Incentive Compensation System

What does the system look like?

High Level

- Purpose for existence
  - we feel it's prudent to have lower volatility (return and risk) than our peers, but, emotionally, we want to have the same discount rate (return) as our peers
- Mission
  - put in place a successful incentive compensation (IC) system to 'hold the gains' on profitable, predictable, sustainable, consistent alpha (over the long term / 'market cycle')
- Plan:
  - Jan: high level objectives of the IC system (in priority order)
  - Feb: are we consistently generating profitable alpha?
    - how much? sustainable and consistent? how do we count (benchmarking)? *all questions answered...*
  - Mar: review of peer IC systems (this may take more time)
  - Apr: detailed design of IC system
  - May: agree on presentation to city council & meet with stakeholders
  - Jun: meet with city council
- Culture
  - stay focused (stay within time budgets to debate and decide at meetings)
  - follow the leader (Drew and Prabhu)
  - do your homework and come prepared (or don't engage in the debate)
- Dealing with the external world
  - tbd

Low Level - Generic Agenda for each monthly meeting

- Debate and decide how to proceed on the straw man proposal from the previous month's meeting

- Present the straw man for the next meeting
  - Straw men to be drawn up initially by Prabhu and Drew
  - Down the road may be drawn up by small, ad hoc sub-committees
    - up to three members – could be drawn from same board since this is the <u>joint</u> personnel committee and has six members
      - proposal: ad hoc committee of Drew, Anurag, and Eswar to build a straw man to be presented at our March JPC meeting to fuel the debate/decide at our April meeting 'detailed design of IC system'

Results of Survey

- <Harvey to present>

Straw Man for Jan Meeting (from Dec meeting)

- Let's reach consensus on <u>our</u> definitions for α, β, ɣ, and benchmark (see slide 3)

- high level objectives of the IC system

Let's Agree on Our Use of Terms

- beta – the underlying risk (volatility) in any given asset class
  - e.g. the beta of US stocks is larger than the beta of US bonds

- alpha – the value-added return gained by active management
  - e.g. our investment officer got us into the top performing real estate manager after a lot of hard work

- gamma – the value added return gained through smart portfolio construction and execution
  - e.g. our strategy to buy into the market as it dipped below 25% paid off handsomely in the Spring of 2020

- benchmark – the mean passive return for a given asset class
  - e.g. the Dow Jones Industrial Average was 10.66% from 1996-2021

Applying Those to San Jose

- benchmark: the actual passive return at the end of the year from our asset allocation at the beginning of the year

- beta: the risk associated with the basket of assets used to determine our benchmark

- alpha: our performance relative to our benchmark

- gamma: our performance beyond alpha due to us changing our asset allocation during the year
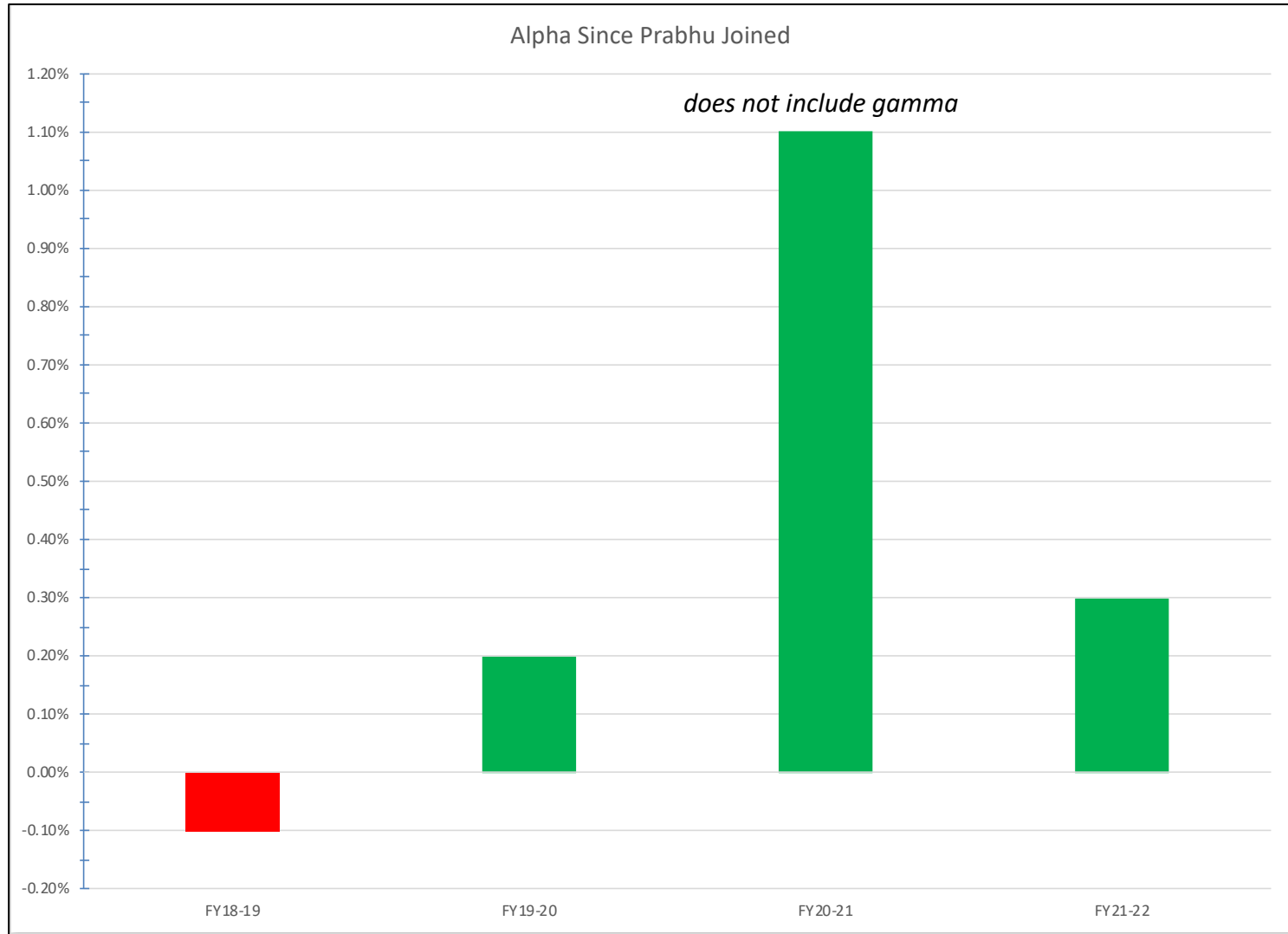
Straw Man: High Level Objectives of the IC System

- Maintain attractiveness of IO jobs (good boss, responsibility and autonomy, Silicon Valley) but make $$$ compensation competitive
  - more about getting them to not leave rather than getting them to stay

- The system itself
  - measurable, well documented, auditable, transparent, ...
    - asset class, benchmark per asset class, annual and historic performance of IO vs benchmark
  - competitive (including a cap)
  - has a 'bank' (amount is added formulaically each year of profitable alpha and adds accumulate over time to be drawn down to pay)
    - a tiny fraction of profitable alpha (~10%?) added to the bank each year
    - a 'bank' because sometimes our team sorely earns their bonus in lean years but it's probably politically unpalatable to hand it out to them then
  - runs autonomously (generates recommendations every year)
  - can discriminate skill from luck – based on measured value added

- Support from the various players
  - system designed to to spit out recommendations that the boards, the city, the CEO and the CIO, and our consultants will all support

Straw Man for our Feb Meeting

- Are we Consistently Generating Profitable Alpha?
  - what are the adjectives we desire for alpha?
    - *consistent*: does it vary wildly?
    - *profitable*: is it more than our IO staff costs us?
    - *predictable*: can we count on it?
    - *sustainable*: how do we keep the golden goose alive and well?
    - …?
  - how is alpha (and gamma) unambiguously measured?
  - what's our history of alpha and gamma since Prabhu joined?
    - what percent of our CIO+IO's salaries is our historic alpha/gamma?

A Cursory Look at the Data

Alpha Since Prabhu Joined

does not include gamma

A Cursory Look at the Data (cont'd)

Alpha Since Prabhu Joined

does not include gamma

Legend: — $1 ret passive — $1 ret active

A Cursory Look at the Data (cont'd)

Alpha Since Drew Joined

does not include gamma

the significant data has an R^2 of 0.85

Prabhu joined

Appendix

Incentive Compensation System

How Will We Get this Done?

The Long Planning Arc

- Drew & Vince -> beta -> DR -> alpha + gamma -> measure G -> hire staff -> Measure 'H' -> results -> incentive compensation system -> city council -> $10+10+10M less contributed by city per year to P&F
  - citizens on the board (2011): Drew and Vince arrive in April of 2011
  - beta (2012): our plan effects the city more in a downturn (Cheiron)
  - DR (2013): ...so we're dialing down our DR relative to our peers
  - alpha (2014): ...but we want to return the same as our peers so we'll have to dial up alpha to compensate for a dialed down beta
  - measure G (2015): ...to dial up alpha we need to hire (and control) a talented CIO and talented staff – but city retained veto right on $$$
  - JPC (2016): Drew and Harvey create the JPC
  - hire staff (2018): Prabhu is hired with a mandate to recruit and retain top notch staff
  - improve annual performance reviews (2019): in preparation for Measure 'H'
  - incentive compensation system (2021): the boards start to work designing the system
  - city council (2023): city council approves the experiment
  - reduction in contributions (2024): P&F asks for $10M less per year
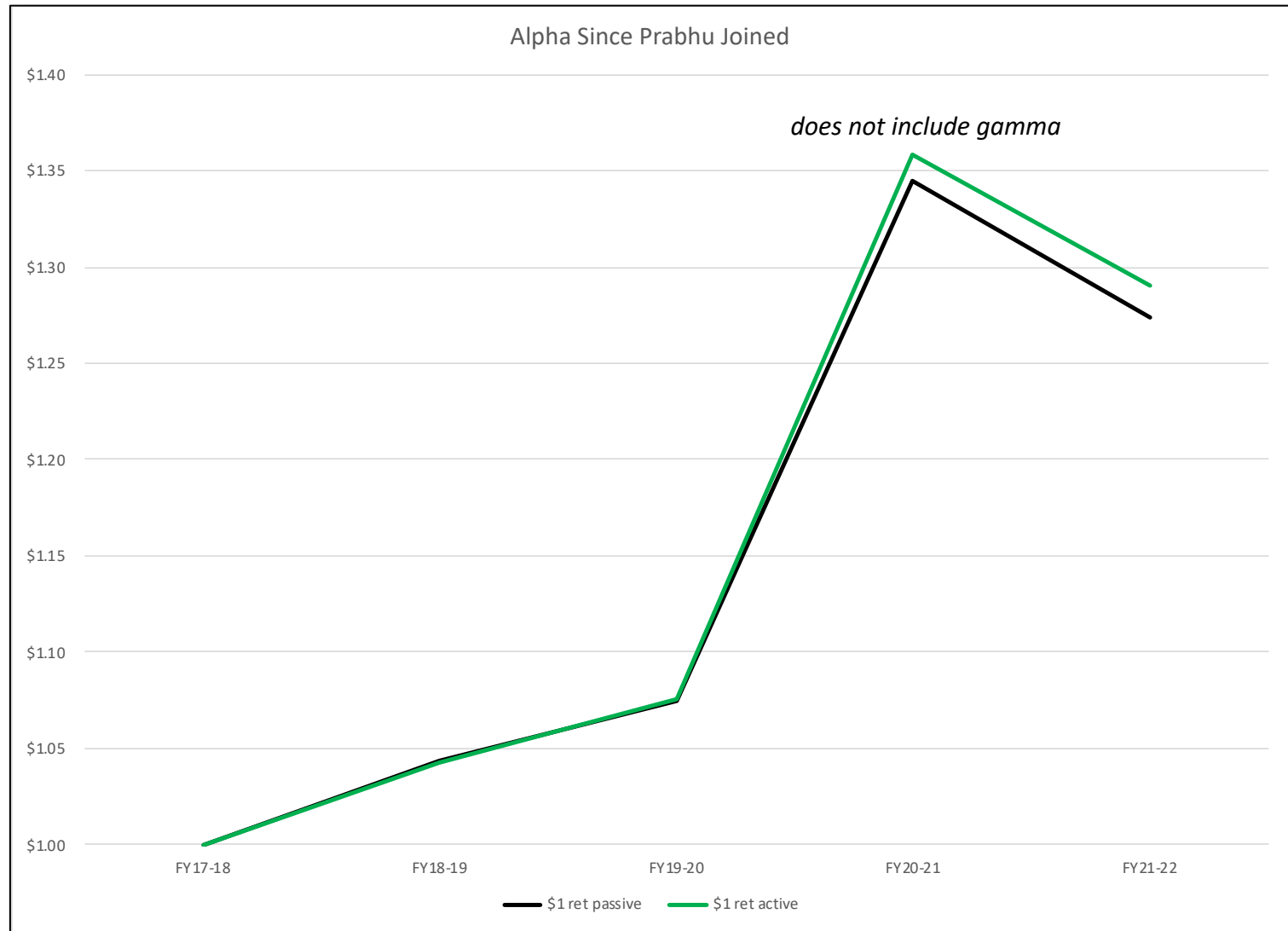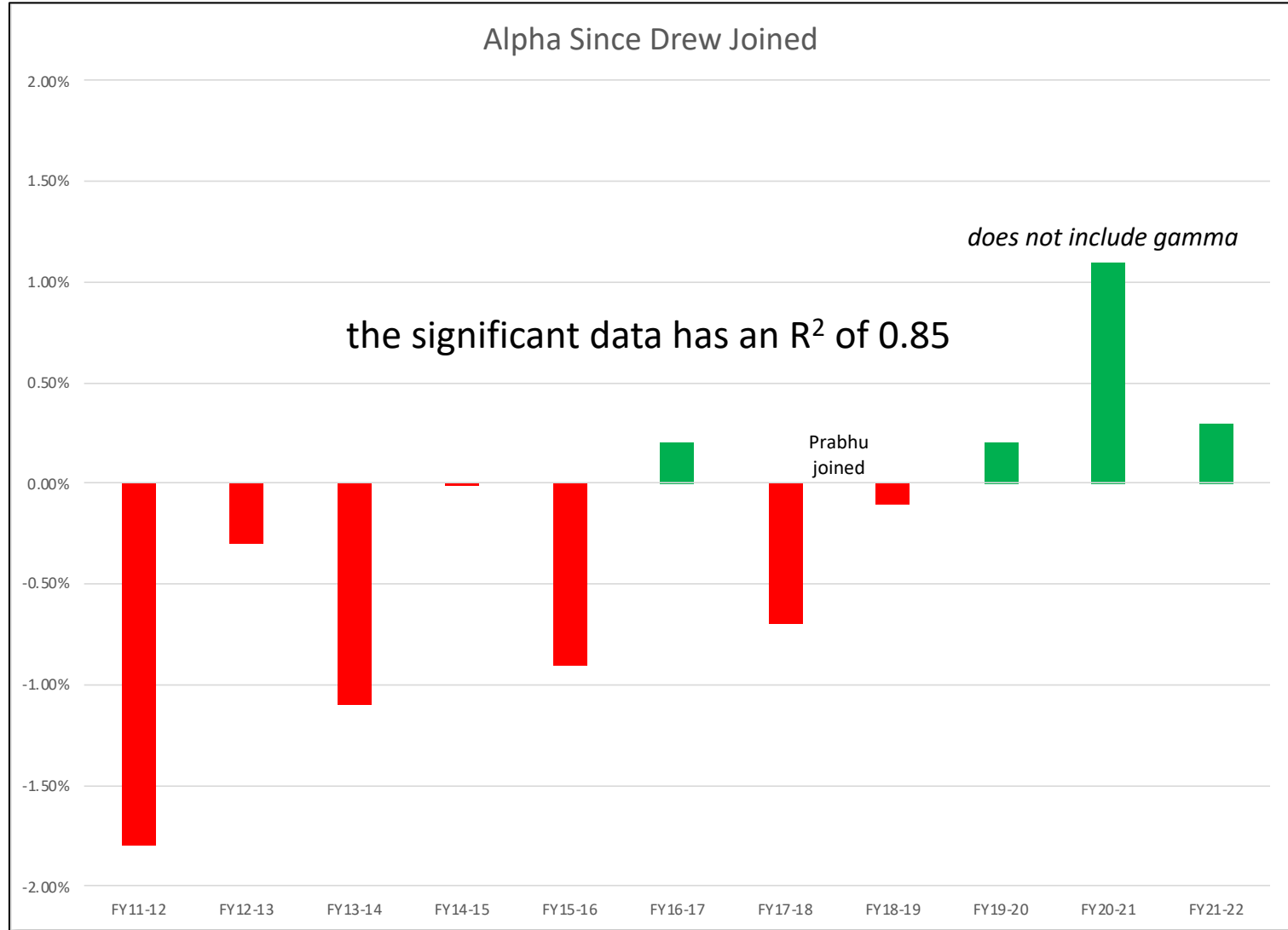
Path to Autonomy – Plans A, B, C

- Plan A: include autonomy with Measure G (failed)

- Plan B: launch Measure 'H' to gain autonomy
  - …ramp up performance evaluation system to gain support

- Plan C: create system and design it and sell it so city council is likely to approve the system's annual recommendations (you are here) – give up on autonomy

Harvey's Summary of What We Believe

- We believe that the Plan could prudently adopt a higher assumed rate of return over the next 10 years by constructing an asset allocation that combines investment in a broadly diversified portfolio with a relatively low volatility with actively managed investments in private markets that reliably deliver excess alpha

- We believe that recruiting and retaining talented in-house investment personnel, collaborating with expert independent investment consultants, offers the best opportunity to continue achieving the excess alpha on which our higher assumed rate of return could be premised

- We believe that adoption of an incentive component to the compensation packages of in-house investment personnel would contribute materially to our ability to increase our assumed rate of return, without increasing risk to the portfolio or the City

- We believe that an investment portfolio constructed on these principles will materially reduce the City's annual contributions out of the General Fund over the next ten years

Let's Agree on Our Use of Terms

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  - e.g. the beta of US stocks is larger than the beta of US bonds

- alpha – the value-added return gained by active management
  - e.g. our investment officer got us into the top performing real estate manager after a lot of hard work

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A Framework for Getting this Done

- What process(es) will we use?
  - high level
    - purpose for existence
    - mission
    - plan
    - culture
    - dealing with the external world
  - low level
    - generic agenda for monthly meetings

High Level

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Straw Man for Jan Meeting

- Let's reach consensus on <u>our</u> definitions for α, β, γ, and benchmark (see slide 3)

- high level objectives of the IC system
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  - support from the various players
    - system designed to to spit out recommendations that the boards, the city, the CEO and the CIO, and our consultants will all support

Incentive Compensation System

The first meeting of the JPC to discuss and design the ICS

A Framework

- Where are we in space and time?

- Objectives of the ICS

- A framework for discount rate = beta + alpha

- Questions asked (and to be answered)

- The beginnings of a 'pitch' to the city to partner with us

The Basic Idea (from Vince in March 2012)

Today's Reality Based on Prudence

Discount Rate

6 5/8%
asset allocation (beta) — Us (red)

7%
asset allocation (beta) — Others (green)

→

A Plan for the City to Pay Less

Discount Rate

7%
alpha
asset allocation (beta) — Us (gray/green)

7%
asset allocation (beta) — Others (green)

The Two Knobs On the Wall

- investing money always involves risk because you are trusting someone else (a money manager) with your money in a volatile asset

- ...and it is always the case that, in general, the more risk you take on the more reward you'll get overall (we call this 'beta')

- ...and it is also always the case that some money managers consistently outperform others (we call this 'alpha')

how risky is this asset class that we're investing in?

how good is the money manager overseeing this asset class?

Each City Sets their Knobs Differently

- every charter city is different (San Francisco is *not* San Jose)
- every charter city's pension has a different financial relationship to the city's overall finances
- the same asset allocation may be just fine for one city but way too risky for another
- goal is to match the asset allocation to the city
  - take on no more risk than a city can bear
    - figuring out what 'bear' means is surprisingly difficult
  - the choice of asset allocation mostly determines the discount rate

- the goal is not to have a high discount rate or to return more than the discount rate, the goal is to pick the 'right' discount rate for the particular city and to achieve it over the long term

Vince's Grand Idea in March of 2012

- to have the same impact as other cities on the city's budget in an economic downturn, our plans *must* invest in less risky assets (lower beta)
  - all cities and plans are different – San Jose is more sensitive to the economic swings of its pension plans than any other California plan

- …but less risky assets have lower returns (lower discount rate)
- to make up for that deficit and to support a discount rate consistent with our peers, Vince's idea was to see if we could generate higher returns by being smarter at managing our portfolio than our peers (higher alpha)

- …and it appears the idea has worked because our system seems to be generating consistently higher returns across equivalent asset classes than our peers have – high enough, maybe, to have a discount rate (beta + alpha) in line with our peers – while still taking less risk than other plans

- the reason why most systems don't do this is because people who can consistently deliver alpha get paid a lot which would mean the highest compensated people in the city/county while be pension fund managers
  - like a football coach is the highest compensated person at a college or the top salesperson is at a startup company

How Do We Consistently Add Profitable Alpha?

- alpha is created by being smarter money managers than our peers

- and that's all about recruiting, hiring and retaining an investment staff that are smarter money managers than their peers (and can also pick smarter sub – money managers)

- incentive compensation is one tool in our toolbox to recruit, hire, and retain money managers that can consistently generate profitable alpha

Design of an Incentive Compensation System (ICS)

- the JPC is ready to start to design an ICS
  - Prabhu believes we are generating consistent, predictable, profitable alpha

- the first step is to 'survey the field' to see what others do
  - we hired McLagan to do that and we've just gotten their draft report

- the next step will be to agree upon the objectives of the system

Objectives of the Incentive Comp System

- straw man, to have an ICS system which:
  - helps recruit, hire, and retain managers that can sustainably generate profitable alpha above that generated by our peers
  - is comparable to similar systems for similar public pension plans
  - is endorsed by the city
  - functions well in both good economic times and bad
    - Prabhu's idea of a 'bank'
  - is likely to gain an 'aye' vote by the city council in most yearsfor the concrete $$$ proposals in that year
    - assuming the council has a veto right over our annual proposals for incentive pay
    - Cheryl Parkman is 'sitting at the table' with the JPC

Beginnings of 'The Pitch'

- straw man
  - our discount rate is beta + alpha
  - beta must be less than our peers
  - alpha has been real and highly profitable for us for 5+ years
  - if we're confident we can sustain alpha going forward then we *could* add it to the discount rate and match the discount rate of our peers
  - …but alpha has been, is, and will be generated by a very talented team and we need a strategy to recruit, hire, and retain talented people to man our alpha team
  - in the industry, those talented people are recruited, hired, and retained partly based on compensation
  - we'd like to propose an ICS where ~5% of the annual savings those talented people generate for the city are shared with them

Beginnings of 'The Pitch' (cont'd)

- straw man, take #2:
  - the relationship between our system and our city is such that an economic downturn effects our city much more than it effects other cities
  - we mitigate that by investing in a less risky basket of assets than other cities – such that our basket goes down less in a downturn (lower beta)
    - …but that means the basket has a lower overall return than the return of other plans because risk and reward are twins
  - we can mitigate the lower return (lower discount rate) by hiring a staff who can outperform their peer investors (higher alpha)
  - we believe we can show that the staff we have is now consistently generating profitable alpha above that generated by their peers
  - …but that trait makes them attractive to be hired away from us
  - we believe they want to stay and will stay if we can compensate them commensurate to what others make at public pension plans
  - that additional pay comes in the form of incentive compensation
  - we believe we can raise our discount rate to be in line with our peers (~7%) if we can count on that profitable alpha while still investing in less risky assets (lower beta)

Proposed New Process To Select a Discount Rate

- straw man
  - determine the appropriate level of risk the plan should take on (volatility)
  - create an asset allocation strategy which delivers that volatility (beta)
  - determine the forecast future return of that basket of assets (passive benchmark)
  - determine if our staff has historically and consistently generated profitable (net of fees) returns above that passive benchmark (alpha)
  - determine if we consistently under or over forecast liabilities and determine a 'balancing' factor (delta) to account for this
  - add beta + alpha + delta to arrive at a discount rate

Questions We Need to Answer (straw man)

- What's an indisputable passive benchmark?

- Over the past few years how much alpha above that benchmark have we generated?

- How stable has our generated alpha been over the past few years? To what can we attribute it?

- How profitable is that alpha after our salaries, consultant fees, and manager fees are subtracted?

- In real dollars over the past few years how much has that profitable alpha generated above the passive benchmark and, per the actuary, in real dollars how much has that alpha reduced annual contributions from the city by?
  - Bill says the delta between 6 5/8% and 7% return is ~$25M per year for Police and Fire

Questions We Need to Answer (straw man)

- In between a passive investment strategy which can be assumed to return the passive benchmark rate and having our own dedicated staff lie consultants that most systems rely on to generate alpha - compared to other systems and including all costs (staff, consultant fees, and manager fees) how much more profitable alpha have we generated than if we had just used consultants (or any other competitive approach)?

- Assuming we can show that having a staff is better than any alternative then what's a competitive compensation range for our staff and how many more dollars per year do we need to pay out from an ICS to have our staff compensated competitively?

- In interviews with Prabhu and his staff, would paying them more be an incentive to stay and can we estimate how much alpha we would lose and for how long if Prabhu or an IO left?

- Finally, if we take the profitable alpha generated by our staff above the next best alternative that doesn't require us to have a staff and measure how many more dollars per year having our staff saves the city in annual contributions above that next best alternative, what % of those annual savings to the city are we recommending we give as incentive compensation to our staff so they're compensated competitively?

A Framework

- Where are we in space and time?

- Objectives of the ICS

- A framework for DR = beta + alpha

- Questions asked (and to be answered)

- The beginnings of a 'pitch' to the city to partner with us

Appendix

Objectives in More Detail

- pick the 'right' risk for the portfolio relative to SJC
- build a team that can sustain 37.5bp (=3/8%) net of alpha over benchmark
  - Prabhu says we've done at least that consistently
- retain the team using all available HR tools
  - one of those tools is compensation (base salary + bonus + incentive)
  - others are: culture, benefits, …
- create an incentive compensation which matches other pension systems incentive compensation levels
  - McLagan study and report
- make sure the ICS is supported by our staff, our boards, and the city
  - designed by the JPC and staff and SJC HR (Cheryl Parkman)
  - may require city oversight and approval (ala Measure G)

Why 7%?

Where Are Our Peers?

Number of Pension Systems with that Discount Rate vs Discount Rate (6-6.8%: 17, 7%: 19, 7.25%: 3)

Email to Committee

Drew Lanza
Alpha

To: Eswar, Prabhu Palani, Anurag Chandra, Cc: Andrew Gardanier, Harvey Leiderman, Roberto Pena, Cheryl Parkman

Sent - iCloud   September 2, 2022 at 7:38 AM

Details

Eswar:

[everyone welcome Cheryl to the team - this email is to get ready to kickoff the incentive compensation system design at next week's JPC meeting - I'll put this into a brief presentation]

I believe our best shot at getting incentive compensation past the politicos is to show that our team uniquely provides a high level of sustainable, predictable, profitable alpha that translates into many tens of millions of dollars the city doesn't have to contribute to their pension systems each year.

Our pitch will be that these much savings can only be achieved with a dedicated team.

So there are two pieces that you and Anurag and Prabhu need to prove. First, that we're generating real, profitable alpha above an indisputable benchmark. And, second, that a dedicated team generates more profitable alpha than any other approach.

Over the next 9 months or so I think we need our investment committees to address on behalf of our JPC and boards:

What's an indisputable benchmark?

Over the past few years how much alpha above that benchmark have we generated?

How stable has our generated alpha been over the past few years?

How profitable is that alpha after our salaries, consultant fees, and manager fees are subtracted?

In real dollars over the past few years how much has that profitable alpha generated above benchmark and, per the actuary, in real dollars how much has that alpha reduced annual contributions from the city by?

In between a passive investment strategy which can be assumed to return the benchmark rate and having our own dedicated staff lie consultants that most systems rely on to generate alpha - compared to other systems and including all costs (staff, consultant fees, and manager fees) how much more profitable alpha have we generated than if we had just used consultants (or any other competitive approach)?

Assuming we can show that having a staff is better than any alternative then what's a competitive compensation range for our staff and how many more dollars per year do we need to pay out from an incentive compensation system to have our staff compensated competitively?

In interviews with Prabhu and his staff, would paying them more be an incentive to stay and can we estimate how much alpha we would lose and for how long if Prabhu or an IO left?

Finally, if we take the profitable alpha generated by our staff above the next best alternative that doesn't require us to have a staff and measure how many more dollars per year having our staff saves the city in annual contributions above that next best alternative, what % of those annual savings to the city are we recommending we give as incentive compensation to our staff so they're compensated competitively?
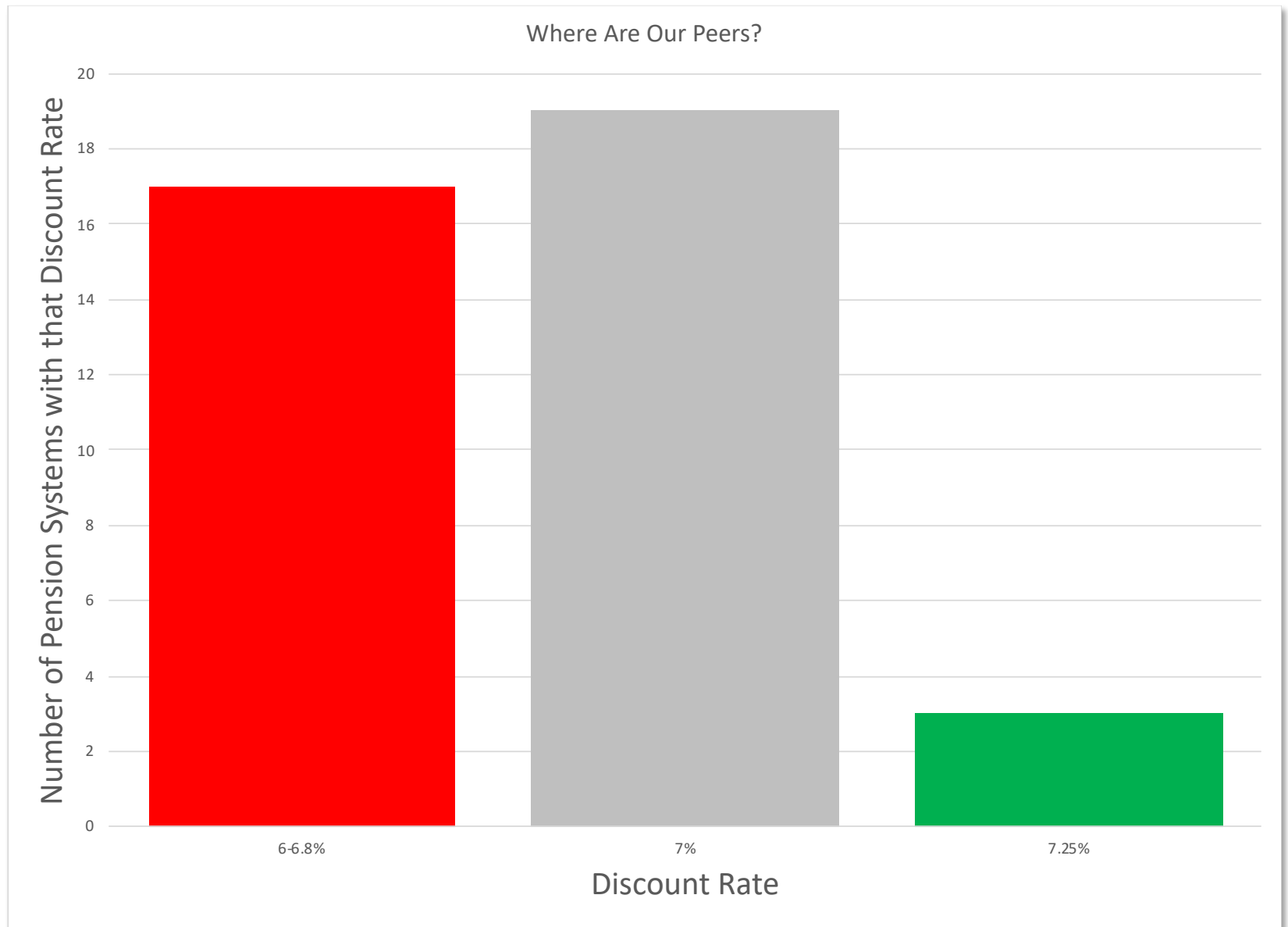
Here's where I think we are. Prabhu says that he believes he can generate ~30% of profitable alpha every year and has done so for the past few years. If we incorporate that into our discount rate we could raise that rate from 6 5/8 to 7% while still maintaining the beta we have today. Bill Hallmark says a 7% discount rate would save the city $25M in annual contributions going forward vs a 6 5/8% rate. Prabhu believes that 10% of that $25M savings ($2.5M) per year would be enough to pay himself and his IOs in incentive compensation to be competitive.

It's not our decision to implement an incentive compensation system or not - it's the city's. And they're not wrong that it may be politically wise to spend more rather than have Prabhu be the highest paid employee in the city. So let's put that question to them in the clearest, easiest to understand, and most irrefutable way: Is it worth it to you to compensate Prabhu $750k per year if he saves you $7.5M that year in contributions to the pension fund?

Also, let's keep an open mind while we do this. As we gather the data above it may become clear that re-jiggering our approach to use more staff and less consultants or vice versa would be a more profitable approach.

The above will be the gist of my brief presentation to the JPC next week. Comments would be much appreciated.

Drew

San Jose Police...

this email is here because Harvey says it violated the Brown Act

I did not believe it did because it was merely gathering input for this presentation which was to be made public

mea culpa