



# Initial Review of Performance-Based Incentive (PBI) Policy

May 18, 2023

- **Introduction**
- **Initial review of the Performance-Based Incentive (PBI) Policy**
- **Next steps**





# **Review of the *Performance Based Incentive Compensation Plan***

STRS Ohio

May 18, 2023





# Introduction

STRS Ohio (“STRS”) asked McLagan to review the design features of its *Performance Based Incentive Compensation Plan* (“the Plan”). More specifically, STRS wants to ensure that the Plan will:

- Attract, motivate, and retain top-caliber professionals.
- Provide competitive pay that balances internal equity with market competitiveness.
- Drive exceptional long-term investment performance with appropriate levels of risk and cost.
- Be fair, reasonable, and relatively easy to understand and administer.

In addition, competitive market practice is summarized and noted where STRS may differ from peers. “Peers” in this document refers to other leading public funds.

Importantly, there is no incentive plan identical to another – highlighted differences may be due to differences in STRS' investment approach, operating model, culture, HR & business objectives, governance, etc.

McLagan looks forward to reviewing and discussing our findings with the Board. Feedback from this meeting will be incorporated into a proposed, revised policy for the June meeting.

# Methodology

To complete this review, McLagan:

- Reviewed background materials provided by STRS (e.g., plan documents, organizational chart, investment policy, etc.).
- Interviewed STRS staff and Board members to understand their perspectives about the organization's investment approach, human resource strategies, and existing incentive plan.
- Compared STRS' incentive plan design features to those of peers.
- Prepared this assessment of the Plan including potential ways to improve the plan.

# Executive Summary

McLagan found that the Plan is generally aligned with competitive market practice. For example, the plan:

- Includes staff who have direct impact on results or perform analysis that facilitates portfolio decisions.
- Has incentive maximums that vary by position.
- Includes a mix of short- and long-term performance.
- Uses a mix of total fund, asset class, and portfolio performance.
- Rewards participants for value-add over policy benchmarks.

However, we recommend STRS consider making some or all the following changes:

1. Measure all investment performance net-of-fees. Currently, there is a mixed use of net and gross.
2. Increase the minimum weighting to total fund performance from 10% to 20%.
3. Simplify the plan by removing one-year measures from portfolio and asset class components (currently weighted at 2-10% of total incentive opportunity).
4. “Clean up” the plan document by ensuring plan provisions are clear and precise. Additionally, consider moving administrative policies into a separate document.
5. Adjusting the absolute return provision to be a linear gradient (e.g., haircut equal to 3x the negative return value, up to a 50% reduction). Also consider a 1x positive return adjustment in positive years.

# STRS vs Peers – Design Features

Key Features	STRS' Current Practice	Peer Practice	Proposed Approach
<b>Plan Participation</b> ✓	“Associates who make direct portfolio or asset class decisions or perform analysis that facilitate or implement portfolio decisions.”	Peer incentive plans include all investment positions. 75% of peers also include at least some non-investment positions, but many are restricted to fund-wide leadership (e.g., ED, COO, etc.).	<b>Maintain current approach</b>
<b>Plan Component Weightings</b> ▲	The Plan is based only on quantitative results with a mix of total fund, asset class, and portfolio performance relative to benchmark. A minimum of 10% is weighted toward total fund performance.	Weightings generally vary by position based on roles and responsibilities. Most peers have at least 20-30% weighted to total fund performance.	<b>STRS would increase minimum weighting to total fund performance from 10% to 20%</b>
<b>Quantitative Component</b> ▲	Performance is measured relative to benchmark on one- and five-year basis.	Generally focused primarily on value-add over benchmark on one- and three-year periods on a net-of-fee basis. Minimum weightings to sub-components are generally 10%.	<b>STRS would remove the 1-year weighting to asset class and portfolio level performance that currently have weightings as low as 2%. Total fund would remain measured on a 50/50 split between one- and five-year.</b>  <b>STRS would measure all performance net-of-fees.</b>

✓ STRS is generally aligned with market practice of peers

▲ STRS differs somewhat from market, but being different may be better for STRS

● STRS is not aligned with market, McLagan suggests a periodic review of this feature to ensure it is still in STRS' best interest



# STRS vs Peers – Design Features ...

Key Features	STRS' Current Practice	Peer Practice	Proposed Approach
<b>Performance Payout Scale</b> ✓	The payout scales for relative benchmark performance are on a linear scale. Scales vary by asset class.	Peers' performance payout scales vary with each fund's investment objectives, risk profiles, time periods, benchmarks, and pay-for-performance standards.	<b>Maintain current approach. Periodically ensure that maximum scales are challenging yet achievable and aligned with STRS investment policy and risk objectives.</b>
<b>Negative 1-year Performance</b> ✓	STRS has a graded system for reducing and deferring compensation in years that absolute performance is negative.	Most peers have a mechanism for what to do in negative years. Some peers defer all awards (without reduction) until the next positive year. Some peers take a similar approach to STRS and modify the incentive award based on the magnitude of down performance. Importantly, these provisions are largely only seen in public funds to manage "headline risk." Other institutional investors (endowments, foundations, corporate plans, etc.) generally do not adjust incentive payouts based on absolute returns.	<p><b>STRS would modify its negative return adjustment to be 3x the negative return, not to exceed a 50% reduction.</b></p> <p><b>Incentives would continue to be deferred for -12.01% or worse returns. The deferred incentive compensation would "earn interest" at the funds absolute rate of return until paid out.</b></p> <p><b>Consider crediting positive absolute returns with a 1x factor (up to 25%).</b></p>
<b>Other</b>	<i>Some stakeholders shared the view that incentive opportunities in excess of 100% of base salary could be perceived poorly. While many peers have incentive opportunities for senior staff that exceed 100% of base, if STRS desires to cap incentive maximums to 100% of base, it should evaluate its base salaries ensuring that total compensation is competitive.</i>		

✓ STRS is generally aligned with market practice of peers

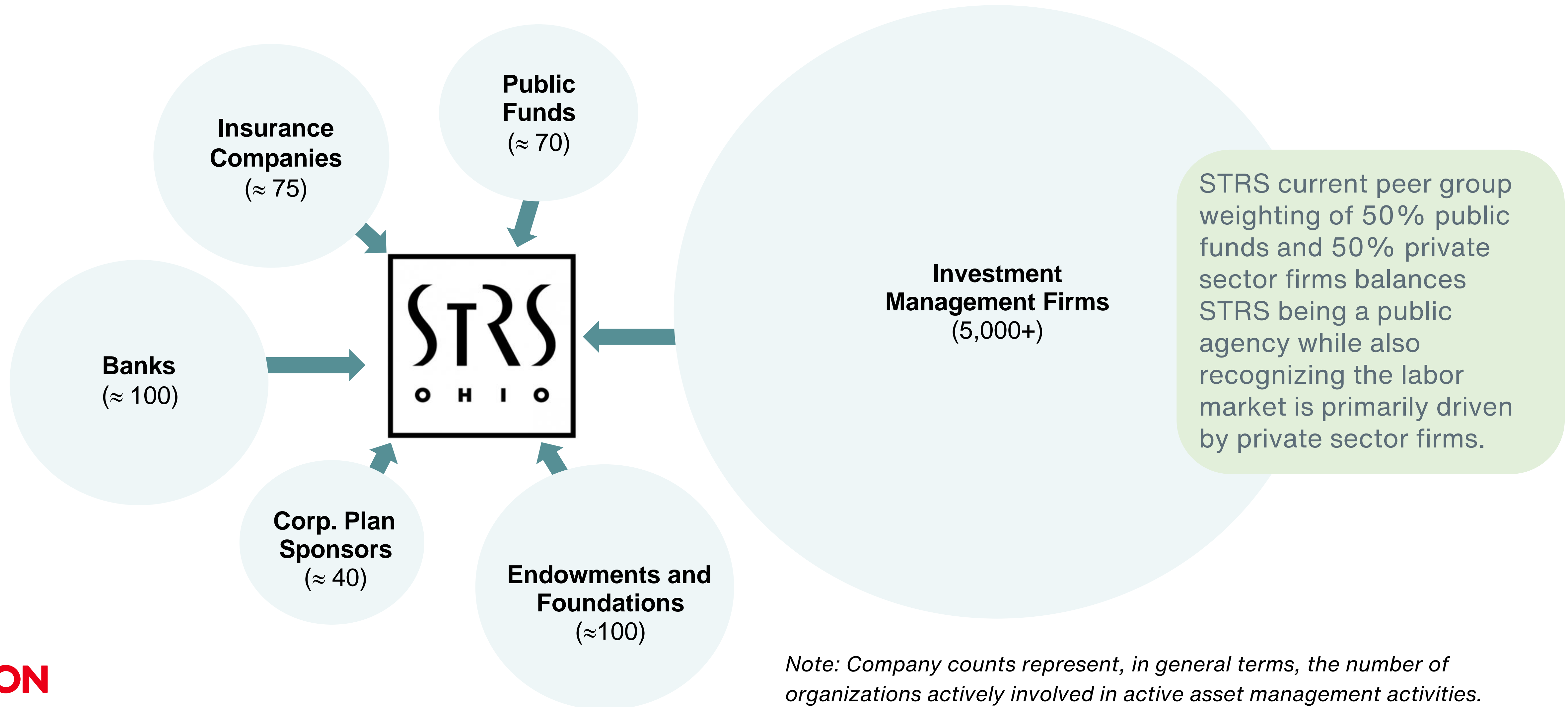
▲ STRS differs somewhat from market, but being different may be better for STRS

● STRS is not aligned with market, McLagan suggests a periodic review of this feature to ensure it is still in STRS' best interest



# STRS Competes with a Broad Range of Firms for Talent

- Measured by potential “job openings,” the labor market for investment talent is dominated by investment management firms, not other public funds.



All values  
are  
illustrative

# “Typical” Peer Incentive Plan

## Near the Beginning of Each Year:

1. Identify/Re-Confirm Target Award
  - Example: 60% of salary, or \$100,000.
2. Weight Target Award to Plan Components

Plan Component	Incentive Weighting	Weighted Portion of Max Incentive
Total Fund	30%	\$30,000
Asset Class	20%	20,000
Portfolio	50%	50,000
Total	100%	\$100,000

Asset class / portfolio performance is typically only seen in funds with internal / direct management. Funds with manager-of-manager measure performance on a total fund basis only.

Approximately 50% of funds have some qualitative mechanism.

3. Establish Performance Criteria/Scales:

Quantitative Perf-Award Scale	
Multi-Year BPS Outperformance	Performance Multiplier
50	100%
:	:
25	50%
:	:
0	0%
Intermediate points interpolated	

## After the End of Each Year:

1. Determine Multipliers for each Plan Component

Plan Component	Performance Illustrative	Performance Multiplier
Total Fund	100 bps →	100%
Asset Class	25 bps →	50%
Portfolio	37.5 bps →	75%

2. Determine Initial Awards

Plan Component	Weighted Portion of Max Incentive	Performance Multiplier	Earned Award
Total Fund	\$30,000	x 100%	= \$30,000
Asset Class	20,000	x 50%	= 10,000
Portfolio	50,000	x 75%	= 37,500
Total	\$100,000	x	= \$77,500

3. Payout Award

# Appendix



# Michael Oak



moak@aon.com

## Michael Oak, Associate Partner

Michael Oak, an Associate Partner in McLagan's asset management practice, oversees our institutional investor clients including public funds, corporate plan sponsors, endowments, and foundations. For these clients, Mike specializes in:

- Board advisory / Executive compensation.
- Incentive plan design / Pay for performance.
- Compensation philosophy & peer group development.
- Compensation benchmarking & salary structure.

Mike also works with a broad range of investment management firms on compensation related issues including managing our *Performance Intelligence Study*, a general ledger benchmarking for asset management firms. Mike is a frequent speaker on pay related topics at numerous industry conferences.

Prior to joining McLagan in 2010, Mike worked as a mathematical statistician for the U.S. Department of Agriculture and in the executive compensation practice at Pearl Meyer & Partners. Mike holds a B.S. in Biometry & Statistics and a Master's degree in Applied Statistics from Cornell University.

Mike resides in Virginia with his wife Jen, who is a wildlife veterinarian. Outside of work, Mike enjoys spending time outdoors and giving back to the community. Mike is a volunteer paramedic with his local fire department, a Virginia state permitted Wildlife Rehabilitator, and a Virginia Master Naturalist.

# Small Sample of Mr. Oak’s Clients

Mr. Oak has advised more than 150 asset management organizations on pay related issues. A small sampling of Mr. Oak’s work is listed below.

## Board Advisory (30+)

### Public Funds

Alaska Permanent Fund  
Virginia Retirement System  
State of Wisconsin Inv Board  
Cities of Austin / Dallas / Fort Worth

### Institutional Investors

Chan Zuckerberg Initiative  
Stanford Management Co  
University of Chicago  
Wash U in St. Louis

### Asset Management Firms

Artisan Partners  
MissionSquare  
Invesco  
TIFF

## Incentive Plan Design (50+)

### Public Funds

Colorado PERA  
MA PRIM  
City of San Jose  
Texas Treasury Safekeeping Trust

### Institutional Investors

Columbia University  
General Motors Asset Mgmt  
The Ohio State University  
University of Virginia

### Asset Management Firms

Commonfund  
John Hancock Funds  
Natixis Global Asset Mgmt  
Prudential

## Pay Benchmarking (75+)

### Public Funds

CalPERS  
CalSTRS  
Texas Teachers  
United Nations

### Institutional Investors

Brown University  
Rice University  
Lockheed Martin  
Harvard University

### Asset Management Firms

Cambridge Associates  
Hirtle Callahan  
Invesco  
Resolute Inv Managers

# Jason Baer

1



jason.baer@aon.com

## **Jason Baer, Senior Consultant**

Jason Baer is a senior consultant in McLagan's asset management practice where he works with a variety of asset management firms. Mr. Baer has assisted on numerous engagements, including firm-wide and executive compensation analyses and incentive plan design projects.

Mr. Baer manages the Canadian compensation surveys and serves as a relationship manager for those clients. Mr. Baer also runs McLagan's benefits market practice study.

Prior to joining McLagan in 2022, Mr. Baer worked at Charles River Associates within their Risk, Investigations & Analytics practice and, before that, at FTI Consulting within their Health Solutions group. In each of these roles, Mr. Baer worked with clients to effectively derive value from their available data to solve their most complex problems. Mr. Baer has significant expertise in working with large volumes of data across disparate systems to draw actionable insights out of complex information.

Mr. Baer holds a B.A. in Economics from the University of Virginia and works remotely from Brooklyn, NY.



# About McLagan

For over 50 years, McLagan has helped investment management organizations with pay-related challenges by leveraging our unique combination of in-depth industry knowledge, proprietary pay data, and consulting expertise.

McLagan is the premier consulting firm to the investment management industry. We have helped hundreds of investment management organizations benchmark their compensation levels, evaluate their salary structures, and modify/design incentive compensation plans. Our staff is fully dedicated to the industry, and we regularly consult with senior leaders and Boards on pay-related matters. In addition to having access to the most comprehensive database of investment industry pay levels, McLagan's consultants are up to date with industry best practice on the full spectrum of compensation matters.

With roughly 300 employees worldwide, McLagan is the leading provider of compensation consulting services to the investment industry. McLagan's clients include over 800 investment management organizations in North America including:

- Endowments and foundations
- US and Canadian public funds
- Corporate plan sponsors
- Family offices
- Investment management/advisory firms
- Insurance company asset managers

- Bank asset managers
- Fund-of-funds
- OCIOs
- Hedge funds
- Private equity firms
- Asset consulting firms

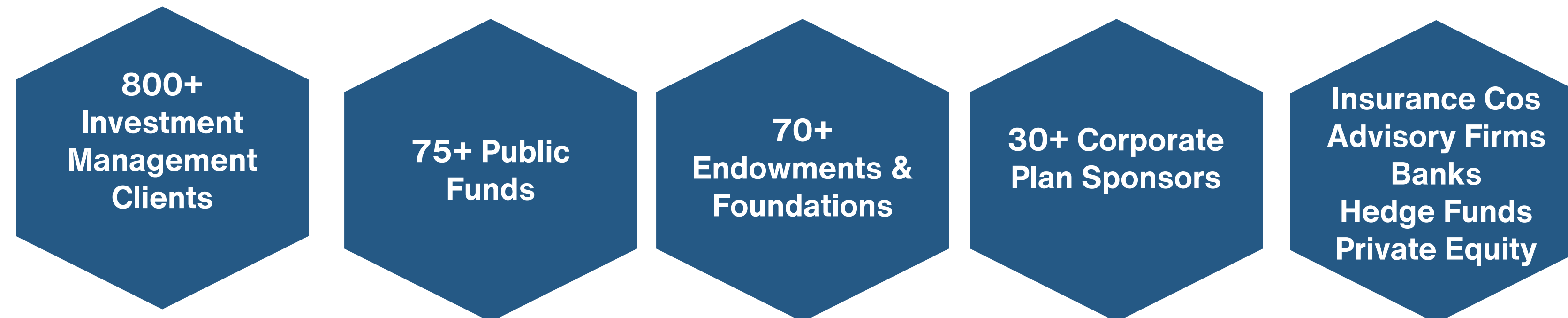
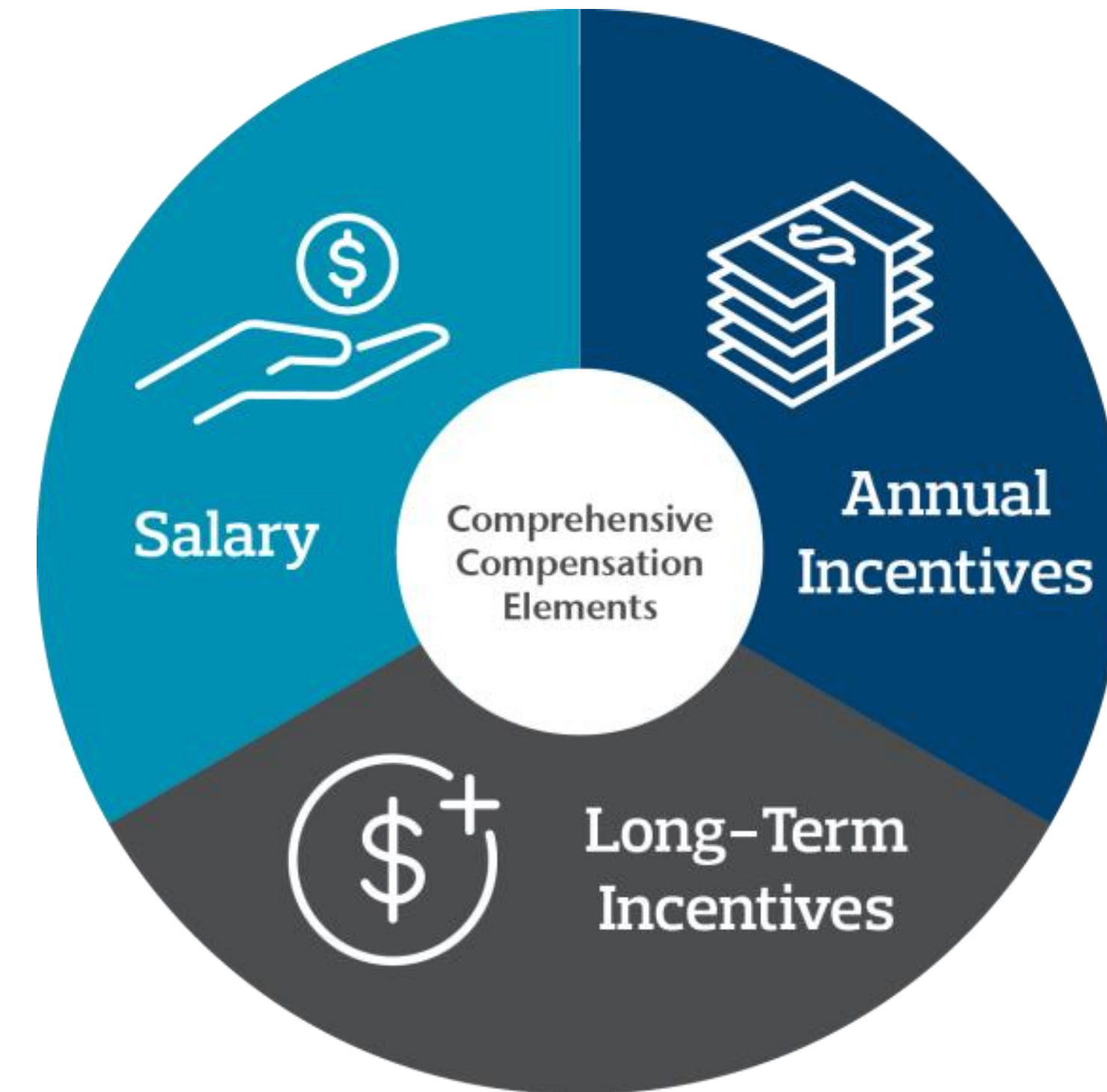
Other McLagan colleagues specialize in wealth management firms, banking and capital markets, credit cards, insurance companies etc. Moreover, Aon and Radford colleagues cover the full spectrum of general industry, high tech and life sciences industries.

# McLagan is the Investment Industry Leader in Pay Design

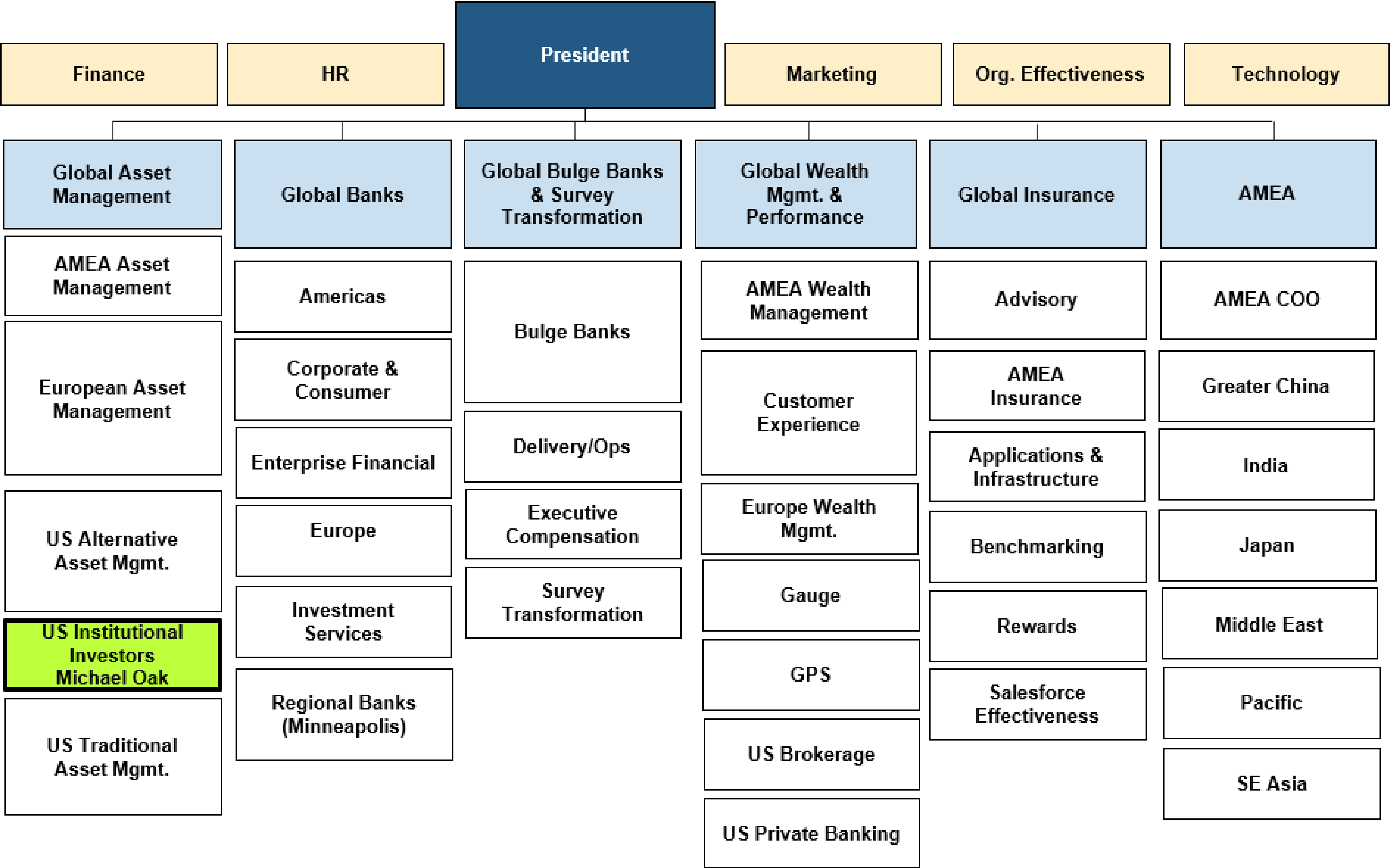
McLagan helps clients design competitive total rewards programs that **attract top talent and incent the results you want to see**. Our recommendations start with a keen understanding of compensation market benchmarks and industry best practice.

We are equipped to **assess your true competitive standing in the market** to facilitate decisions around balancing your compensation mix in relation to your operational and investment objectives.

While pay is not everything, it is a key lever in growing and retaining top talent.



# McLagan Global Organizational Chart (~300 Employees Globally)





# About Aon (McLagan's Parent Company)

A leading global professional services firm providing a broad range of risk, retirement and health solutions enabled by data & analytics



## The Aon Portfolio

Commercial Risk Solutions	Reinsurance Solutions	Retirement Solutions	Health Solutions	Data & Analytic Services
<ul style="list-style-type: none"><li>• #1 primary insurance brokerage</li><li>• +\$60B bound premium annually</li><li>• +90% average retention</li></ul>	<ul style="list-style-type: none"><li>• #1 treaty and facultative brokerage</li><li>• +\$30B bound premium annually</li><li>• 24 consecutive quarters net new business in core treaty</li></ul>	<ul style="list-style-type: none"><li>• +4T assets under independent advisory</li><li>• \$100B assets under delegated management</li><li>• 1000's of companies trust their retirement plans to Aon</li></ul>	<ul style="list-style-type: none"><li>• #1 provider of health exchange solutions</li><li>• Leading provider of global health &amp; benefits</li><li>• \$180B in premium and equivalents placed globally</li></ul>	<ul style="list-style-type: none"><li>• \$400M annual investment in data and analytics</li><li>• \$170B bound premium through Aon Inpoint platform</li><li>• +30M individual customers from +200 organizations served by Aon Affinity</li></ul>

# Aon's Four Focused Solution Groups



## Human Capital Solutions

Human Capital Strategy  
Selection and Assessment  
Culture and Engagement  
Leadership Development  
Employee Compensation  
Executive Compensation  
Total Rewards Strategy  
Sales Compensation  
Sales Force Effectiveness  
HR Effectiveness  
Performance Benchmarking  
Performance Consulting  
People Analytics



## Retirement & Investment

Actuarial/Retirement Consulting  
Investment Consulting  
Delegated Investment Management  
Defined Benefit Administration  
Defined Contribution Administration  
Participant Advisory Services  
Global Retirement Plan Consulting  
Compliance Services



## Health & Benefits

Health & Benefits Brokerage and Consulting  
Aon Active Health Exchange  
Aon Retiree Health Exchange  
Global Benefits Consulting and Administration  
Health & Welfare Administration  
Executive Benefits  
Dependent Verification  
Advocacy Services  
Reimbursement Account Administration  
Compliance Services



## HR Services

Cloud Deployment Solutions  
Cloud Services  
Application Management Services  
Hosted Business Process Outsourcing  
Managed Payroll Solutions  
Tax & Garnishment Services  
Integrated Talent Management



# Questions?

This material is intended for use by the board of the State Teachers Retirement System of Ohio (STRS Ohio) and not by any other party. STRS Ohio makes no representations, guarantees, or warranties as to the accuracy, completeness, currency, or suitability of the information provided in this material. Nothing included herein is either a legal reference or a complete statement of the laws or administrative rules of STRS Ohio. In any conflict between the information provided herein and any applicable laws or administrative rules, the laws and administrative rules shall prevail. This material is not intended to provide tax, legal or investment advice. STRS Ohio disclaims any liability for any claims or damages that may result from reliance on this material or the information it contains, including any information obtained from third parties.