GPIF Research Project

SURVEY ON COMPENSATION STRUCTURE (INCENTIVE SCHEME) OF GPIF ASSET MANAGERS

<REPORT FOR PUBLICATION>

March 2019

Mercer

BACKGROUND, PURPOSE AND APPROACH

BACKGROUND AND PURPOSE

- GPIF has steadily realized the mission of long-term investment return expansion contributing to the benefit of the pension recipients, through publication of Investment Principles/ Stewardship Principles/ Proxy Voting Principles, joint research with The World Bank Group on ESG investment, enhancing engagement with related organizations, and other various initiatives over the past several years, as mentioned in the 2017 and 2018 Stewardship Activities Report.

- Over the past few years, investment performance has been well above pension financial calculation premise because of environmental factors such as positive stock markets in Japan and overseas, and efficient organizational management. On the other hand, in active investments, which approximates 20% of all assets, few funds have achieved their target excess return during the FY 2014 to 2016 period.

- From the view that some part of the low return rooted in non-proper operation in active funds (especially the tendency to focus on AUM growth rather than investment return under business requirement), as well as selection approach of asset managers, GPIF fully introduced a new performance - based fee structure in 2018, and have shown emphasis of alignment of interest.

- In these contexts, it is important to clarify if compensation structures for GPIF asset managers have incentive scheme **avoiding short- termism, or promoting long-term return expected by asset owners**.

- Thus, we examined the current compensation structure (especially incentive scheme) through questionnaire/ follow-up interviews, reviewed and analyzed if the compensation structure is contributing to long-term return expected by long-term asset owners, and tried to reflect the result into selection and assessment of GPIF asset managers.

APPROACH

Questionnaire

- **Questionnaire survey on compensation structure for GPIF asset managers**

✓ Investigation of compensation structure for CEOs, CIOs and fund/portfolio managers of all GPIF asset manages.

✓ Questionnaires are common to all asset managers, centering on compensation and including wide HR related theme that may affect asset manager’s behavior.

Follow-up Interview

- **Face-to-face or telephone interviews with all survey participants**

✓ Revisit background and purpose of the survey.

✓ Conduct face to face or phone interviews with all GPIF asset managers.

✓ Based on the questionnaire, follow up focusing on whether they have compensation structure effectively avoiding short-termism or promoting long-term return.

Reporting

- **Summary of survey and interview**
- **Suggestion to assess compensation structure**

✓ Summarize current status of compensation structures and operations of asset managers as individual reports.

✓ Overview the current status of individual asset managers, and develop assessment perspectives of compensation structure contributing to long-term return.

✓ Offer assessment perspectives of compensation structure (incentive scheme) as part of the selection/ evaluation process by GPIF.

SUMMARY OF SURVEY AND INTERVIEW

COMPENSATION STRUCTURE SUMMARY

- We assessed the compensation structure (incentive scheme) of the asset managers from the perspective of avoiding short-termism, and increasing long-term return.
- Most companies had moved into a compensation structure, effectively avoiding short-termism, reflecting the trends and discussions in setting guidelines especially in EU/UK from the prudential/solvency standpoints.
- From the perspective of promoting long-term return, we observed the below in leading companies, although they varied by organizational context, history, etc.

  - Compensation philosophy aligned to increase long-term return stipulated/ communicated
  - Proper percentage against base pay and volatility of variables
  - Individual bonus KPI based primarily on Investment Performance and not on AUM
  - Assessing mid-long term Investment Performance (including equal to or more than 5 years (some are including even 8 /10 years)
  - Evaluate teamwork and contribution to organizational and talent development
  - Have compensation structure based primarily on investment performance, and have proper discretion to reflect true contribution of the individual
  - Have Deferred schemes in payment or decision of the payout amount (not only time-based, but also performance-based vesting)
  - Promoting or having structure to invest in own funds

- With regard to ESG Head, a limited number of companies offered information, and not many have compensation structures in line with their roll and responsibility.

ASSESSMENT PERSPECTIVES – FOCUSING ON HEAD FM

Perspectives				Description
1	**Compensation Philosophy**		Alignment	• There is a Compensation Philosophy aligned with promoting long-term investment performance and incentivizing high performance.
2	**Bonus**	**Total Fund**	Flexibility	• There is flexibility within the Company Bonus Pool in order to reward high performers even if the overall company is not performing well.
3			Investment Performance Reflection	• Investment Performance is clearly included as a KPI in deciding the total Bonus Pool.
4		**Individual Allocation (KPIs)**	Investment Performance Weight	• Investment Performance has a certain weight (>70%) among the individual KPIs determining individual Bonus amount.
5			Investment Performance including 5 years or more	• Investment Performance KPI includes more than 5 years performance which would be effective to avoid short termism.
6			not linked to AUM	• Individual KPIs are not linked to AUM, which would make more focus on investment performance of the existing funds.
7			Pay-out Distribution over time	• Bonus percentage vs Base is significant and the pay-out distribution reflecting individual performance is significant (e.g. 100%×0.5-1.5 or more).
8			Deferred	• Bonus payout is partly deferred until after particular years or paid over several years in the form of cash/stock/fund etc.
9	**Long-term Incentive**		Eligibility	• Has long-term incentive, paid after vesting period in the form of cash/stock/performance share etc.
10	**Investment in Own Fund**		Promoting	• There is a requirement of a certain percentage of Bonus/LTI to be invested in Own/Flagship fund or promoting investment from own money.
11	**Own Shares including Phantom**		excluding listed shares of non- AM Parent Company	• There is a scheme of providing shares (including phantom, but excluding shares of Parent Company, covering other business).

COMPENSATION STRUCTURE BY CATEGORIES

- We assessed the compensation structure (incentive scheme) of the asset managers, and classified them into 3 categories. The rough features of each are as follows.

Lagging*	Average	Leading
■ Compensation structure is not fully utilized strategically ■ Sales, AUM growth rate and commission fees tend to be emphasized. ■ Bonus funds and individual bonus are determined by the same scheme with that of parent company (banks, securities and insurance). ■ Bonus ratio vs base salary (in some cases reflect seniority rather than expertise), is very low and bonus volatility reflecting performance is also very small. ■ There is limited ability to view mid-long term (several years) bonus fund decisions and individual investment performance. ■ No mid-to long term (several years) structure regarding payment and vesting.	Similar to Leading ： ■ Compensation structure is utilized strategically. ■ Proper percentage against base pay and volatility of variables. ■ Have Deferred schemes in payment or decision of the payout amount. Slightly different from Leading ： ■ Investment performance is not properly emphasized. ■ Period of investment performance assessment is slightly short (3 years or less) ■ No schemes to invest in own funds	■ Compensation structure is utilized strategically. ■ Proper percentage against base pay and volatility of variables ■ Individual bonus KPI based primarily on Investment Performance and not on AUM. ■ Calculating Investment Performance systematically, and evaluating discretionary appropriately excluding environmental factors. ■ Assessing mid-long term Investment Performance (including equal to or more than 5 years). ■ Have Deferred schemes in payment or decision of the payout amount. ■ Promoting or having structure to invest in own funds

*Almost no compensation structure was found to promote short-termism due to guidelines and initiatives from solvency perspective in EU / UK, etc.. Many are classified as Lagging, as they do not use compensation structure strategically.

COMPENSATION STRUCTURE OVERVIEW 1/2

CATEGORY

	Lagging	Average	Leading
International	**Low Disclosure(N=5)** **Unique Compensation Philosophy (N=1)**	**In between (N=10)** Similar with Leading; ✓ Strategic use of compensation, and have deferred structures. On the other hand; ✓ Lesser weight in reflecting investment performance.	**Strategic use of Compensation structure (N=20)** ✓ Have compensation structure based primarily on investment performance, and have proper discretion to reflect true contribution of the individual.
Domestic	**Non-strategic use of compensation structure (N=7)** ✓ Started to introduce structures that fit asset management, but not yet in a phase to utilize compensation strategically.	**In between (N=2)** ✓ Reflecting equal to or more than 5 years investment performance, and variable/volatility percentage higher. ✓ Have deferred portion/ investment in own fund.	

COMPENSATION STRUCTURE OVERVIEW 2/2
COMPANY TYPE

International

Listed
(N=5)

- ✓ With Mutual Fund Unit.
- ✓ Stock grant/ stock ownership plan linked to company performance.

Parent Listed
(N=21)
Subsidiaries of banks, securities/ insurance companies, etc.

- ✓ While CEO/CIO have the same compensation structure of parent company, have certain uniqueness as asset managers (such as emphasis on mid- long term investment performance, etc.).

Private – Partnership (N=5)

- ✓ Have Profit-Share Bonus/ Stock Ownership/ Investment in own fund plan.
- ✓ Develop individual investment professionals from a long-term perspective.

Private – Others (N=5)

- ✓ Have Phantom Stock scheme.
- ✓ Bonus ratio is properly high and investment performance weight in KPI is also high.

Domestic

Parent Listed
(N=9)
Subsidiaries of banks, securities/ insurance companies, etc.

- ✓ Mostly within compensation structure/ level of parent/group company.
- ✓ Emphasize long-term talent development and team investment.

INCENTIVE SCHEME : OVERVIEW

Base	Bonus	Deferred	LTI (Long-term Incentives)

Base :

- Fixed cash payments, annually reviewed reflecting such as market increase rate, inflation rate, evaluation, and responsibility.
- Base and total compensation determined to be competitive taking into account market levels by country.

Bonus Fund:

- Increase/decrease within a certain range, taking into both company performance and individual performance.

Allocation to individuals:

- KPI consisted of mainly numeric (investment performance for past 1 and multiple years, company/division performance) and some qualitative.
- With proper volatility reflecting performance.
- KPI and volatility range are determined as scheme or with discretion.

Deferred Bonus :

- Part of bonus deferred and paid out cliff or distributed over several years.

Long-term Incentives :

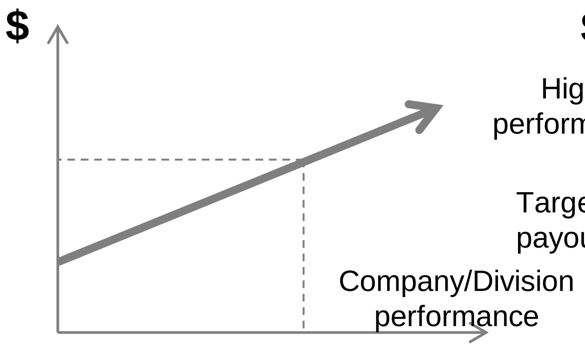
- Grant certain amount of shares, stock options or phantom stock, and vest according to stock price/ company performance several years later.

Deferred bonus with performance conditions has similar effect with LTI (not only retention but also motivation for long-term performance improvement)

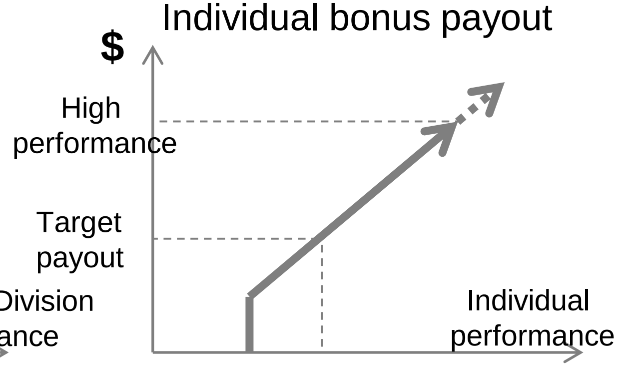
INCENTIVE SCHEME : BONUS

Bonus fund → **Allocation to individual** → **Bonus payout**

Bonus fund amount



Individual bonus payout



Bonus

onetime payout (cash)	**Deferred**

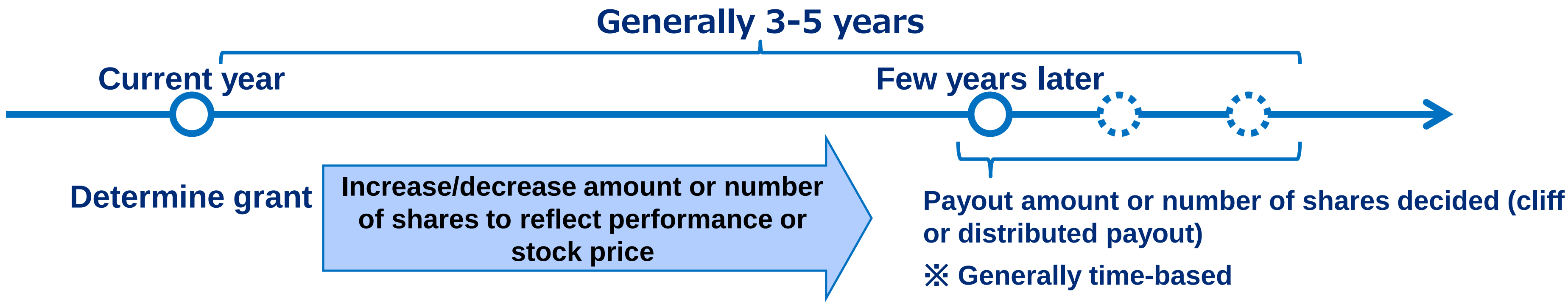
generally 3-5years

Payout	increase/decrease
[no conditions] Fixed amount will be paid a few years later	(No change)
[with performance conditions] Amount of payment changes according to the performance over several years until the payment	Granted as stock
	Linked to company performance
	Investment in own fund

- Increase/decrease within a certain range, taking into both company/division performance and individual performance.
  - Some companies have larger fluctuation reflecting company/division performance.

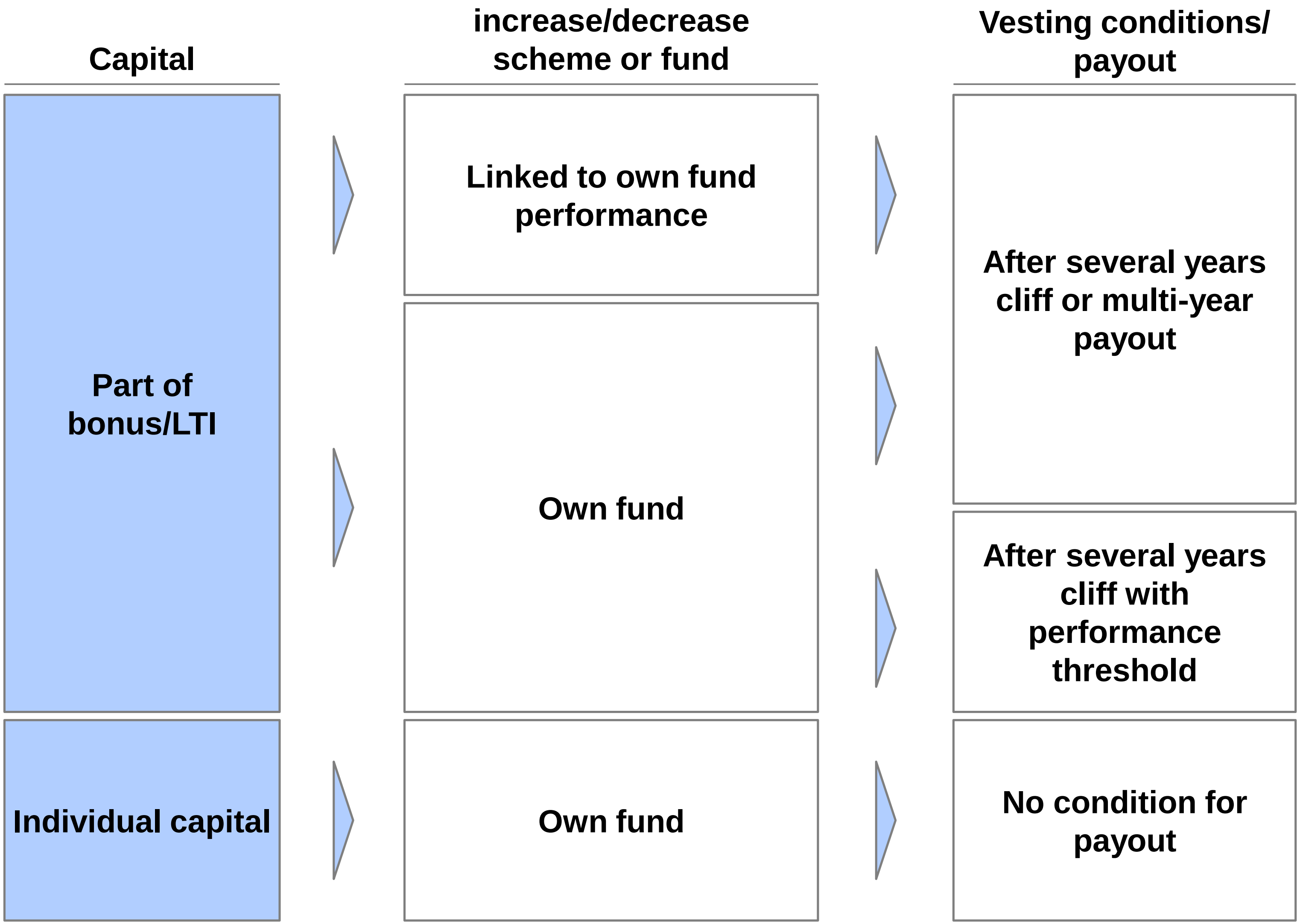
- KPI consisted of mainly numeric (investment performance for past 1 and multiple years, company/division performance) and some qualitative.
- With proper volatility.
  - Often with threshold as shown above

INCENTIVE SCHEME：LTI



LTI vehicle	Stock/cash	Increase/decrease
Restricted share	Stock	Stock price
Performance share **(Stock reflecting company performance)**	Stock	Stock price/ company performance
Stock option	Stock acquisition right	Stock price
Phantom stock	Cash	Stock price
Investment in own fund	Cash	Investment performance

INCENTIVE SCHEME:
INVESTMENT IN OWN FUND

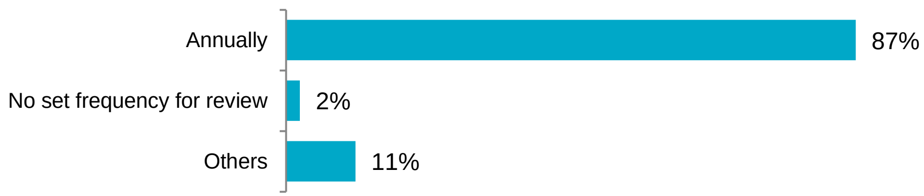


QUESTIONNAIRE SUMMARY

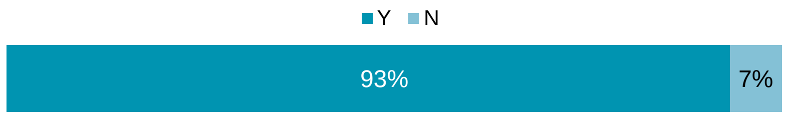
QUESTIONNAIRE SUMMARY 1/4

Performance and Review Cycle

How often is fixed pay reviewed for covered roles?



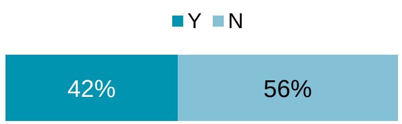
Do employees receive an annual performance rating?



Do employees have a separate rating for behavior?

Is there a minimum performance rating threshold for any of the following?

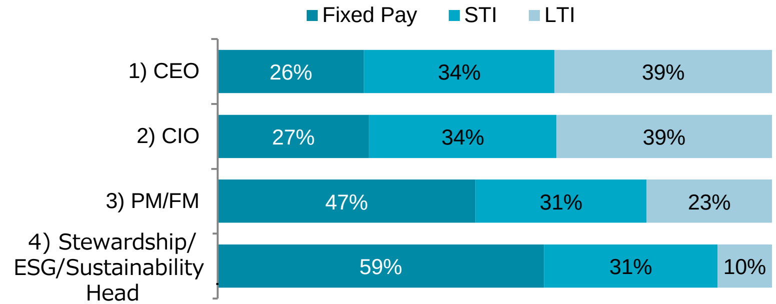
STI Payment/Delivery



LTI Payment/Delivery

Pay Mix

Compensation Mix (Average)



Percentage of Variable Pay vs Annual Base Salary

STI	1) CEO		2) CIO		3) PM/FM
	Target	Actual	Target	Actual	Target
Median	45%	126%	75%	53%	58%

LTI	1) CEO		2) CIO		3) PM/FM
	Target	Actual	Target	Actual	Target
Median	190%	273%	114%	177%	268%

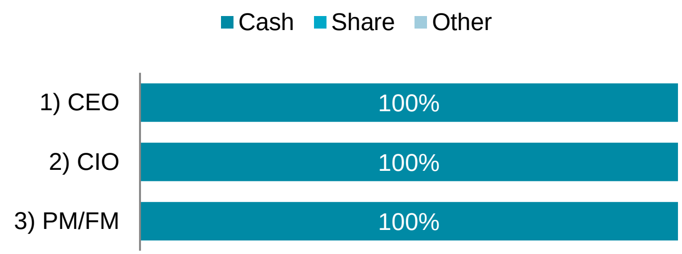
STI Volatility (STI Target = 1)

	1)CEO			2) CIO			3) PM/FM		
	Min	Target	Max	Min	Target	Max	Min	Target	Max
Median	0.0	1.0	1.5	0.5	1.0	1.5	0.5	1.0	1.3

QUESTIONNAIRE SUMMARY 2/4

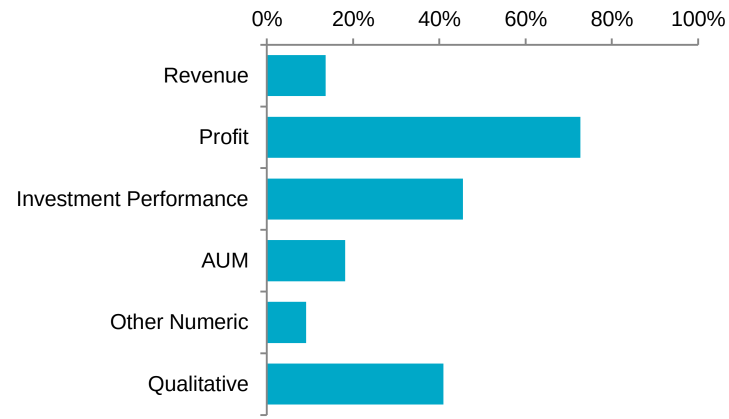
Annual Base Salary/ Fringe Benefits

Fixed Pay: percentage (Average)

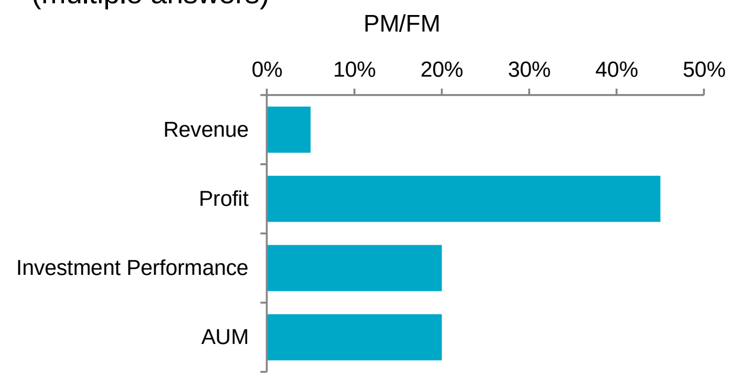


Short term incentives 1/3

Fund KPI (KPI for the bonus pool funding)
(multiple answers)



Individual KPI
(multiple answers)

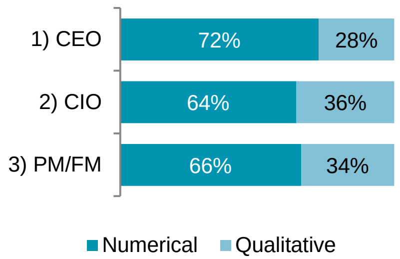


QUESTIONNAIRE SUMMARY 3/4

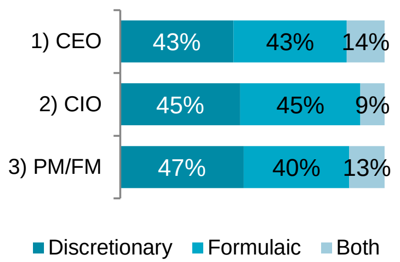
Short term incentives 2/3

Short Term Incentive KPIs / metrics

Numerical vs Qualitative

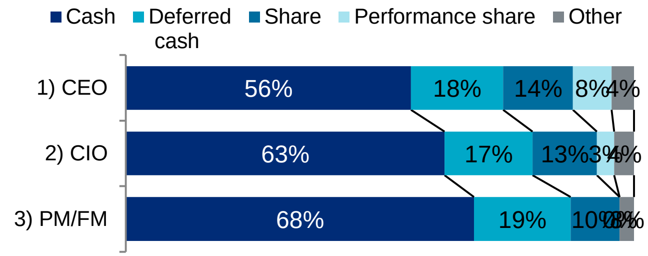


Discretionary vs Formulaic (Numerical)



Short term incentives 3/3

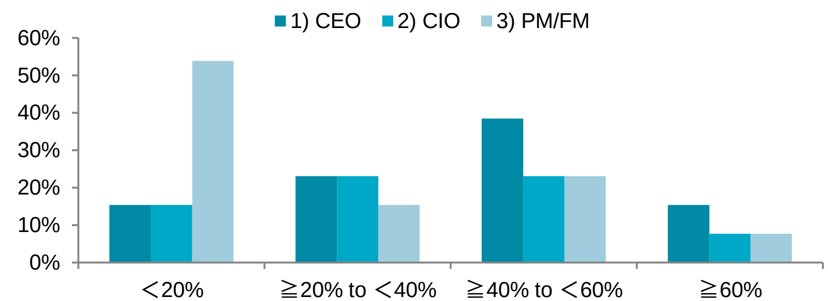
STI cash/share /other percentage



Vesting provisions / time frame

	CEO	CIO	PM/FM
No deferral	30%	42%	35%
Less than 3 years	7%	0%	4%
3 years	48%	54%	38%
4 years a more	11%	4%	19%
Others	4%	0%	4%
Total	100%	100%	100%

What % of STI is mandatorily deferred?



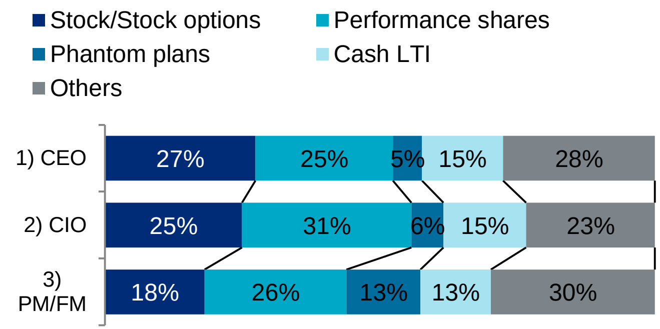
QUESTIONNAIRE SUMMARY 4/4

Long term incentives

LTI eligibility

	Yes
1) CEO	65%
2) CIO	56%
3) PM/FM	36%

LTI vehicles



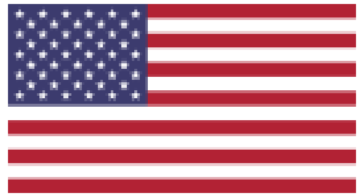
Own investment in the fund

Yes
52%

APPENDIX 1

GENERAL TRENDS ON GLOBAL COMPENSATION STRUCTURE

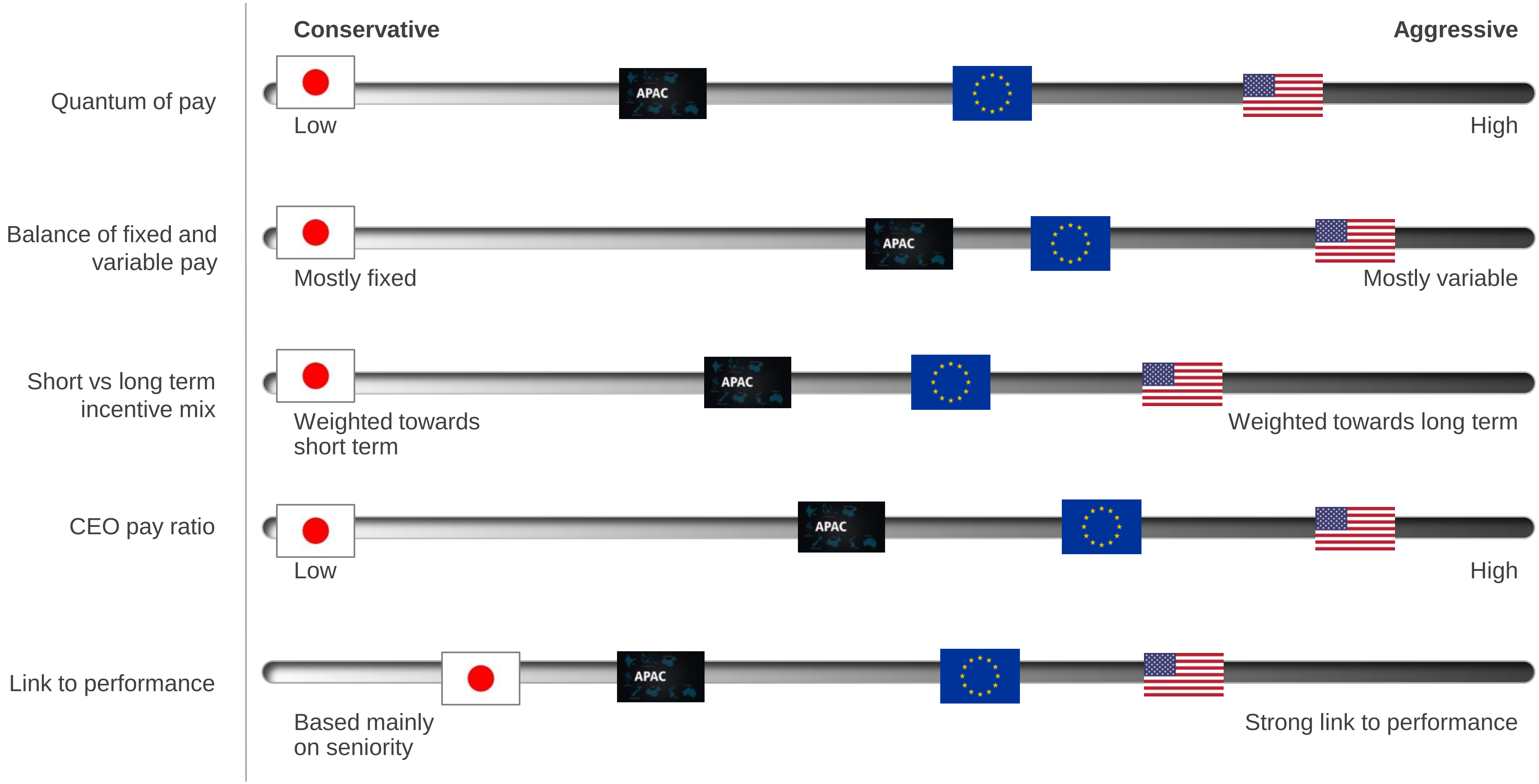
WHILE EXECUTIVE REMUNERATION STRUCTURES BETWEEN KEY GEOGRAPHIES HAVE SOME UNIQUE CHARACTERISTICS, WE ARE BEGINNING TO SEE CONVERGENCE



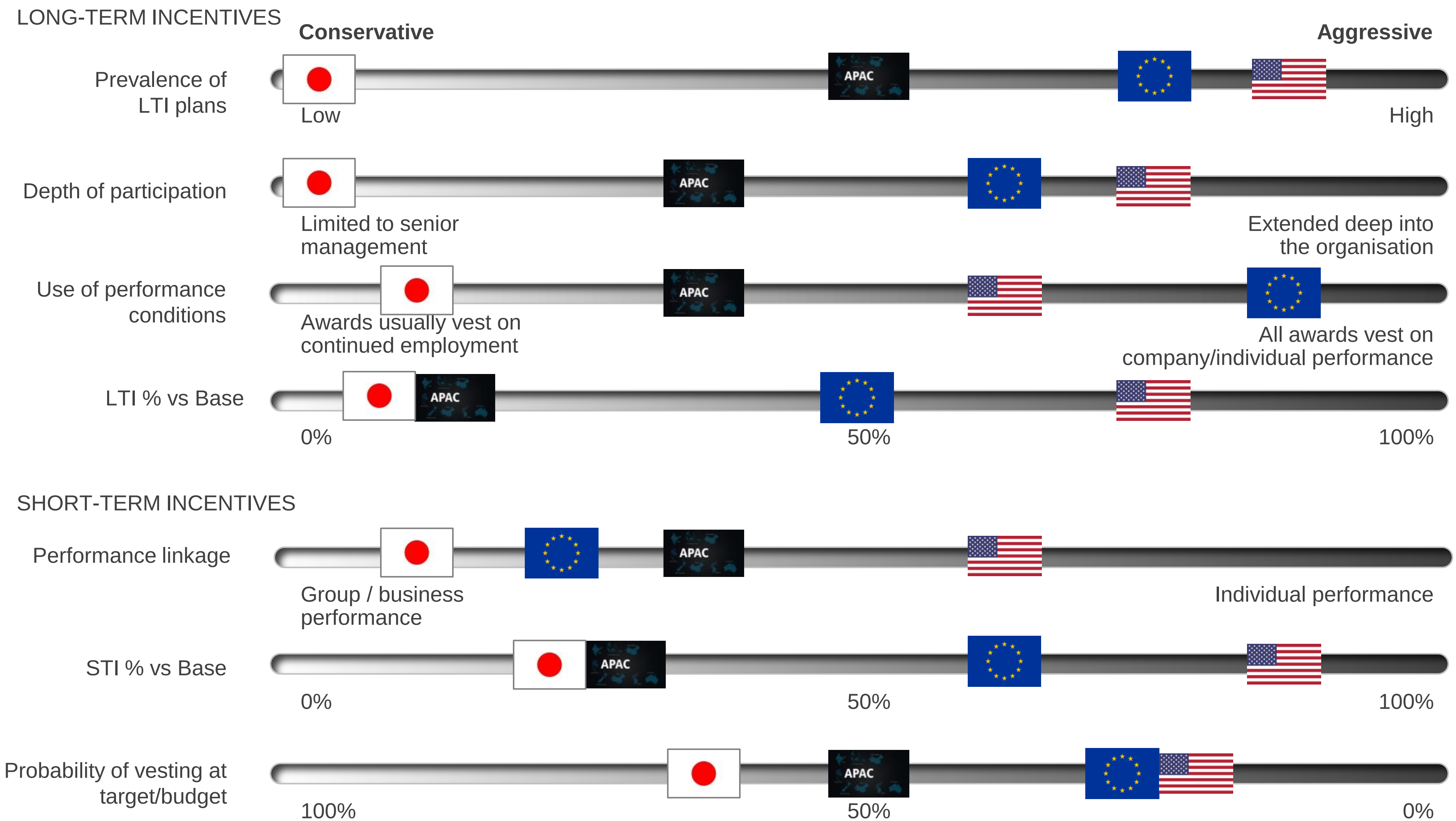
Europe	USA	APAC
• Salary increases generally in line with Retail Price Inflation • Convergence on a “market norm” • LTI typically a performance share plan vesting subject to EPS growth and total shareholder return • Time horizons are increasing to 5 years • Increasing use of bonus deferral and LTI holding periods becoming more common • Number of measures increasing, with traditional measures (e.g. EPS) being complemented with other financial / strategic measures (e.g. returns)	• Moderate salary increases – broadly aligned with Europe – albeit salaries remain much higher than in Europe • More leveraged pay mix than in Europe • Extensive use of annual variable pay plans, both in terms of eligibility and meaningful size of award opportunities • Broader eligibility for LTI participation • A “portfolio” approach to LTIs is common, with c.2-3 plans – typically a performance share plan, share options, and time-vesting shares • Performance shares have increased in both prevalence and weight in overall LTI mix • For performance shares, use of total shareholder return is prevalent though is increasingly being complemented with other performance metrics	• Approach differs depending on country maturity • Salary increases also vary materially • Pay mix typically weighted more towards fixed pay than USA and Europe • As the global market place for executive talent increases, there is a general trend to move towards European and USA practice, i.e. more variable pay, higher quantum • Cash bonuses common; beginning to see an emergence of LTIs

Overview of global remuneration structures & emerging trends

- On a regional level, the typical structure of remuneration packages varies, with APAC/Japan generally being more conservative and the US the most aggressive



Overview of global remuneration structures & emerging trends



APPENDIX 2

REGULATORY ENVIRONMENT SURROUNDING ASSET MANAGEMENT

REGULATORY CHALLENGES FACING ASSET MANAGEMENT

Recognising sub-sector and location specifics

FSB

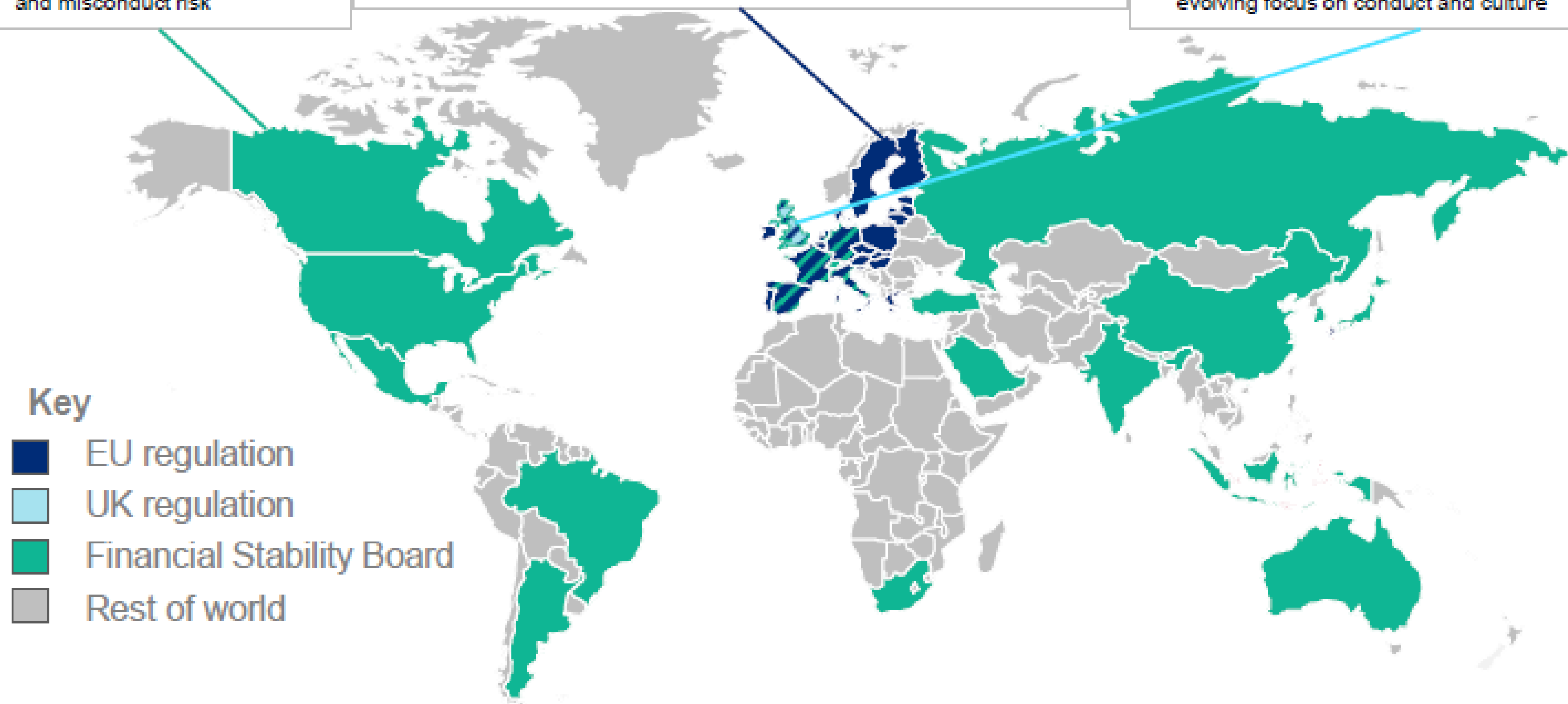
- Includes majority of G20 as members
- High level principles for significant banks. Application differs between countries
- Recent guidance covers pay and misconduct risk

EU

- Asset managers directly covered by UCITS, AIFMD and MiFID
- Asset managers with bank parents may be impacted by CRDIV and those with insurance parents by Solvency II
- Remuneration codes cover remuneration governance, policy and structure
- Some provisions specific to identified risk takers and others to all staff

UK

- Senior Manager & Certification Regime (SMCR) accountability framework and requirements extended to wealth and asset management in 2019
- Senior Manager Function responsibility for remuneration
- Regulatory guidance well developed and covers evolving focus on conduct and culture



UK REGULATION OF REWARD

The FCA has six Remuneration Codes relevant to asset management

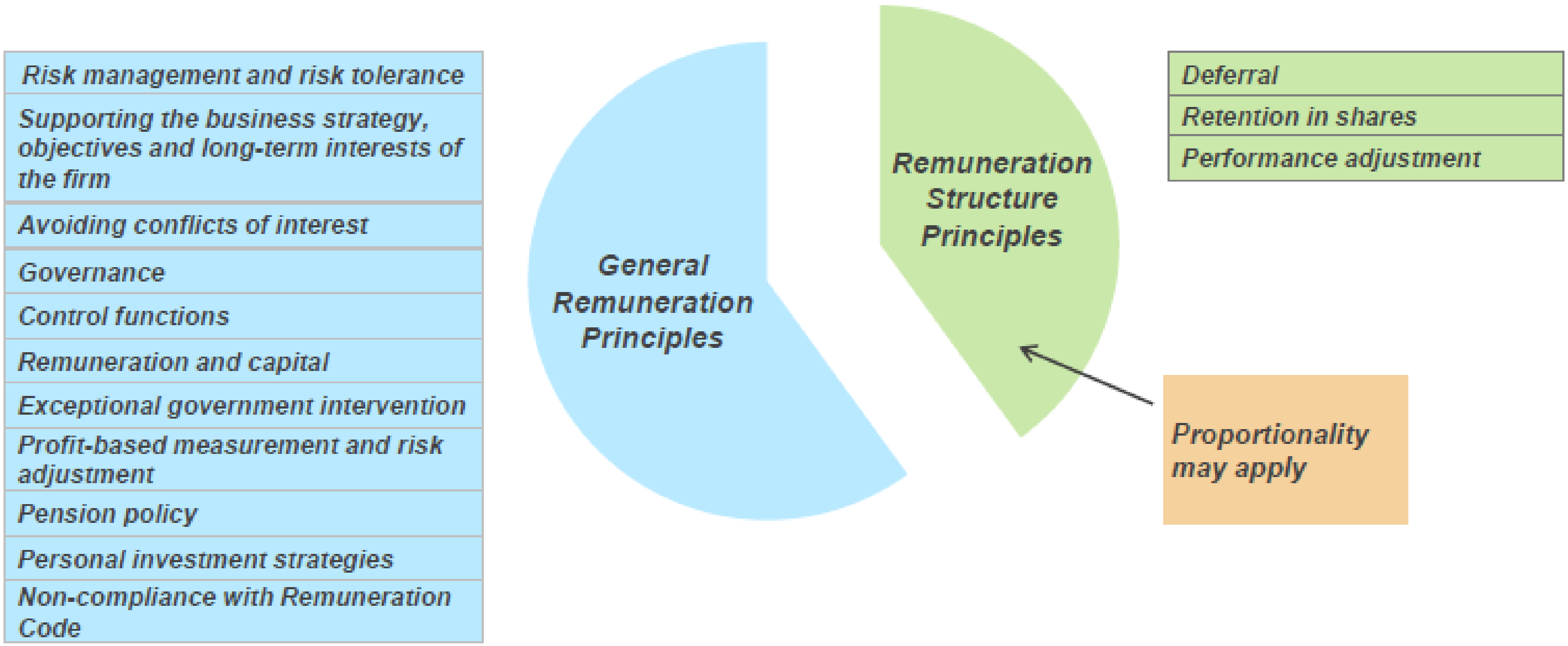
The Remuneration Codes include:

- Similar general principles
- With Code specific approaches to applying the remuneration structure requirements on a proportionate basis.

The focus of the MiFID code is setting remuneration so that it does not conflict with the best interests of clients

THE REMUNERATION CODE PRINCIPLES – GENERAL AND STRUCTURE

The general principles apply regardless of proportionality; for firms subject to proportionality judgement can be used in applying the remuneration structure principles



EUROPEAN-LED REMUNERATION REGULATION FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS, AND ASSET AND FUND MANAGERS

	Summary of European-led financial services regulations as they pertain to remuneration for Material Risk Takers		
	CRD IV	AIFMD	UCITS V
Types of firms affected	Credit institutions and certain investment firms	Asset / fund (excluding UCITS) management firms	UCITS find management firms
Applicable from	1 January 2014	22 July 2013[1]	18 March 2016[1]
Remuneration requirements for Material Risk Takers			
Variable pay cap	Must not exceed 1x fixed pay (or 2x subject to shareholder approval)	n/a	n/a
Vehicle	Minimum of 50% of Variable remuneration to be delivered in appropriate instrument(s). E.g. shares, non-cash instruments and/or bail-in/convertible instruments[2]		
Deferral	Minimum 40% of Variable remuneration to be deferred over minimum of 3 to 5 years, rising to 60% where Variable remuneration is “particularly high”, vest no faster than on a pro-rata basis		
Pension	Discretionary pension benefits must be held by the firm in the form of instruments for a period of 5 years after leaving the firm, or retirement		
Malus / Clawback	Required…		
	… for misconduct which resulted in significant losses to the institution, or failure to meet appropriate standards of fitness and propriety	… for malfeasance or a material failure to manage risk by senior staff who could be reasonably expected to be aware of misconduct, or misconduct	… to considerably contract total variable remuneration where subdued or negative financial performance of the management company or of the UCITS concerned occurs
Disclosure	Details of their firm’s remuneration policies at least annually		

1. *Member state deadline for transposing EU legislation into national law*
2. *For UCITS, does not apply if UCITS management is < 50% of the total portfolio managed by the management company*

Mercer consultants compiled the report entrusted by GPIF as a research project.
Mercer’s more than 23,000 employees are based in 44 countries, and the firm operates in over 130 countries. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), the leading global professional services firm in the areas of risk, strategy, and people.

GPIF as well as Mercer do not guarantee accuracy and completeness of information and data included in the report.

Title: “Survey on compensation structure (incentive scheme) of GPIF asset managers”（March 2019）
Published by: Mercer (Midtown Tower, 9-7-1, Akasaka, Minato-ku, Tokyo 107-6216, Japan)