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Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
Dubai
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Minato-ku, Tokyo 107-0052
Japan
Tel: 813.5549.1850
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Bonus Plans within Public Pension Funds:

Should they stay or should they go (now)?

By Chris Murphy and Adam Barnett
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Taxpayers, beneficiaries and politicians are up in arms about paying bonuses to public fund investment staff during this economic crisis. For some, it is unconscionable to pay bonuses when pension benefits are being cut, other state workers are on salary freezes or work furloughs, and AUM levels have been decimated by the market meltdown.

The angst about paying bonuses to public fund investment staff has been compounded by widespread reports about TARP participants paying billions of dollars of "our money" in bonuses, CEOs purchasing $34,000 commodes, and President Obama commenting that Wall Street bonuses were "shameful" and "irresponsible."

Pension boards are on a slippery slope. Clearly, for some boards, the easy decision would be to appease beneficiaries, politicians and the press by eliminating bonus plans, especially given the pain being felt by the broader public. In contrast, other boards recognize that it would be short-sighted to eliminate bonus plans in light of the critical investment and funding challenges facing their pension plans. Like it or not, these boards understand that investment professionals live in a bonus-paying market that is unlikely to go away.

Pension funds facing severe funding shortages will be best served if they continue to offer bonuses as a way to attract and keep top-caliber investment staff. But, these pay plans should likely change in light of today's economic and political realities.

PUBLIC PENSION FUND BONUS PLANS

A Primer on Prevailing Market Practice

The specific design features of bonus plans vary from fund to fund. In essence, most plans link bonus and incentive payouts to the achievement of specific levels of above-benchmark performance measured over multi-year time periods. When staff out-perform passive benchmarks, they earn bonus payouts. When staff under-perform, they receive no bonus payouts.

Fund-to-fund differences in bonus plan design typically relate to: the existence of a qualitative or subjective pay component, the overall focus of performance measurement (e.g., total fund, asset class or portfolio), the time-periods used to measure performance, and the form and method of payout.

Why did we agree to pay bonuses in the first place?

Historically, public pension funds could not compete with private sector firms for top investment talent. To address this issue, many boards, especially at some of the largest pension funds, adopted bonus plans to attract and retain top investment talent. While none of these funds found joy in paying bonuses to investment staff, these institutions

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recognized that high-performing staff could generate significant amounts of above-benchmark performance and save their systems substantial sums of money in external management fees.

Until now, bonus programs have been a win-win for boards, staff, beneficiaries and taxpayers.

During the good times, prevailing bonus plan designs (which focus on relative returns) satisfied all key constituencies:

- **For beneficiaries and taxpayers:** Virtually all excess value was retained by the pension system. That is, while individual bonus payouts sometimes reached six figures, the largest funds often kept over 99% of the dollars of out-performance generated by staff.
- **For boards:** Bonus plans helped public funds attract higher-caliber talent and ensure staff continuity and stability.
- **For staff:** Bonus plans made the economic tradeoffs of a public sector career more palatable.

The market collapse causes us to question conventional pay practices.

It is much easier, even in the public sector, to digest the payment of $100,000+ bonuses in good times when markets are rising and the economy is thriving. So, what happens when pension assets are being crushed?

The events of the past year have resulted in a dramatic shift in our collective thinking about compensation, particularly as it relates to the financial services industry and especially to institutions that are getting relief from the federal government.

In 2008, compensation moved more at private sector investment firms than in any previous year. What's unique is that this movement was downward, something that many investment professionals never experienced. These professionals' pain will be compounded later this year, given the clear expectation of further bonus cuts in 2009.

Investment results at public pension funds, as measured in absolute terms, have been terrible; shattering the funding statuses of once fully-funded systems.

The combination of private sector pay cuts and job losses, declining public fund AUM levels and widespread economic dislocation, calls into question the merits of paying bonuses to public fund investment staff.

So what should pension boards do?

In our view, boards should modify their bonus programs as follows:

1. **Change bonus targets to reflect current market pay levels:**
   Industry economics directly impact pay levels at public pension funds. Private sector firms have been forced to cut pay and down-size staff. The asking price for talent is going down and will continue to fall.

   Public pension funds must review pay levels at competing organizations and re-establish — potentially downward — their target pay levels.

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2. **Consider adjusting bonus payouts and/or targets based on absolute results:**
   When markets are declining and absolute performance is especially poor, bonus payouts should potentially be:
   - Reduced and/or
   - Partially deferred until markets improve.

   Conversely, when absolute performance is especially strong, bonus plans should include features that adjust payouts upward. Gives and gets should be aligned.

3. **Continue to reward relative performance:**
   Since pension investment staff are primarily responsible for meeting or exceeding board-defined investment objectives (and not defining asset allocation guidelines), it is appropriate to link their pay to relative results.

   Portfolio managers and analysts are tasked with picking the best securities in their assigned sectors. It is wrong to hold them fully accountable for AUM declines that are primarily influenced by their board's asset allocation decisions.

4. **Any changes to the bonus plan's design should be applied prospectively, not retrospectively:**
   Changing incentive plan design features, targeted payouts, or actual payouts mid-year will foster potentially irreparable mistrust between staff and the system.

   Justifiably, current staff and potential future hires will ask themselves: "Can this system be counted on to deliver on its pay-related promises? Is this system serious about being a professional, world-class asset manager? Or, does this system vacillate, shifting its policies at whim in response to press and/or political pressures?"

   To preserve trust between staff and the system, changes to incentive plan designs should become effective at the beginning of the next performance year.

5. **Communicate and, more importantly, educate:**
   Board members and other stakeholders may be highly educated and knowledgeable within their respective areas of expertise, but they may have no experience with incentive compensation. Board members and key stakeholders must be educated about how their bonus plans work, why bonus plans are critical to attracting and retaining top talent, and how bonus plans directly benefit taxpayers and the public at large.

   For better or worse, investment professionals live in a world where bonuses are the norm. Although bonus plans can be maligned and misused, they will not go away.

Summary

The investment management industry's prevailing bonus culture is changing, but will not go away. Articles about public pension staff earning six-figure bonuses will continue to sell newspapers.

However, moves to entirely eliminate bonuses are short-sighted. Instead, we urge boards to modify, but not eliminate, bonus plans, especially since pension systems will increasingly rely on staff expertise to help restore funding levels and preserve the benefits promised to millions of public sector workers. ■

Adam Barnett is McLagan's Head of Asset Management. Located in the firm's Stamford office, Mr. Barnett provides total pay consulting services to investment management organizations, including advisory firms, mutual fund companies, banks, insurance companies, public funds, in-house managers, and hedge funds.

Adam Barnett can be reached at (203) 602-1200 or abarnett@mclagan.com.

Chris Murphy is a Vice President at McLagan. Mr. Murphy manages McLagan's compensation survey program for plan sponsors (both public and private organizations), endowments and foundations. In addition, Mr. Murphy provides compensation consulting services to plan sponsor, endowment, foundation and private sector investment management firms.

Chris Murphy can be reached at (203) 602-1258 or cjmurphy@mclagan.com.

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Aon Center
200 East Randolph Street
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

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