



Performance Based Incentive (PBI) Discussion

Aug. 17, 2023

Review of the Performance-Based Incentive Program for Fiscal 2024



- Annual process
- Program in place for over 35 years
- Designed to align the interest of investment staff and membership
- Common among large pension plans with a significant portion of assets internally managed
 - STRS Ohio manages nearly 2/3 of assets internally
 - Attract, motivate, reward and retain highly qualified investment professionals
- CEM reported internal investment management saved over \$100 million
- Performance over the benchmark added over \$2 billion in value during the past five years
- Changes proposed for fiscal 2024

Purpose Updated



| | | |
|---|----------------------------|--------------------------|
| SUBJECT: Performance-Based Incentive Compensation | SECTION: Compensation | HRS POLICY NUMBER: 4.150 |
| EFFECTIVE DATE: March 15, 1985 (Amended by June 16, 2022 August 17, 2023 board action) | FOR USE BY: All Associates | |
| CONTACT: Director, HRS | | |

Purpose:

The State Teachers Retirement System of Ohio's ("STRS Ohio" or "System") mission is to provide Ohio's public educators a foundation for their financial security. The STRS Ohio Retirement Board ("Board") is committed to the internal management of its investment assets as it is the most cost-effective alternative for achieving the investment objectives for the System. As a mature plan that pays out more annually in benefits than it receives in contributions, the System relies on the performance of its investments as a key source of funding for benefits. Thus, achieving the System's investment objectives is central to sustaining and potentially enhancing long-term benefits for members. STRS Ohio's investment beliefs include that internal asset management capabilities are a strategic advantage providing low-cost access to both active and passive strategies. In order to maintain a successful internal management program, it is necessary to provide a compensation plan that is designed to attract, retain, motivate and reward above-average investment talent.

Investment Compensation Philosophy:

To attempt to compete effectively for investment talent, the STRS Ohio targets a total compensation (base salary and Incentive Compensation) for PBI-eligible investment associates and investment associates in salary schedules 308 through 317 will utilize the benchmark between 60% and 80% of the median compensation of a blended peer group of weighted 50% to large/leading public funds and 50% to national private sector firms, and may, on a case by case basis, vary from the target range based on factors including maintaining market competitiveness and internal equity. The Executive Director is responsible for ensuring this these objectives is are met and that the STRS Ohio annual operating budget submitted to the Board is adequate to achieve this these objectives. The STRS Ohio Salary Schedule is increased by a factor of 1.2X for investments associates in pay grades 308 through 317.

Summary:

The Performance-Based Incentive Program ("Program") in conjunction with base salary is designed to motivate, attract, reward, and retain highly qualified investment associates for achieving and sustaining outstanding investment performance based on a written yearly plan of objectives. The Program is intended to provide incentive compensation for Eligible Associates based on the results of the Total Fund, Asset Class and Individual Portfolio performance and the Eligible Associate's individual goals. These objectives are aligned with the achievement of the organization's overall long-term investment performance, since STRS Ohio is a long-term investor.

Board Approval:

The Program and any Incentive Compensation under the Program are subject to review and approval on an annual basis by the Board, Ohio Administrative Code Rule 3307-01-05.

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Guidelines: Eligibility

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Eligibility

Only full-time exempt Investment Department associates who make direct portfolio or asset class decisions ~~or perform analysis that facilitate~~ or implement portfolio decisions may be eligible to participate in this Program. The relative degree of value added is reflected in the compensation percentage at each level. Eligible positions and their respective maximum incentive percentages are listed on Attachment A, titled "Maximum Eligible Incentive Compensation by Position". The maximum incentive percentages for any eligible new positions not listed on Attachment A will be determined by Human Resources Services and the Executive Director and will be added to Attachment A upon review and approval by the Board. Part-time associates are not eligible to participate in the Program.

Associates newly employed (hired, transferred, or promoted) into an eligible position in the Investment Department during the fiscal year (July 1 – June 30) will be eligible to receive pro-rated Incentive Compensation for that period based on the date of employment. The Eligible Associate must be newly employed in the eligible position by the fifth business day of the month to receive a full month's credit.

Pro-ration is determined as follows:

| Month employed by the 5 th business day | PBI Pro-rata (No. of months) | % (Prorata/12) |
|--|------------------------------|----------------|
| August | 11 | 92% |
| September | 10 | 83% |
| October | 9 | 75% |
| November | 8 | 67% |
| December | 7 | 58% |
| January | 6 | 50% |
| February | 5 | 42% |
| March | 4 | 33% |
| April | 3 | 25% |
| May | 2 | 17% |
| June | 1 | 8% |

An Eligible Associate who receives more than one rating of "Needs Improvement" on a STRS Ohio annual associate performance appraisal at any time during the fiscal year will be ineligible for Incentive Compensation for the corresponding year.

Any Eligible Associate who is promoted or transfers to another position within the Investment Department will have their Maximum Eligible Incentive Compensation adjusted for that year. The Maximum Eligible Incentive Compensation will be based on the Maximum Eligible Incentive Compensation for each position in which the Eligible Associate was employed during the fiscal year, weighted by the amount of time the Eligible Associate was employed in each position for that year, as documented in an updated individual PBI Incentive Memo.

An Eligible Associate who takes a paid or unpaid leave of absence of more than twelve weeks during the fiscal year shall receive earned Incentive Compensation on a pro-rated basis factoring the number of leave days beyond twelve weeks in the calculation for the fiscal year.

In the event of a death or disability of an Eligible Associate, any incentive compensation payment will be pro-rated to the end of month of the last day worked and based on the full year results.

Incentive Compensation

The Maximum Eligible Incentive Compensation for Eligible Associates is outlined in Attachment A.

Incentive Compensation will be calculated on the Eligible Associate’s annual base salary in effect on the final full pay period of the fiscal year.

Annual compensation (base salary plus Incentive Compensation earned) of an investment associate in any calendar year cannot exceed two times the maximum amount of pay grade 317.

Performance Measures

The following performance measures will be applied to every Eligible Associate’s Incentive Plan:

- Only quantitative goals will be utilized. Subjective goals will not be used.
- If the STRS Ohio Total Fund does not earn a positive Absolute (actual) Return in the fiscal year, the Incentive Compensation for each Eligible Associate will be reduced as follows: by a factor of 4x the Total Fund Absolute Return, up to a maximum reduction of 50%. In the event a reduction of the earned incentive reaches the maximum of 50% (i.e., Total Fund Absolute Return at or below -12.5%), all incentives will be deferred for a one-year period.

See attachment D for an example of a negative Absolute Return reduction.

| STRS Ohio Total Fund Absolute Return | Reduction |
|--------------------------------------|---|
| -0.01% to -2% | 10% |
| -2.01% to -4% | 15% |
| -4.01% to -6% | 20% |
| -6.01% to -8% | 25% |
| -8.01% to -10% | 25% |
| -10.01% to -12% | 50% |
| -12.01% or lower | 50% (however payment deferred for one year) |

- Linking Incentive Compensation to the financial health of the System directly aligns the Program with member outcomes. Therefore:

If the Board’s actuary determines the System does not have at least a de minimis amount available under its Sustainable Benefit Enhancement Plan (SBEP) for the fiscal year during which Incentive Compensation is scheduled for payment, the Incentive Compensation for each Eligible Associate will be reduced by 5%.
- A minimum of 40% of every Eligible Associate’s Incentive Plan will be based on the Total Fund Net Relative Return allocated 50% to the 1-year period and 50% to the 5-year period. The Net Relative Return that must be met for full incentive achievement will be based on the Board’s current Net Relative Return Objective as defined in the annual Statement of Investment Objectives and Policy.
- No associate will earn their Maximum Eligible Incentive Compensation unless the Total Fund Net

Relative Return meets or exceeds the current Net Relative Return Objective as defined in the annual Statement of Investment Objectives and Policy in the fiscal year. The total fund costs (difference between gross and net of fee performance goals) are reported annually by CEM Benchmarking Inc. on a calendar year basis and are reflected on the Board's Trustee Summary performance report prepared by the Investment Consultant.

- ~~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 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 investments. Each asset class will be based on Relative Returns net of all external management fees and costs including (as applicable) carried interest and other fund expenses as per industry convention but no costs deducted for internal management. Consistent with industry standards, private market performance is lagged one quarter due to the timing and availability of financial information.~~

Quantitative incentive goals are established for the associate's responsibilities, Individual Portfolio and the Asset Class by the supervisor and asset head and approved by the Deputy Executive Director - Investments. The asset head may take into consideration the tracking risk of the Individual Portfolio and Asset Class goals in the Board's Investment Policy (refer to the Statement of Investment Objectives and Policy) which is reviewed annually. ~~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 able to earn the maximum incentive for their new position.~~ For general guidelines on allocating the incentive goals to individual positions, see Attachment B. These guidelines are in place to achieve consistency among the Asset Classes. Since STRS Ohio invests for the long-term, incentive goals at the Asset Class and Individual Portfolio/industry levels will generally include results on a 1 and 5 year basis. A value of no less than 5% will be assigned to any individual incentive goal. Industry standard Geometrically Linked Annualized Returns will be used.

Using a Linear Basis to calculate the PBI, the Relative Return (in basis points) is divided by the Maximum Incentive Hurdle (in basis points) for the Total Fund, Asset Class and Individual Portfolio. This demonstrates the Board's policy to exceed expectations in the Asset Classes and Individual Portfolios as compared to their specific benchmarks. These performance figures and hurdles are found on the Incentive Compensation Performance worksheet (Attachment E), which is updated annually through June 30th.

Relative Return calculations will be rounded to the nearest whole basis point and no decimals will be used (e.g., 3.5 basis points will be rounded to 4 basis points and 2.4 basis points will be rounded to 2 basis points).

See Attachment D for an example of an associate's incentive calculation.

Program Administration

Incentive goals are established annually based on the Board's Statement of Investment Objectives and Policy and are submitted for review to the Deputy Executive Director—Investments. The Deputy Executive Director – Investments will submit the individual goals for all Eligible Associates to the Executive Director, after review and approval by Finance, Human Resource Services and Internal Audit (generally occurring in June), for the next incentive period for final review and approval. Once approved, the

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Executive Director issues an individual PBI memo that is provided to each Eligible Associate outlining the individual goals generally no later than one month after the start of the fiscal year. See Attachment F for a Sample of an Individual PBI Memo.

At the end of the incentive period, the performance of the Total Fund, Asset Classes and Individual Portfolios are evaluated by the Finance Department in comparison to the benchmarks and compiled on the Incentive Compensation Performance worksheet. Performance results of the Asset Classes and Total Fund will be examined annually by a third-party performance verification firm. The Finance Department will provide, and the Investment Department asset heads will confirm, each Eligible Associate's overall percentage earned of their Maximum Eligible Incentive Compensation based on their incentive goals and the Incentive Compensation Performance worksheet. The Deputy Executive Director—Investments reviews all calculations of performance and the proposed payments. (Refer to Attachment D for an example of the Incentive Calculation.) The Internal Audit Department and the Human Resources ~~Services~~ Department will review each of the individual incentive calculations to verify the Program is in compliance with Board policy. Once the internal audit review is complete, the Executive Director will review program administration memos from Finance, Human Resource Services and Internal Audit which affirm each respective department has completed the above administration and that payouts have been calculated in accordance with Board policy, and approve all individual Incentive Compensation and then submit the recommended Incentive Compensation to the Board, typically in August, for final approval. ~~Any administratively applied geographical pay differential will be noted. Once a third-party performance verification firm confirms total fund performance is calculated and reported in accordance with the Global Investment Performance Standards (GIPS), Approved-~~ approved Incentive Compensation will ~~forwarded to be processed for payment by~~ approved Incentive Compensation will ~~forwarded to be processed for payment by~~ Human Resource Services for the final processing and payment.

Payment

Incentive payments (via direct deposit according to the banking distribution currently on file) will be made separate from regular earnings following the end of the fiscal year generally no later than the third Monday of the month following the month in which Incentive Compensation is approved by the Board.

Eligible Associates must be employed by STRS Ohio on the date of payment (except in the case of a death or disability) in order to be eligible for the Incentive Compensation.

Governance

The Program may be interpreted, amended, rescinded and/or terminated by the Board at any time. Participation in the Program in one year does not confer the right to participate in the current or any other year and does not confer the right to continued employment.

ATTACHMENTS/REFERENCES:

- A – Maximum Eligible Incentive Compensation by Position
- B – General Guidelines for Allocating Incentive Goals
- C – Definitions
- D - Incentive Calculation Example (For Illustration Purposes only)
- E - Incentive Compensation Performance Worksheet (For Illustration Purposes only)
- F – Sample of Individual PBI Incentive Memo (For Illustration Purposes only)

Attachment A: Maximum Eligible Incentive Compensation



Attachment A Maximum Eligible Incentive Compensation

| Position Title | Maximum Incentive |
|--|-------------------------|
| | Current FY 2023-2024 |
| Deputy Executive Director, Investments | 125100% |
| Assistant Director, Investments | 125100% |
| Director, Domestic Equities | 125100% |
| Director, International Equities | 125100% |
| Director, Fixed Income | 125100% |
| Director, Alternative Investment | 125100% |
| Director, Real Estate | 125100% |
| Director, Midwest Region | 125100% |
| Director, Western Region | 125100% |
| Director, Eastern Region | 125100% |
| Director, Southern Region | 125100% |
| Portfolio Manager, Equities | 100% |
| Portfolio Manager, Director of Research, Equities | 100% |
| Portfolio Manager, International | 100% |
| Portfolio Manager, Fixed Income | 100% |
| Portfolio Manager, Quantitative Equities | 100% |
| Portfolio Manager, Alternative Investments | 100% |
| Portfolio Manager, EAFE Quantitative | 100% |
| Portfolio Manager, EAFE Value | 100% |
| Portfolio Manager, Emerging Markets | 100% |
| Portfolio Manager, REITs | 100% |
| Managing Director, International Real Estate | 100% |
| Director, Asset Allocation and Strategy, Investments | 100% |
| Asset Management Director | 100% |
| Acquisition Director | 100% |
| Senior Economist | 80% |
| Chief of Staff, Investments | 80% |
| Consulting Analyst | 80% |
| Head Trader | 80% |
| Assistant Portfolio Manager, Equities | 80% |
| Assistant Portfolio Manager, International | 80% |
| Assistant Portfolio Manager, Fixed Income | 80% |
| Assistant Portfolio Manager, Quantitative Equities | 80% |
| Assistant Portfolio Manager, Alternative Investments | 80% |
| Senior Asset Management Officer 2 | 80% |
| Senior Acquisition Officer 2 | 80% |
| Manager, International Real Estate | 80% |

Attachment B: Allocating Incentive Goals



General Guidelines for Allocating Incentive Goals

Attachment B

The chart below is used as a general guideline for allocating the incentive goals to individual positions. This attachment is referenced on page 6 of the PBI Program document.

The allocation percentages listed below for the one year Asset Class and Total Fund performance represent minimum allocation levels. However, each Associate is generally expected to have on a combined basis, an effective weight on one year performance of at least 25%. The Portfolio/Industry group may include goals related to Individual Portfolios, industry sectors, analyst groups or other appropriate subsets within the relevant Asset Class. Private direct real estate is included in the Portfolio/Industry category for real estate positions. The "Asset Class" category for Fixed Income will include only the Core portfolio. Refer to Attachment D for an example of an incentive calculation and how these allocation percentages are used.

| | Incentive Allocation Percentages | | |
|--|----------------------------------|----------------------------|----------------------------------|
| | Assistant Director | Strategy Committee Member* | All Other PBI Eligible Positions |
| Portfolio/Industry, if applicable ³ | 50% | 60% | 70% |
| 1 Year Relative Performance | 50% | 5% | 40% |
| 5 Year Relative Performance | 45% | 55% | 60% |
| Asset Class | 20% | 20% | 20% |
| 1 Year Relative Performance | 20% | 2% | 20% |
| 5 Year Relative Performance ⁴ | 18% | 18% | 20% |
| Total Fund | 30% | 20% | 40% |
| 1 Year Relative Performance | 15% | 10% | 510% |
| 5 Year Relative Performance | 15% | 10% | 510% |
| Total Incentive Allocation | 100% | | 100% |

Notes:

Currently, the Strategy Committee includes the following positions: Director, Domestic Equities; Director, Fixed Income; Director, Alternative Investments; Director, International Equities; Director, Investment Operations; Director, Real Estate. There are other positions held on the Strategy Committee that are not listed here because they are included in this footnote below. The Deputy Executive Director, Investments has a 60% allocation to Total Fund and a 40% allocation to the individual asset classes. The Sr. Economist, Director, Asset Allocation and Strategy, Investments and Chief of Staff, Investments have a 50% allocation to Total Fund and a 50% allocation to the individual asset classes.

The Sr. International Economist has a 50% allocation to Total Fund and 50% to the Total International Asset Class. The Head Trader, the Sr. Securities Trader, and the Securities Trader positions have a 4% allocation to the 1 year and a 40% allocation to the 5 year within the Asset Class level; and a 10% allocation to the 1 year and a 40% allocation to the 5 year within the Portfolio/Industry level. The Managing Director, International Real Estate position has a 7% allocation to the 1 year and 30% allocation to the 5 year within the Portfolio/Industry level and a 5% allocation to the 1 year and a 50% allocation to the 5 year within the asset class level. Real Estate Acquisition positions have a 25% allocation to the 1 year and 35% allocation to the 5 year within the Portfolio/Industry group.

For the liquid asset classes, individuals within 59 years or less of experience on an assigned Portfolio/Industry have the entire allocation to the Portfolio/Industry category based on the actual number of months on the Portfolio/Industry.

New Eligible Associates in the liquid asset classes have a 1 Year Asset Class Relative Performance goal in the first eligible fiscal year, which ~~and this~~ increases annually by an additional year until the 5 Year Relative Performance period is met. Effectively the entire allocation to the Asset Class category in the first eligible fiscal year is on the 1 Year Relative Performance.

Definitions

Attachment C

Absolute Return: The STRS Ohio actual return (income plus appreciation/depreciation expressed as a percentage) that is earned over a certain period of time.

Asset Class: A collection of securities that have conceptually similar claims on income streams and have returns that are highly correlated with each other. The current asset classes used by STRS Ohio include liquidity reserves, fixed income, domestic equities, international equity, real estate, and alternative investments.

Eligible Associate: A full-time exempt investment department associate who makes direct portfolio or asset class decisions or performs analysis that facilitates or implements portfolio decisions.

Geometrically Linked Annualized Returns: The compounding of period-to-period returns calculated using a time weighted rate of return method. Annualized returns are the equivalent to the annual return which, if earned in each year of the indicated multi-year period, would produce the actual cumulative return over such period.

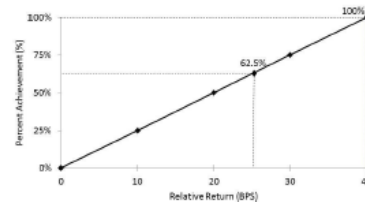
Incentive Compensation: The amount of the incentive payout that is earned by an Eligible Associate.

Incentive Plan: The Performance-Based Incentive Compensation Program that is documented as HRS Policy Number 4.150 and is approved and reviewed by the Board annually.

Individual Portfolio: A pool of assets for which the Eligible Associate has responsibility. Within an Asset Class, there can be several individual portfolios used to accomplish the objectives and goals at the asset class level.

Linear Basis: The mathematical relationship of direct proportionality that, when plotted on a graph, traces a straight line. The Net Relative Return or Relative Return (in basis points) is divided by the Maximum Incentive Hurdle (in basis points) to determine the Percentage Achievement.

Linear Chart Example





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