

# MEKETA

INVESTMENT GROUP

## California State Teachers Retirement System (CalSTRS)

January 28, 2022

## Benchmarking Project



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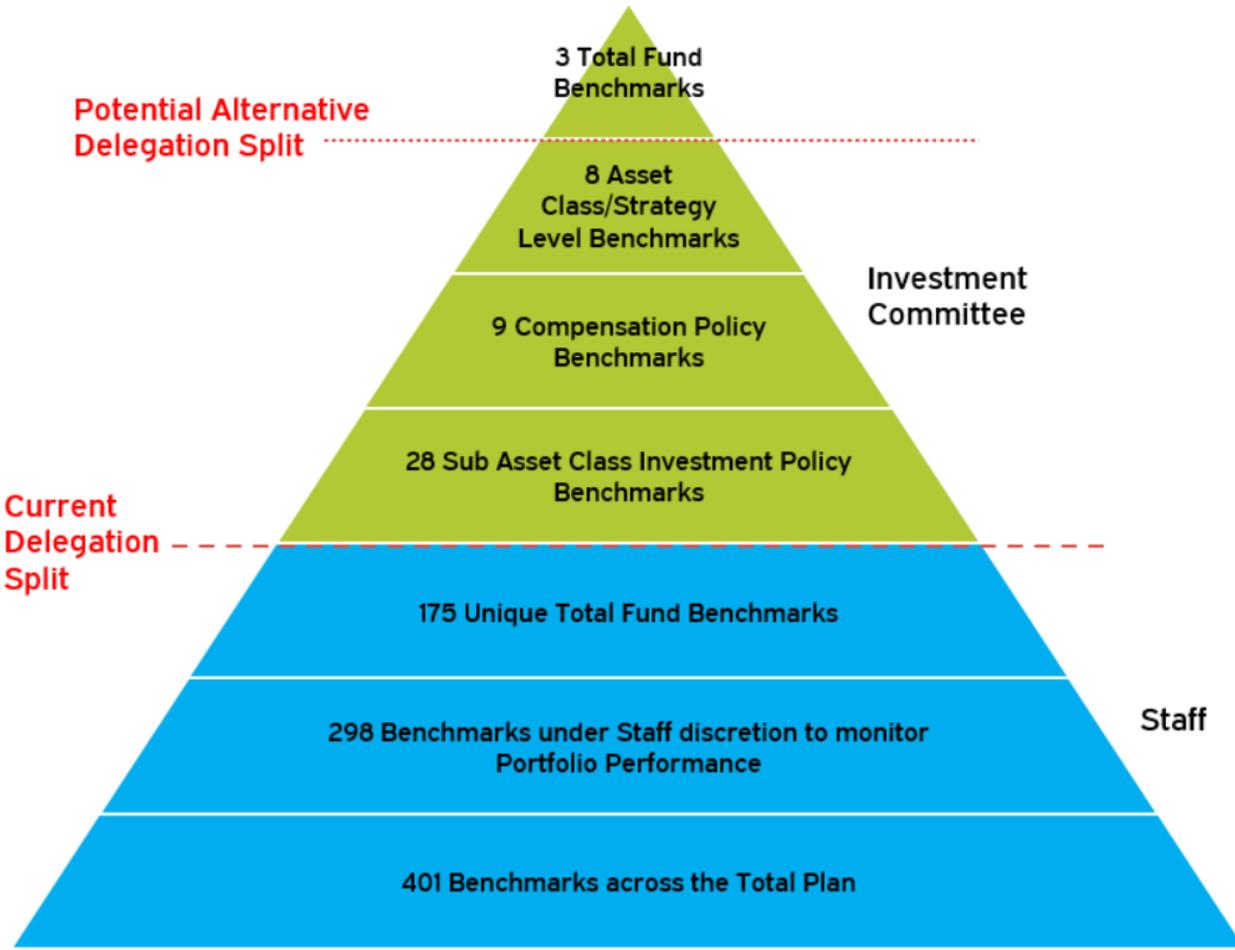
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# Current State of Benchmarks at CalSTRS



### Current State of CalSTRS Benchmarking

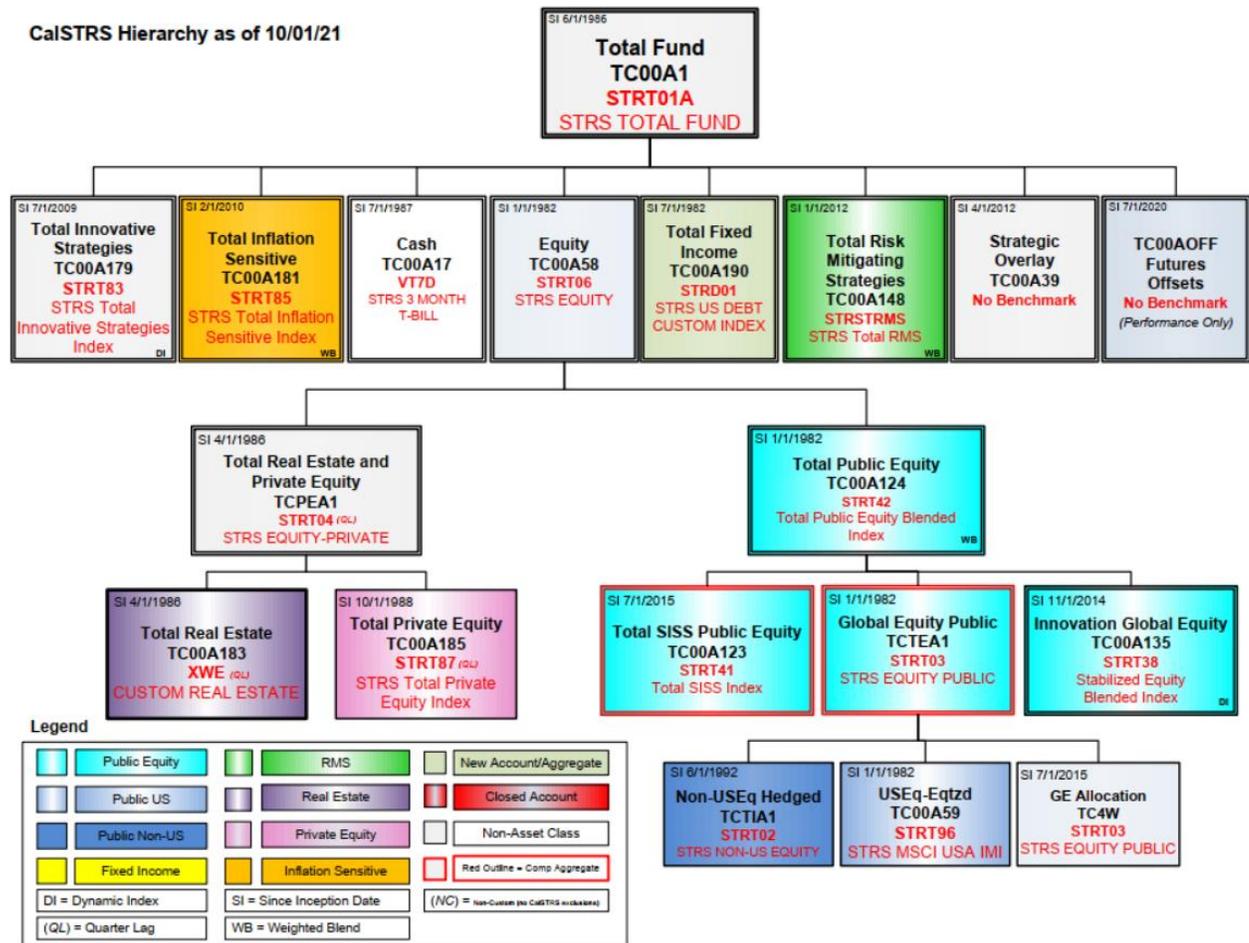
- The Breadth of Benchmarks pyramid shows how the choices of benchmarks that ultimately affect the total portfolio.
  - The number of benchmark choices expands in breadth and complexity.
- Policies set by the Board define:
  - 3 Total Fund Benchmarks
  - 8 Asset Class / Strategy Level Benchmarks
  - 9 Compensation Policy Benchmarks
  - 28 Sub Asset Class Benchmarks
- Currently, delegated authority allows for implementation by Staff in selecting 298 benchmarks to monitor portfolio performance.
- An alternative approach delegates the asset class and sub asset class strategies to Staff/consultants.





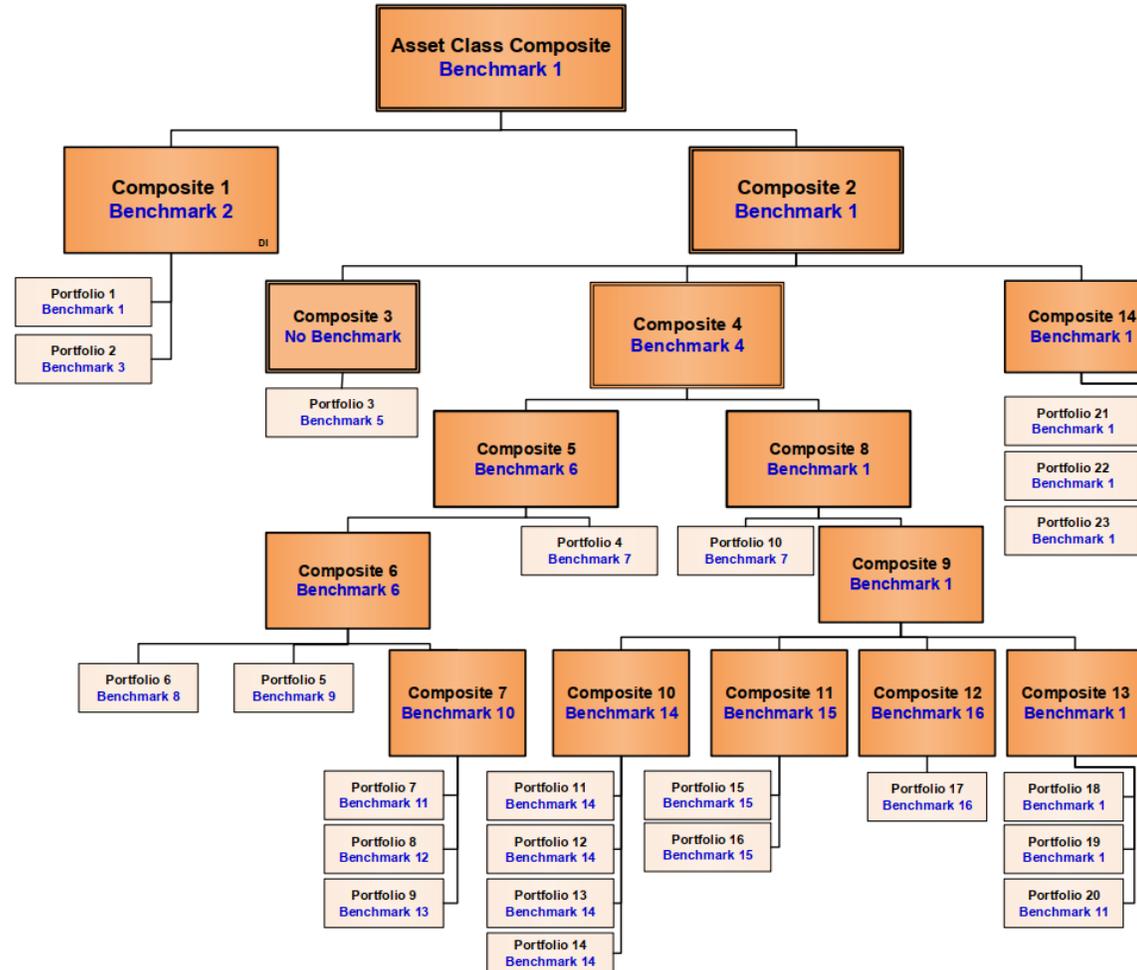
## Current State of CalSTRS Benchmarking – Portfolio Hierarchy

- As of December 31, 2021, CalSTRS had 175 unique benchmarks across all levels of the portfolio (total policy, asset class, sub asset class, and external manager).
  - This extends out to 401 benchmarks when considering duplicates across multiple funds and asset classes.
  - Included in the 9 Compensation Policy benchmarks, there are 20 underlying benchmark components.
- With magnitude comes complexity. Requiring an intimate knowledge of the relationships between these general benchmark practices and incentive compensation.





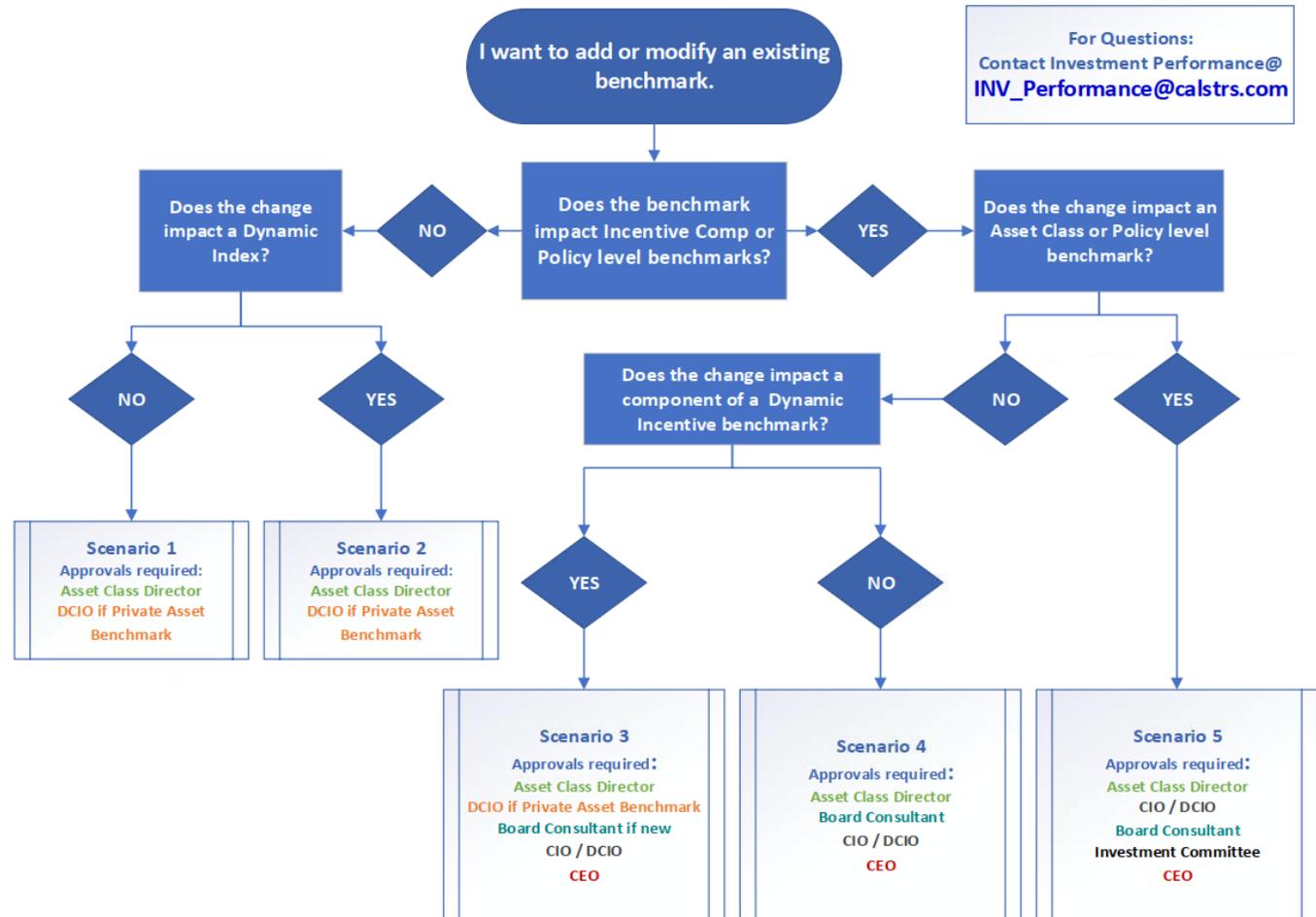
## Example of a CaSTRS Benchmark





## CaSTRS' Benchmarks – Approval Process for Modifications or Additions

- An important key control to note is that Investment Services' Performance Staff review all new and modified benchmarks, and only authorized Staff in the Investment Services' Performance team can instruct the custodian to add or modify a benchmark.



# CalSTRS Benchmarking Survey Results



## Survey of CalSTRS Board

- In October 2021, Meketa conducted a benchmark survey with the Board.
  - The survey covered areas of concern, the perceived purpose of benchmarks at CalSTRS, and a variety of judgement on the preferred use of benchmarks by the Board.
  - Meketa also conducted one-on-one interviews with Board members that requested them.
    - 5 Board members requested one-on-one interviews.



## Summary of Results

- Areas that lack Board consensus:
  - Specific area of concern with benchmarks at CalSTRS.
    - While there was broad agreement that benchmarks are overly complex, there was no consensus on which areas were most problematic.
  - The purposes of benchmarks at CalSTRS .
  - Whether to have a separate set of benchmarks for incentive compensation purposes and investment monitoring purposes.
  - Whether benchmarks should be customized for CalSTRS' specific investment constraints.



## Summary of Results (continued)

- Areas of Board consensus:
  - Benchmarks should be reviewed when the asset allocation policy is reviewed.
  - The Board should be involved in approving the benchmark for the Total Fund.
  - The Board should be involved in approving the benchmarks used for incentive compensation purposes.
  - The Board should not be involved in approving the benchmarks for sub-asset classes.
  - Benchmarks should be aligned with CalSTRS' long-term objectives (not short-term considerations).



## **Additional Conclusions from Interviews**

- Benchmarking for the Board is complicated by benchmark usage in incentive compensation.
- Many Board members would prefer simplifying the Board's role in incentive compensation and, therefore, in benchmarking.

# Peer Benchmarking Survey Results



## Peer Benchmarking Survey

- Meketa surveyed 13 of the largest US Public Pension Plans (by AUM) on the following benchmarking practices:
  - Incentive Compensation
    - Overall usage, benchmarking for evaluation, and implementation/approval process
  - General Benchmarking Practices
    - Approval processes, composition, and rate of change
- The following pages summarize the survey results and identify benchmarking trends among peers
  - The survey yielded nine respondents (five decided not to participate due to time and complexity)
- Along with these findings, it's important to keep in mind that there are a wide array of approaches to benchmarking, and each fund has unique situations and characteristics surrounding determining factors such as funding and resources (staff, ability to manage complexity, knowledge and experience of the Board).
- The information provided from this survey is meant to serve as a point of reference and context for CalSTRS



## Summary of Results

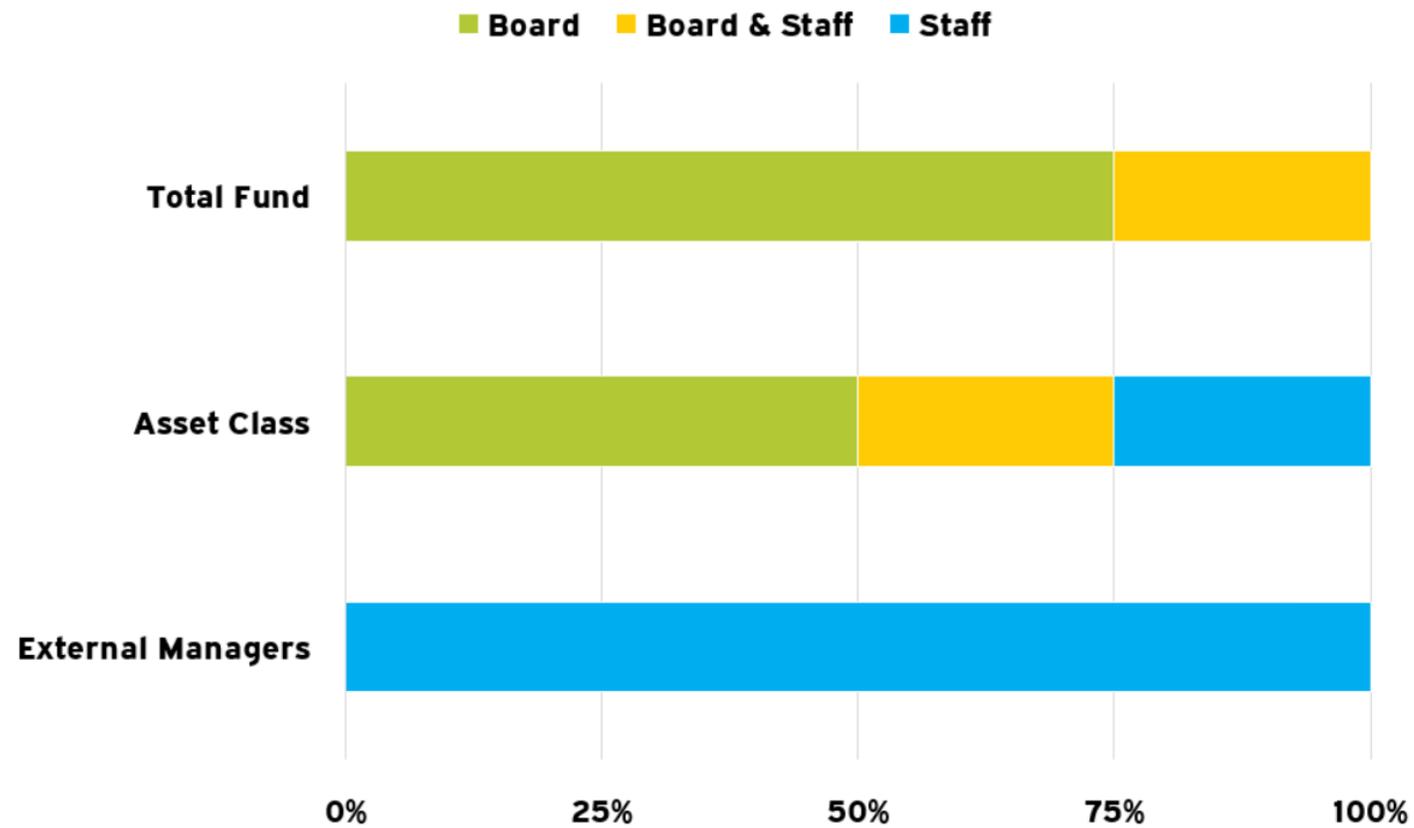
- Incentive Compensation:
  - 56% of systems surveyed have incentive compensation for Staff
    - 60% determine incentive compensation versus a benchmark, whereas 40% use both a benchmark and absolute return of the portfolio
    - 40% of these plans with incentive compensation utilize a reference portfolio (e.g., 70% equity/30% bond mix)
    - 80% of these plans utilized a compensation consultant to assist with structure and maintenance
    - Of the five plans that have incentive compensation for Staff:
      - 3 – Board approves incentive compensation benchmarks
      - 1 – Both Board and Staff approve compensation benchmarks
      - 1 – A separate Incentive Compensation Committee approves benchmarks



### Summary of Results (continued)

- General Benchmarking Practices:
  - 75% of respondents use broad industry benchmarks, whereas 25% customize for plan-specific constraints/preferences.
  - 37% of respondents have multiple benchmarks at the Total Fund level.
    - Multiple benchmarks include: Static, Dynamic, Simple Stock/Bond Mix
  - 63% of respondents review benchmarks when asset allocation is reviewed (typically every three years).
    - 37% review benchmarks on a periodic basis

**Benchmark Approval Processes at Various Portfolio Levels**





## Summary of Results

- General Benchmarking Practices: Open-Ended Feedback from Peers
  - If you could change anything about the plan's incentive compensation, benchmarks, or the respective processes, what would it be and why?
    - “More could be delegated to Staff and Consultant.”
    - “I like it [incentive compensation benchmark] at total fund level but would have made sure the CIO had buy in prior to it being launched, and honestly, I’d probably do like a West Coast peer and get rid of incentive comp completely.”
    - “Create one [incentive compensation benchmark], to become competitive with market.”
    - “Make sure that the benchmark chosen represents the opportunity set that you want the Fund to be investing in. Many heads of an asset class are reluctant to touch something that is not in their benchmark.”
    - “Keep incentive calculations at the Total Fund level (no asset class). At our Plan, incentive comp starts getting earned at a -15 basis point level, then gradually increases with higher levels of outperformance (up to a ceiling). Using a graduate scale for incentive compensation is important, because binary thresholds can lead to problematic employment decisions.

## Next Steps



## Next Steps

- It is clear from the analysis and survey that the Board's involvement in benchmarking is overly burdensome and complex.
- Meketa will be:
  - Receiving feedback from the Board regarding this presentation and its results
  - Working with Staff, the compensation consultant, and the Board to identify possible solutions to streamline benchmarking (and incentive compensation) decisions for the Board
  - Recommending possible changes to benchmarking at CalSTRS to the Board before the beginning of next fiscal year.

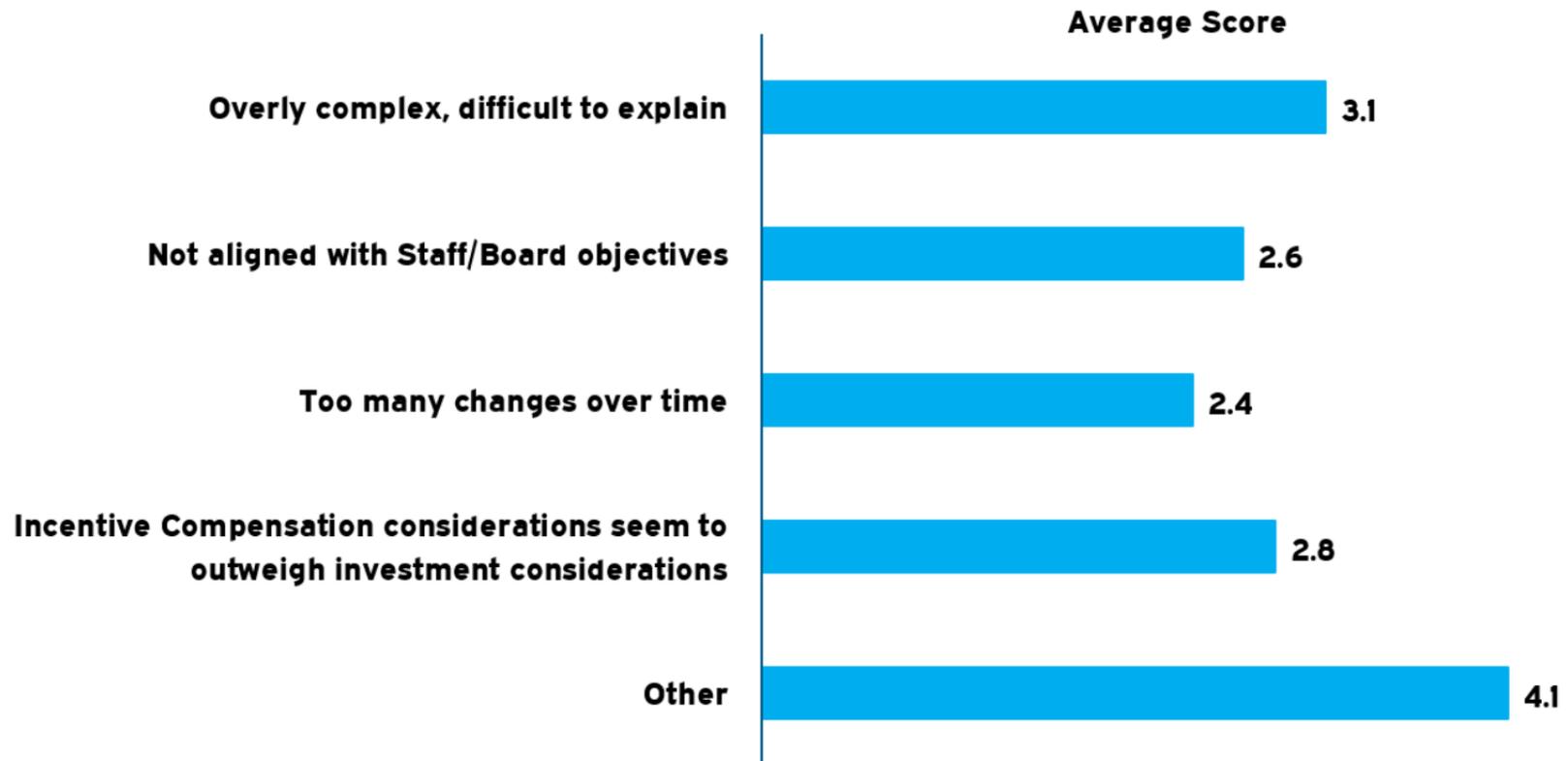
# Appendix



# CalSTRS' Benchmarking Responses

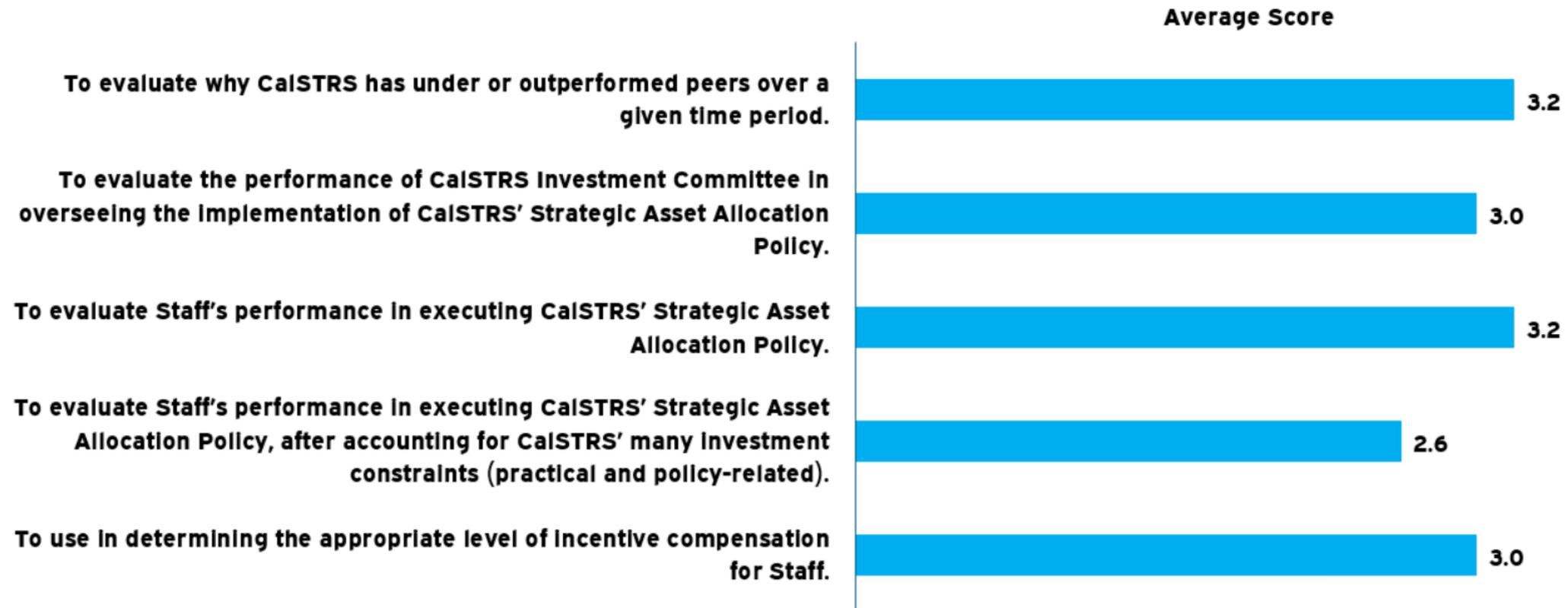


Rank from 1 to 5 (1 being the least concerning and 5 being the most) your biggest concern/complaint about benchmarking at CalSTRS today?



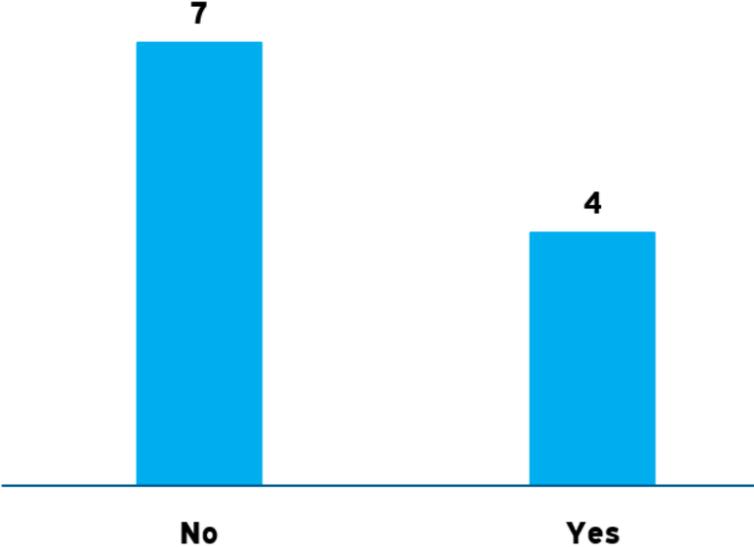


**Rank from 1 (least important) to 5 (most important)  
the appropriate purpose of the Total Fund Policy Benchmark at CalSTRS:**



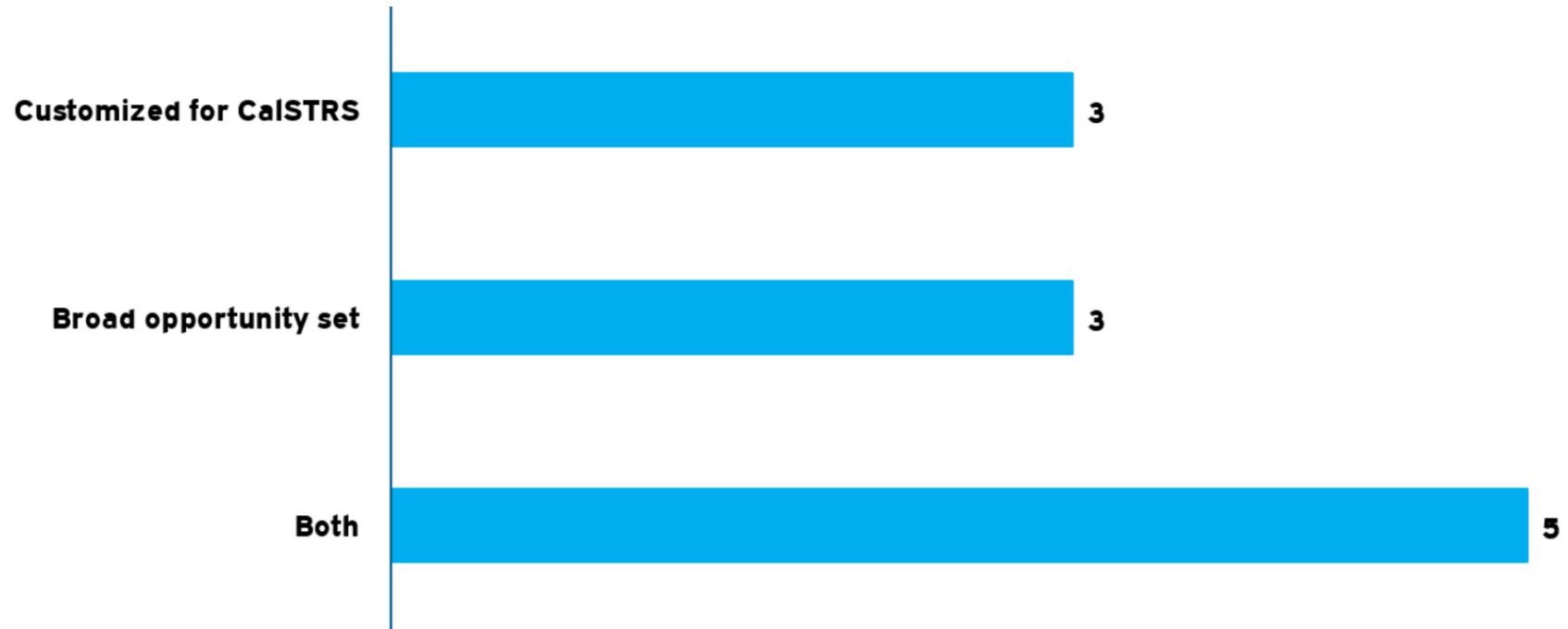


**Do you believe it is appropriate to use different types of benchmarks for different purposes (e.g., one set of benchmarks for judging investment outcomes, and one set for determining incentive compensation)?**



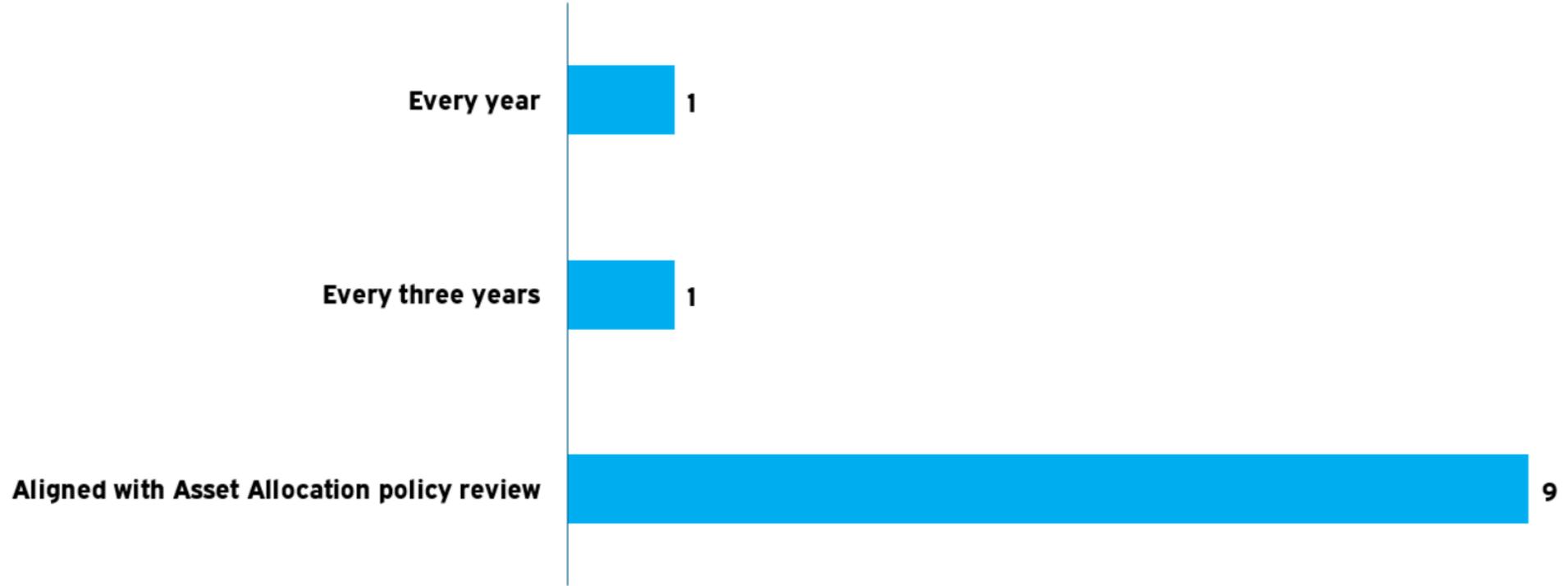


**Do you believe that benchmarks should be customized to reflect CalSTRS' specific investment strategy/ constraints/opportunities? Or, should benchmarks reflect the much broader investment opportunity set (unconstrained) for institutional investors?**



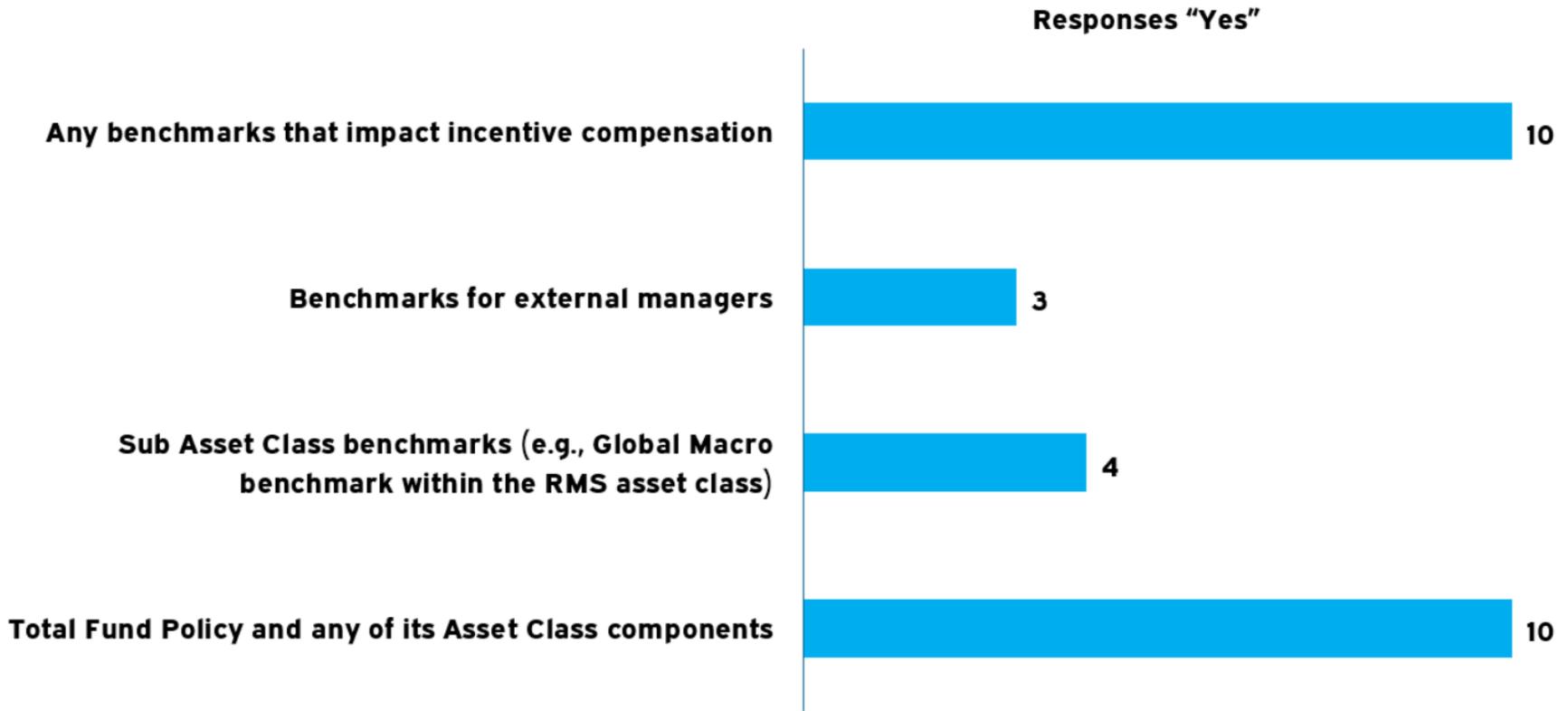


**How often should benchmarks be reviewed?**



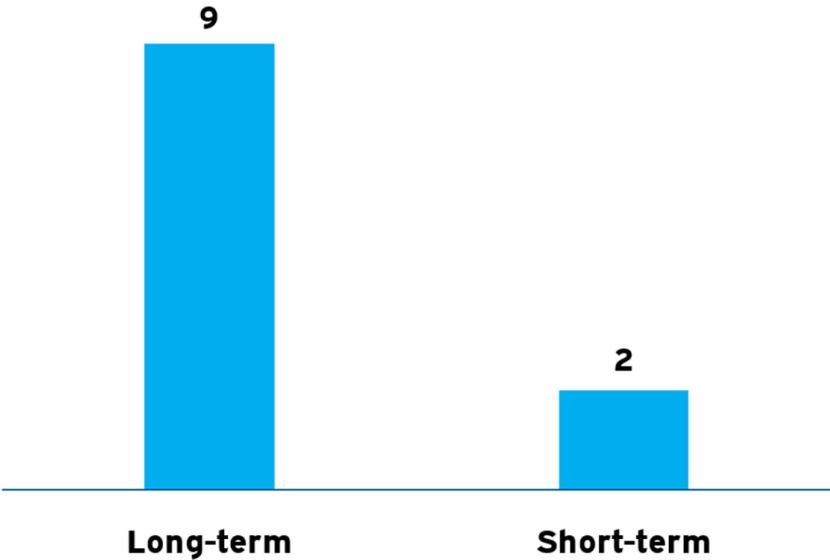


Should Investment Committee approval (as opposed to staff delegation)  
be required for benchmark changes?





Do you believe that benchmarks should be chosen to reflect/explain short-term returns in asset classes/strategies? Or should they be chosen to fit the long-term expectations of an asset class or total fund policy (acknowledging there may be more tracking error in relation to the benchmark in the short term)?

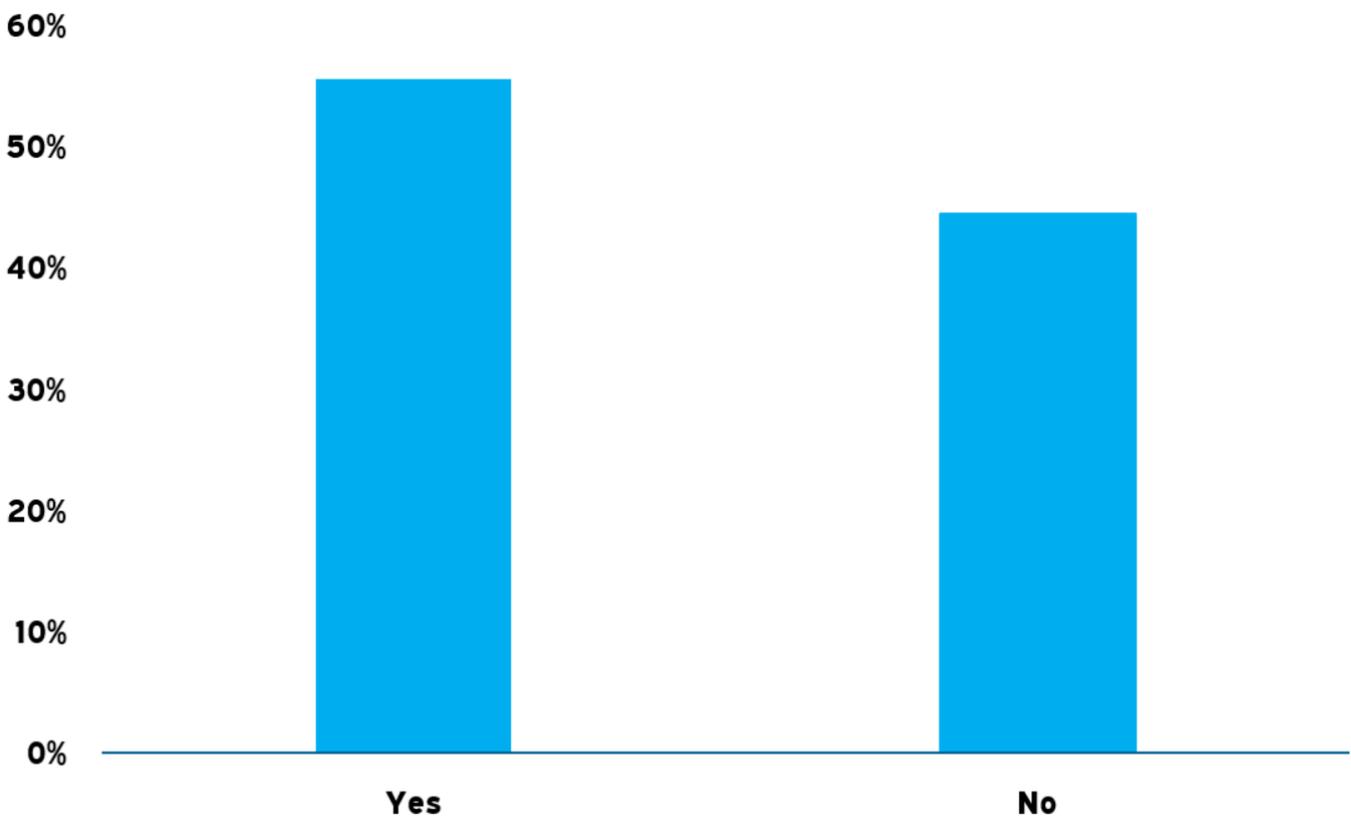




# Peer Benchmarking Responses

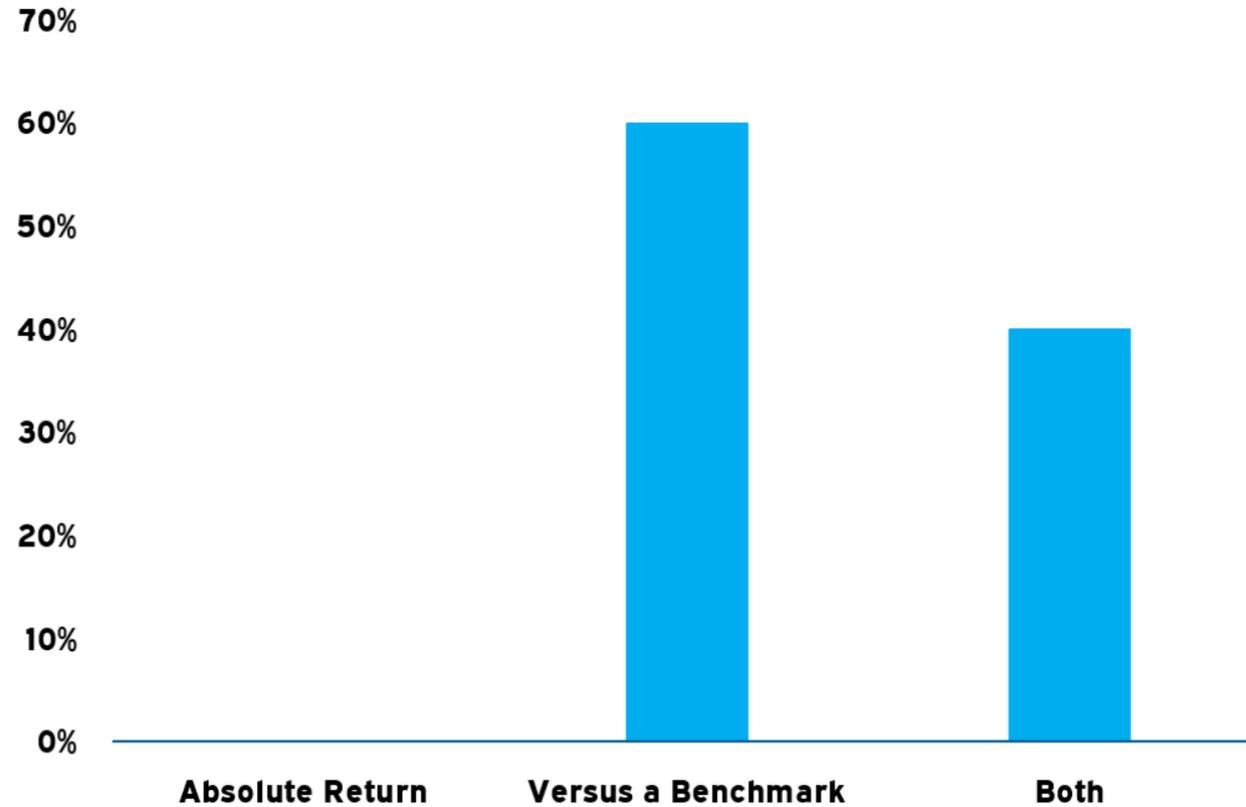


**Does your organization have incentive compensation for Staff?**



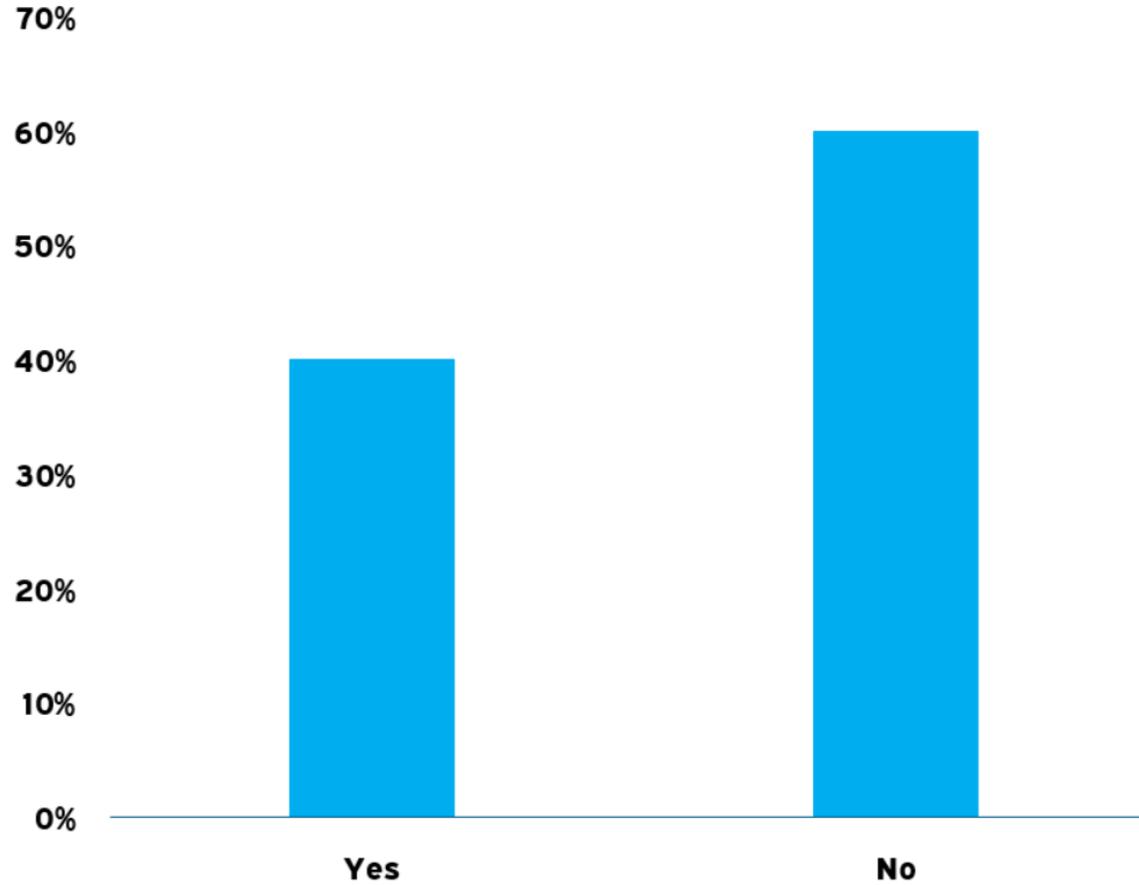


Is the incentive compensation based on absolute returns or versus a benchmark?



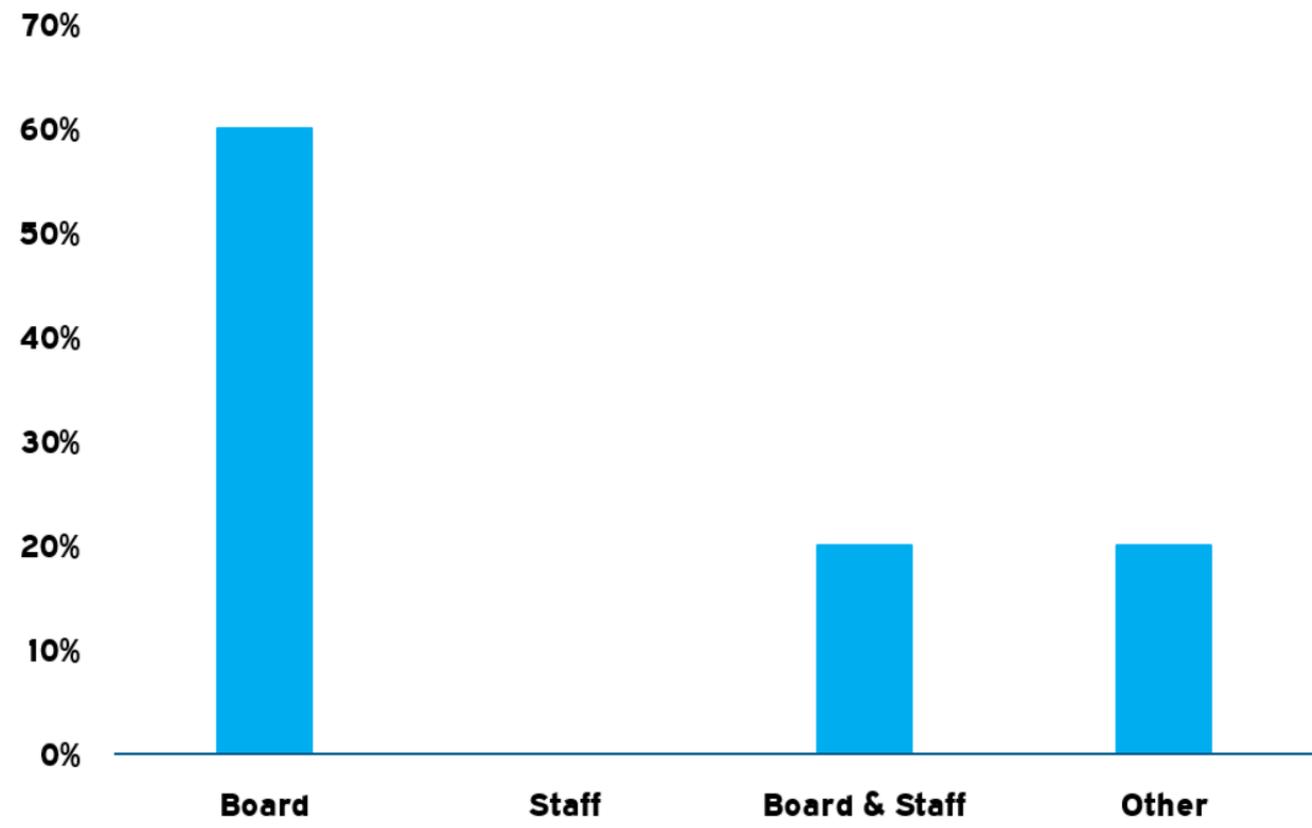


**Is the incentive compensation based on a reference portfolio?**



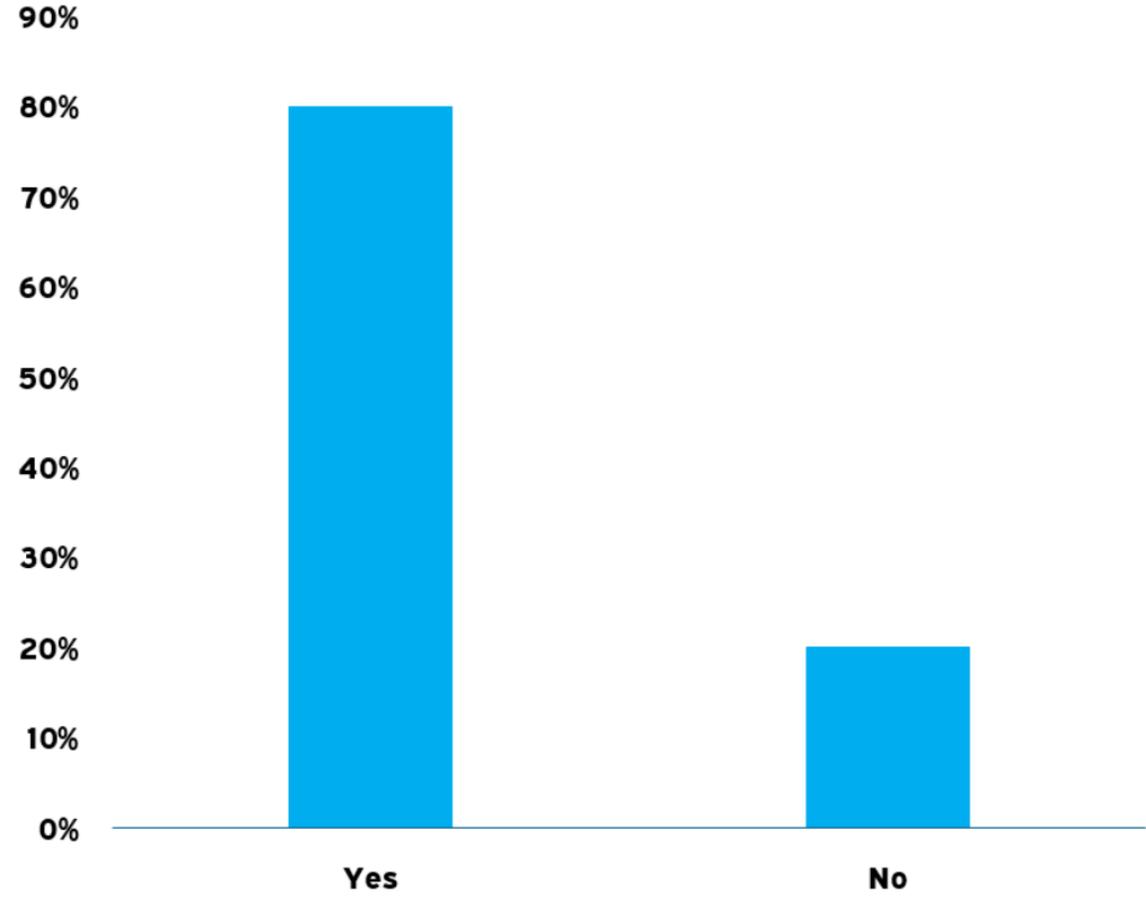


Who approves the incentive compensation benchmarks, Board or Staff?



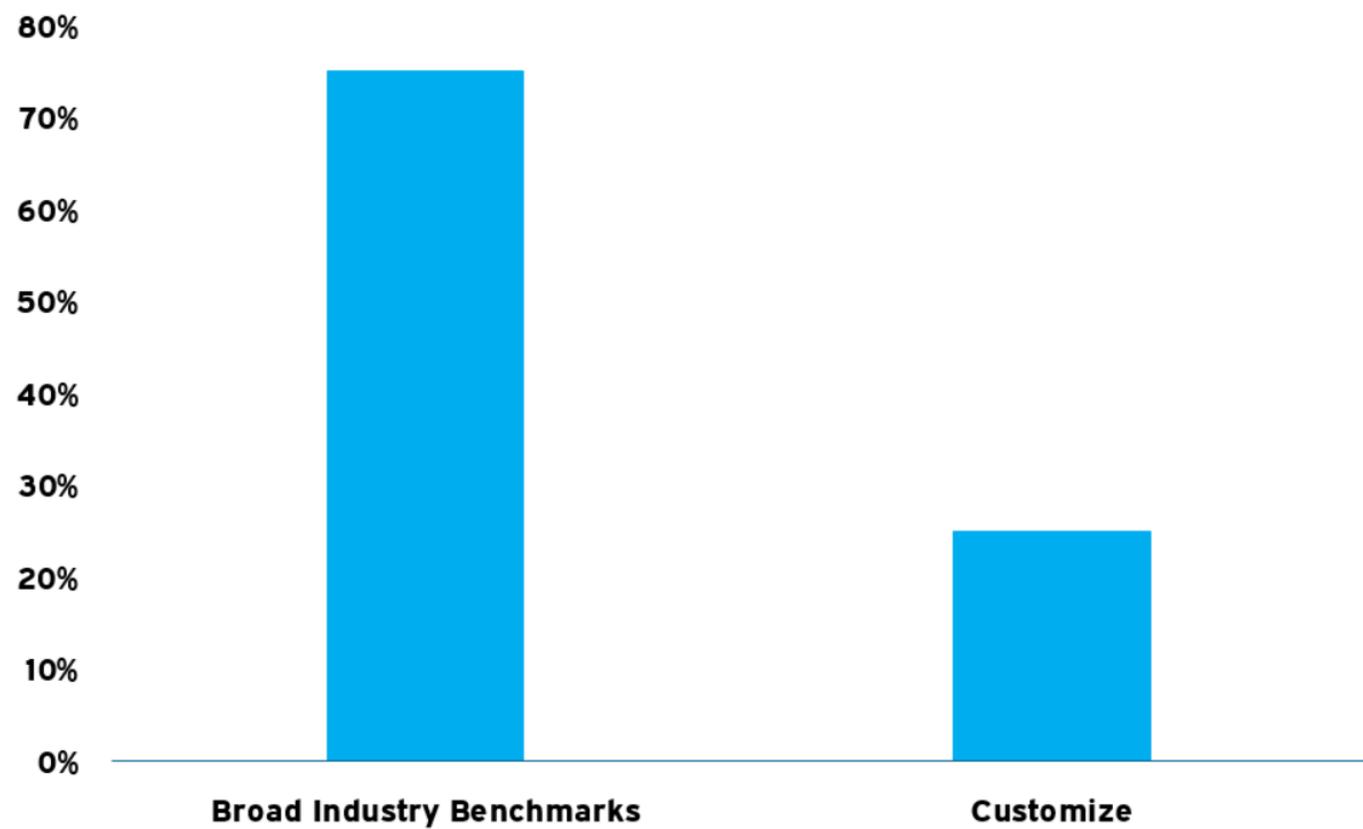


**Do you have a compensation consultant to assist with structure and maintenance?**



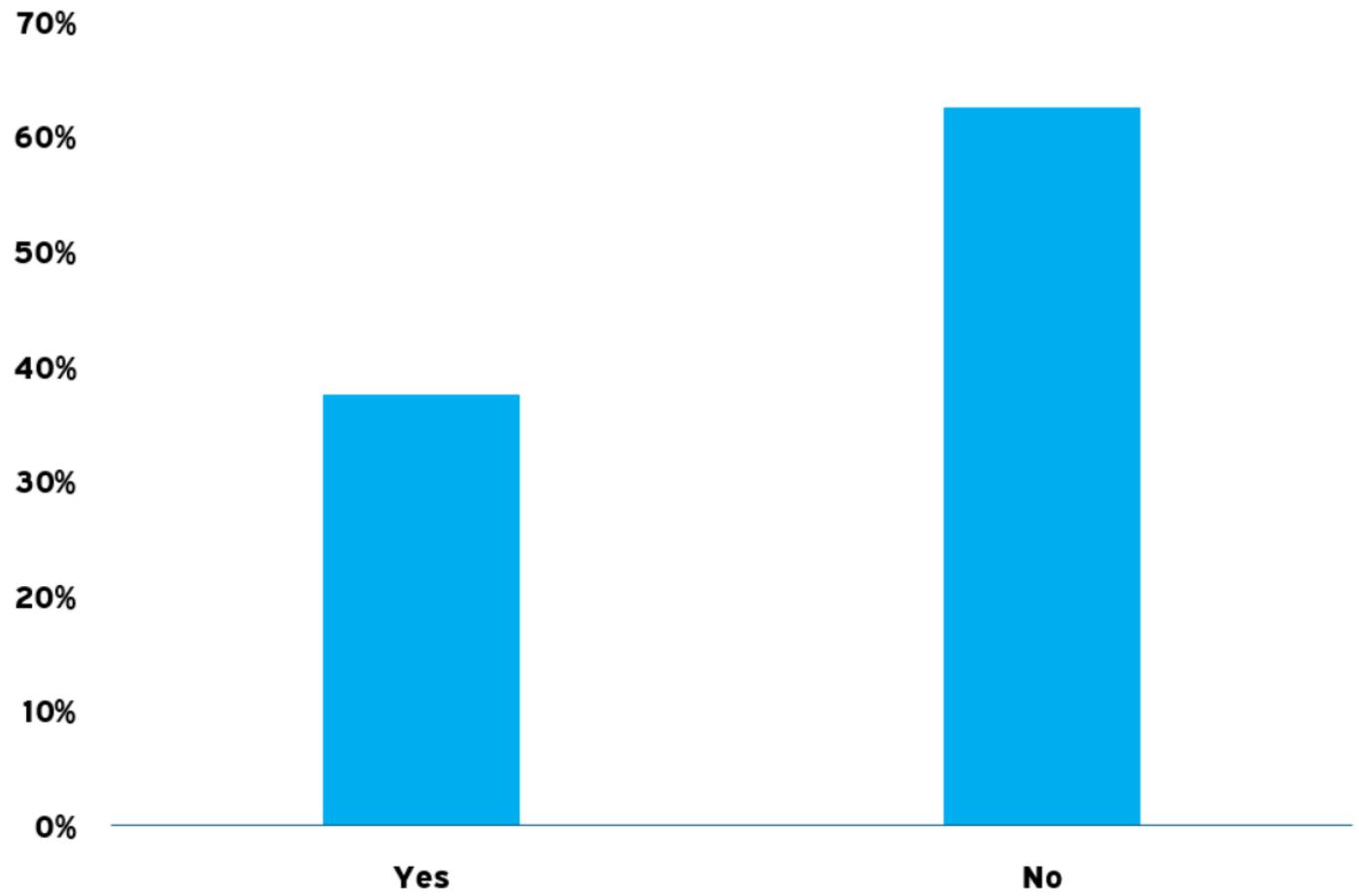


Does your organization customize benchmarks for plan-specific constraints/preferences, or use broad industry benchmarks?





**Does your plan have multiple benchmarks at the Total Fund level?**





Are benchmarks reviewed on a periodic basis or in-line with asset allocation reviews?

