline

Component	Assistant Dir.	Strategy Comm.	All Others
Portfolio	50%	60%	70% 60%
Asset Class	20%	20%	20%
Total Fund	30%	20%	10% 20%

Proposed





3. Proposed Asset Class and Portfolio Weightings

Current

Component	Assistant Dir.	Strategy Comm.	All Others
Portfolio 1yr / 5yr	5% / 45%	5% / 55%	10% / 60%
Asset Class 1yr / 5yr	2% / 18%	2% / 18%	2% / 18%
Total Fund 1yr / 5yr	15% / 15%	10% / 10%	5% / 5%

Redline

Component	Assistant Dir.	Strategy Comm.	All Others
Portfolio 1yr / 5yr	5% / 45%	5% / 55%	10% / 60%
Asset Class 1yr / 5yr	2% / 18%	2% / 18%	2% / 18%
Total Fund 1yr / 5yr	15% / 15%	10% / 10%	5% / 5%

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 Component
 Assistant Dir.
 Strategy Comm. and All Others

 Portfolio 1yr / 5yr
 0% / 50%
 0% / 60%

 Asset Class 1yr / 5yr
 0% / 20%
 0% / 20%

 Total Fund 1yr / 5yr
 15% / 15%
 10% / 10%

McLagan recommends that a value of no less than 5% be assigned to any line-item measurement.



Current

4. Simplify Negative Return Adjustment

Total Fund Return	Reduction
01% to -2%	10%
-2.01% to -4%	15%
-4.01% to -6%	20%
-6.01% to -8%	25%
-8.01% to -10%	35%
-10.01% to -12%	50%
-12.01% or lower	50% and deferred 1 year

4 x negative Return, up to 50%. Deferred for one year if 50% cap is realized (i.e., -12.5% or lower). Example: -1% return = 4% reduction



Transfers and Promotions

Current

"In order to encourage success in the new role when an associate is promoted or laterally transferred, the associate's long term performance may be transferred to the new position provided it does not disadvantage them from being eligible to earn the maximum incentive for their new position."

Redline

In order to encourage success in the new role when If an associate is promoted or laterally transferred, the associate's past long-term performance may will be transferred to the new position. provided it does not disadvantage them from being eligible to earn the maximum incentive for their new position.

Proposed

If an associate is promoted or laterally transferred, the associate's past long-term performance will be transferred to the new position.



Fund-Wide Performance Measures

At the May meeting, several Board members expressed interest in exploring the potential of including additional performance measures in the plan such as funded status, COLAs to retirees, ability to reduce years of service requirements for active members, meeting the assumed rate of return, etc.

These measures are not typically found in investment professional pay programs and may incent negative behaviors like excessive risk taking. A detailed study of the behaviors Board members want to encourage with these metrics as well as potential "unintended consequences" would be prudent if the Board wishes to move forward with these concepts.



Plan Participation

McLagan understands that some Board members believe that participation in the Plan is too broad. If STRS would like to reduce participation to those professionals who make direct portfolio management decisions, a possible approach is:

Current

"...associates who make direct portfolio or asset class decisions or perform analysis that facilitate or implement portfolio decisions..."

Redline

"...associates who make direct portfolio or asset class decisions or perform analysis that facilitate or implement portfolio decisions..."

Alternative

"...associates who make direct portfolio or asset class decisions..."

Importantly, those being removed from the plan would have their base salaries adjusted by 2/3 the maximum incentive opportunity being given up. These adjustments would need to be reviewed considering internal equity and external market competitiveness.



Reduction of Maximum Incentives to 100% of Base

McLagan understands that some members of the Board believe that incentive opportunities that exceed 100% of base salary are inappropriate for STRS. If STRS would like to limit maximum incentive opportunities to 100% of base, a possible approach is:

Deputy Executive Director: 125%

Assistant Director: 125%

Directors: 125%

Alternative

Limit incentive maximums to 100% of base. Those with reductions to their incentive opportunities would have their base salaries adjusted by 2/3 of the maximum incentive opportunity being given up (i.e., 16.67% for every 25%) reduction). These adjustments would need to be reviewed considering internal equity and external market competitiveness.

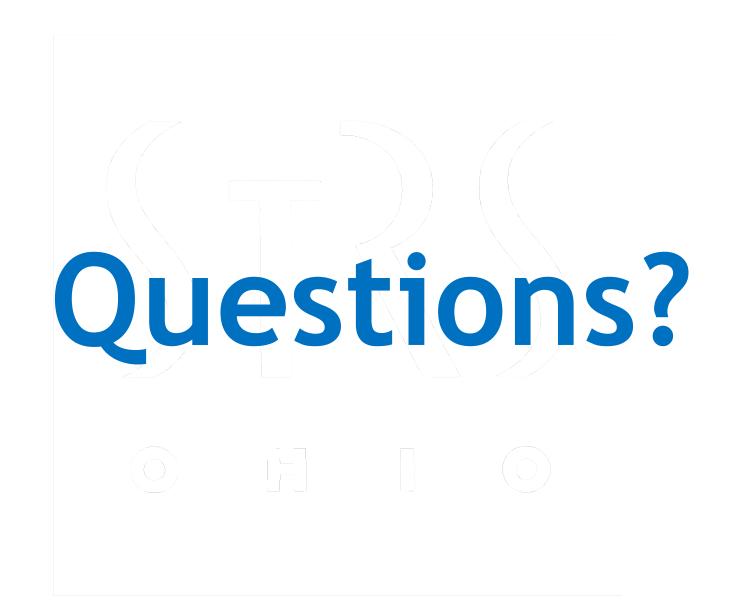
Deputy Executive Director: 100%

Assistant Director: 100%

Directors: 100%







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