Investment Staff

(Vantage Points)

Aligning Pay with Performance in Endowment Incentive Plans

Incentive compensation plans in nonprofit investment offices[1] are designed to fulfill a number of important objectives - the most significant of which is to ensure the alignment of pay with investment staff performance. As investment returns are published and closely evaluated by stakeholders, the media and other constituents, it is essential for Boards and management to establish an appropriate correlation between pay and performance, and to ensure that the design of the incentive program is both successful and defensible.

Investment office stakeholders should regularly assess the programs in place to determine whether incentive pay and investment performance properly align with the organization's objectives, appropriately reflect the changing marketplace, and successfully deliver both competitive and reasonable compensation to investment staff.

UNDERSTANDING MARKET PRACTICES

While the prevalence of incentive compensation arrangements in endowment investment offices has steadied over the past decade, it still remains high. In the Endowment and Foundation Investment Staff Compensation Survey, SullivanCotter conducts an annual assessment of key investment staff positions among leading colleges and universities, private foundations and other not-for-profit organizations. Our database of over 70 investment offices reports that nearly all organizations with assets under management of greater than $1 billion offer incentive compensation to investment staff.

Not much has changed on the design front over the last decade. Representing 70% to 80% of the overall incentive award for the CIO, the policy portfolio benchmarking metric remains the most prevalent way in which to measure investment performance. Measurement is typically done on a relative basis because it most accurately reflects the value added by the investment office.

Other metrics, such as asset class, absolute return and peer group, remain low in prevalence.

1. The term 'nonprofit investment office' for the purpose of this article is defined as the investment team or group managing the investable assets of a university, foundation or other not-for-profit organizations.

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ASSESSING PLAN EFFECTIVENESS

By regularly assessing your endowment's incentive compensation plan, your organization can ensure that investment staff pay is properly aligned with performance.

The following best practices are key assessment factors to consider in the incentive compensation decision-making process:

Consistency with the compensation philosophy.

Review the plan design in light of the organization's compensation philosophy of how competitive to be, and with whom. For example, if the organization intends to compensate staff at the median of the market with target levels of performance, a review of the plan design and current compensation levels will confirm if the existing program is aligned with the stated philosophy.

Appropriate peer group definition.

The peer organizations against which compensation levels and pay practices are compared is critical. Recent scrutiny by the IRS and other regulators has been focused on peer group composition, and aspirational peer groups (those that represent a desired, future state, such as endowments with significantly larger assets under management) are difficult to defend. It is important to ensure that peers reflect the organization's current size, portfolio strategy and complexity, and not what the organization expects or hopes to look like in 10 years.

Alignment with investment objectives.

The metrics used and the period of time over which performance is measured should reflect the organization's investment objectives. For this reason, less than 10% of organizations measure performance over a one-year period. Most plans (82%) measure performance over a three-year period to balance a longer term time horizon with the reality of line-of-sight, investment staff tenure and the ease with which new hires can be incorporated into the plan.

Mitigation of risk.

How awards are interpolated (or not), capped and set relative to one another are important considerations for the mitigation of risk. For example, placing too much pay at risk can place a significant amount of pressure on the participants to deliver expected outcomes. This pressure may consciously or unconsciously affect decision making.

Effective investment performance measures.

An effective incentive plan will have measures that staff can directly affect, such as performance relative to the policy benchmark. Incorporation of metrics over which investment staff may not have control or influence, such as absolute return or peer group measures, may lead to unintended behavioral consequences and affect the competitiveness of the plan.

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Evaluation of performance in multiple contexts.

Incorporating the measurement and reward of individual contributions or the ability to qualitatively evaluate performance on both the overall organizational and individual level, such as the successful leadership of staff during a particularly challenging economic environment, completion of an asset allocation study or major rebalancing effort, is an effective way to ensure that performance is evaluated and rewarded in multiple contexts. This can provide a reference to not only what gets done, but how.

The use of credible benchmarking data.

Quantitative plans based predominantly on investment metrics with a capped incentive opportunity have a greater chance of passing the test for reasonableness. Utilizing credible survey data is key in knowing where to set these caps. Custom peer groups can be helpful, but should represent a robust and appropriately broad sampling of the relevant talent market. In addition, multiple survey sources should be utilized whenever possible.

PROCESS IS IMPORTANT

Aligning pay with performance for endowment investment staff and ensuring that the correlation is defensible requires a process of due diligence through Board and management oversight and good governance of the compensation decision-making process. A regular assessment of incentive programs as well as a strong partnership between the Investment and/or Compensation Committee, management and a qualified independent consultant is critical to the overall success and reasonableness of incentive compensation design.

About C3 Nonprofit Consulting Group

C3 Nonprofit Consulting Group is an advisory services firm focused exclusively on helping nonprofit organizations unleash the full potential of their people. We partner with nonprofits to design competitive compensation and rewards programs, build equitable workplace strategies, and implement talent programs designed to propel their missions forward. C3 is here to help your workforce thrive.

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