



Performance-Based Incentive (PBI) Policy

July 19, 2024

- **Incentive compensation is standard in the investment industry and drives alignment of interests**
- **STRS Ohio has exceptional investment performance; if STRS Ohio outsourced management of the assets it manages internally, system expenses would increase**
- **Public pension funds across Ohio and the United States include incentive compensation as a component of total compensation**
- **In June the board did not approve the PBI Policy or an alternative**

- Approve an Investment Department compensation structure for the 2025 fiscal year (July 1, 2024-June 30, 2025)
- To comply with the board's duty of prudence, the board will need to reinstate the PBI Policy or approve an alternative
- Options:

Current	Reinstate the PBI Policy as proposed in May and June 2024
Alternative	Adopt an alternative – from McLagan “Those with reductions to their incentive opportunities would have their base salaries adjusted by 2/3 of the maximum incentive opportunity being given up.” Example: Base Salary = \$200,000; Max Potential PBI = 65% Adjusted Salary = $\$200,000 + (\$200,000 * 65\% * 2/3) = \$286,666.67$

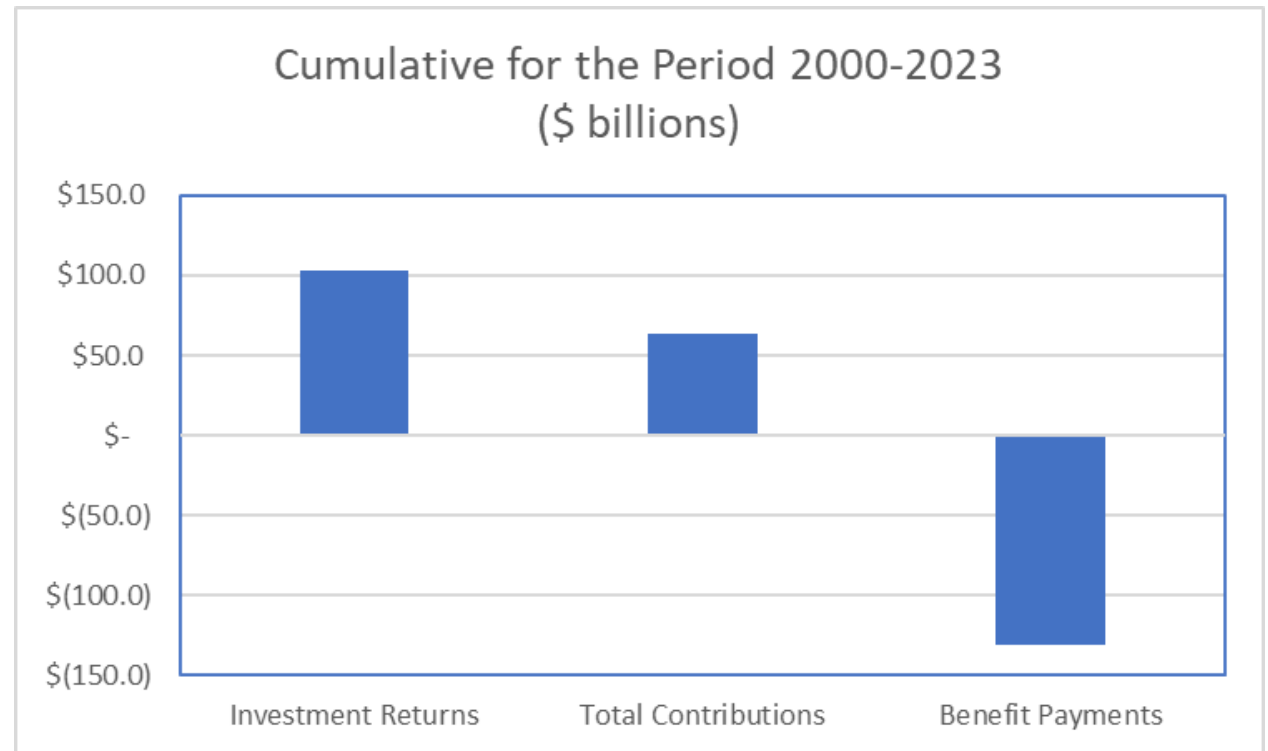
- **Proposed changes are for the fiscal year 2025 STRS Ohio PBI Policy**
 - Fiscal year 2025: July 1, 2024-June 30, 2025
- **During fiscal year 2025, Meketa will lead the STRS Ohio board through an asset-liability study**
 - Reference benchmarks will be explored as part of that process
- **The STRS Ohio PBI Policy is reviewed annually and changes for fiscal year 2026 will be reviewed spring 2025**
- **Over the last 10 years, the PBI Policy has been voted in April (five times), May (three times), June (one time) and August (one time)**
 - It is important for eligible associates to understand performance goals and expectations before the fiscal year begins

Why Pay Incentive Compensation?

- **STRS Ohio's PBI Policy allows it to maintain a successful asset management program**
- **More generally, performance-based incentive programs:**
 - Are designed to attract and retain high quality investment talent to drive performance for members
 - Align the economic and financial interests of stakeholders and investment professionals
 - Incentive payments increase with good performance and value added to the fund
 - Are the variable component of total compensation (base pay + pay for performance)

Why Pay Incentive Compensation?

- **STRS Ohio is a mature plan that pays out more annually in benefits than it receives in contributions**
 - Investment performance is a key source of funding for benefits
- **Internal asset management capabilities are a strategic advantage**
 - Provide low-cost access to both active and passive strategies



Performance-Based Incentives: Investment Industry Standard, Including at Public (Ohio) Pension Funds



	<u>STRS Ohio</u>	<u>OPERS</u>	<u>SERS</u>
Participation Levels	Assistant Portfolio Managers to CIO	Entry Level Analysts to CIO	Entry Level Analysts to CIO
Employees in the Program	69	58	11
AUM \$ billions (a/o 12/31/23)	\$91.6	\$111.7	\$18.2
% Internally Managed	65%	54%	3%
% Actively Managed	90%	74%	83%
Maximum Incentive Range (<i>varies by position based on roles & responsibilities; the lower bound of the range is higher at STRS Ohio since the Policy is limited to more senior positions</i>)	50%-95%	25%-100%	10%-90%
Goals	100% Quantitative	80% Quantitative / 20% Qualitative (Max)	100% Quantitative
Time Periods Measured for Incentives	1-year (10-15%) & 5-year (85-90%)	1-year (25%) & 3-year (75%)	1-year (25%) & 3-year (75%)
Total Fund Incentive Weights	20%-60%	NA	25%-100%
Negative Return Impact on Incentive Payouts	Reduction of 4 x Negative Return up to 50%; 1-year deferral at max	NA	Reduction of 10% - 50%
Actuarial Impact	Reduction of 10% if less than de minimis under SBP for the fiscal year during which Incentive Compensation is scheduled for payment	NA	Reduction of 10% if the 5-year annualized return of the total fund (net of fees) is less than the actuarial assumed rate of return (currently 7.0%)

Examples of Public Pension Funds With Performance-Based Incentive Programs



	12/31/23 Market Value of Assets (\$ billions)
CalPERS	\$ 483.7
CalSTRS	\$ 327.0
Florida State Board of Administration	\$ 190.4
Wisconsin (SWIB)	\$ 155.1
Ohio PERS	\$ 111.7
Virginia Retirement System	\$ 105.0
Mass PRIM	\$ 101.0
Oregon State Treasury (which manages on behalf of PERS)	\$ 97.7
STRS Ohio	\$ 91.6
Maryland Retirement System	\$ 66.4
Texas ERS	\$ 37.8
Orange County ERS	\$ 22.3
Ohio SERS	\$ 18.2
Wyoming Retirement System	\$ 10.8
Missouri ERS (MOSERS)*	\$ 9.1

*Actual market value shown; Portfolio is 140% leveraged

STRS Ohio Investment Program



Fiscal Year End	Market Value of Assets (\$ billions)	Total Investment Staff	Associates Eligible for PBI Policy	Total Investment Staff Salary	PBI earned	5-year Net Relative Performance versus Benchmark	5-year Value Added Through Active Management (\$ millions)	5-year Total Fund Percentile Rank
2024*	\$ 94.5	108	69	\$22,496,701	\$ 8,500,000**	0.51%***	~\$2,000.0	NA
2023	\$ 90.1	108	91	\$19,602,572	\$ 8,579,085	0.54%	\$ 2,286.8	Top 8%
2022	\$ 87.6	110	92	\$18,936,720	\$ 9,655,708	0.65%	\$ 2,743.9	Top 5%
2021	\$ 94.8	111	90	\$18,518,137	\$ 6,689,501	0.36%	\$ 1,268.3	Top 10%
2020	\$ 77.1	115	93	\$18,611,999	\$ 7,259,183	0.17%	\$ 556.4	Top 17%

*FY24 is an estimate only

**Budgeted

***As of 3/31/2024

- **STRS Ohio’s net total fund performance is in the top 10% of Meketa’s plan sponsor peer group analysis over the long term (as of 3/31/24):**

✓ 3 yrs (top 4%)

✓ 5 yrs (top 10%)

✓ 10 yrs (top 5%)

✓ 20 yrs (top 3%)

- **Outsourcing investment management would cost more money**

- From CEM: if STRS Ohio outsourced management of the assets it currently manages internally, system investment expenses would increase by more than \$130 million annually

Aon McLagan Compensation Data



STRS Ohio:		Total Comp		STRS vs Public Funds		Percent Under 60th Percentile	Percent Under 80th Percentile
		Public Funds 60th Percentile	Public Funds 80th Percentile	60th Percentile	80th Percentile		
2023 Actual Total Comp	\$ 25,048	\$ 32,924	\$ 40,998	\$ (7,876)	\$ (15,950)	31%	64%
2024 Estimated Total Comp							
\$7.5 million PBI	\$ 27,337	\$ 32,924	\$ 40,998	\$ (5,587)	\$ (13,661)	20%	50%
\$8.5 million PBI	\$ 28,337	\$ 32,924	\$ 40,998	\$ (4,587)	\$ (12,661)	16%	45%

Source: Aon McLagan

STRS Ohio Total Comp = Salary + Incentives

Public Fund Total Comp = Salary + Incentives*

Analysis limited to 86 positions (removes investment staff who have left since the 2023 compensation study; does not include associates hired since the time of the study)

All comparisons are 1 for 1 / position to position

** Incentives may include current fiscal year cash incentives, long-term incentives and/or deferred compensation*

Option 1: Reinstate PBI Policy	Option 2: Alternative
Approve PBI Policy as presented in May and June	Replace PBI Policy with adjustment to base salaries
No change to fiscal 2025 budget	Approve amended fiscal 2025 budget <ul style="list-style-type: none">• Budget impact approximately \$9.3 million• Total compensation will not vary based on performance
Evaluate steps to achieve targeted 60 th -80 th percentile of public funds <ul style="list-style-type: none">• Total compensation is significantly below the 60th-80th percentile of public funds	Evaluate steps to achieve targeted 60 th -80 th percentile of public funds <ul style="list-style-type: none">• Total compensation is significantly below the 60th-80th percentile of public funds

- **Reinstate the PBI Policy or adopt an alternative**
- **Pursue further discussions to determine a path to get investment employee compensation within targeted ranges (60th to 80th percentile of public funds)**



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- **Additional information from June 2024 presentation**

STRS Ohio's Leading Public Fund Comparator Group



	12/31/21 AUM (\$Bs)
CA Public Employees' Retirement Sys	\$440.0
CA State Teachers' Retirement Sys	327.6
New York State & Local Retirement Sys	279.7
Florida State Board of Administration	206.4
State of Wisconsin Investment Board	165.6
Teacher Retirement System of Texas	160.0
Washington State Investment Board	146.5
North Carolina Retirement System	115.0
Virginia Retirement Sys	107.2
Ohio Public Employees Retirement Sys	92.1
PA Public School Employees' Ret Sys	75.1
CO Public Employees' Retirement Assoc.	66.1
High Quartile	224.8
Median	153.2
Low Quartile	103.4
State Teachers Retirement System of Ohio	\$96.7

Source: Aon McLagan

Review of the Performance-Based Incentive Policy for Fiscal Year 2025



- **In May / June 2023:**
 - McLagan found the STRS Ohio incentive plan is aligned with competitive market practice
- **In August 2023:**
 - The board approved substantial PBI Policy changes including:
 - More than 30 positions removed from the PBI Policy
 - Maximum incentive percentages were reduced
 - A 10% reduction to PBI payments in any year where the board’s actuary determines there is not sufficient funding to change member benefits
- **Minimal changes proposed for fiscal year 2025**

Changes to the 2024 PBI Policy (Board Approved August 2023)



Target Changed

- Targets a total compensation (base salary and Incentive Compensation) between the 60th percentile and 80th percentile of a peer group of large/leading public funds; may, on a case-by-case basis, vary from the target range based on factors including maintaining market competitiveness and internal equity
- Previously utilized the benchmark of the median compensation of a blended peer group weighted 50% to large/leading public funds and 50% to national private sector firms

Simplified

- 20% minimum of PBI based on net total fund returns (increased from 10%)
- Increased emphasis on longer-term (5-year) performance relative to 1-year performance
- Relative performance for each asset class is net of external management fees and costs

Structure Changed

- Decreased the number of investment professionals in the Policy
- Reduced the maximum incentive for everyone remaining in Policy

Further Linked to System Financial Health

- Added: If the board's actuary determines the System does not have at least a de minimis amount available under its Sustainable Benefit Plan for the fiscal year during which PBI is scheduled for payment, the PBI will be reduced by 10%
- The reduction for total fund negative absolute return remains

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 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.

- 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 10%.

- A minimum of 20% 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. 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.
- 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 (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.

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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 5 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 ⁴	All Other PBI Eligible Positions
Portfolio/Industry, if applicable³	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%	18%
Total Fund	30%	20%	42%
1 Year Relative Performance	15%	10%	51%
5 Year Relative Performance	15%	10%	51%
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.

Presented 8/17/2023



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	Incentive Allocation Percentages	
	Assistant Director	All Other PBI Eligible Positions
Portfolio/Industry, if applicable³	50%	60%
1 Year Relative Performance	0%	0%
5 Year Relative Performance	50%	60%
Asset Class	20%	20%
1 Year Relative Performance	0%	0%
5 Year Relative Performance ⁴	20%	20%
Total Fund	30%	20%
1 Year Relative Performance	15%	10%
5 Year Relative Performance	15%	10%
Total Incentive Allocation	100%	100%

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Proposed