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MEMORANDUM

TO: Investment Committee, CalPERS
FROM: Lisa Bacon, Christy Fields, and Steve McCourt, Meketa Investment Group
CC: Nicole Musicco
DATE: September 19, 2022
RE: Total Fund Policy Revisions Relating to Real Assets—First Reading

Meketa Investment Group ("Meketa") has been asked in its capacity as Board Consultant for the Real Estate and Infrastructure asset classes to provide an opinion on revisions proposed for the CalPERS Total Fund Investment Policy ("TF Policy"). The redline proposal will be presented to the Investment Committee on September 19, 2022 as Item 05b-03 (with 05b-03 as the clean version).

In summary, Staff's substantive recommendations include the following revisions:

→ In Total Fund Investment Policy Section X. Real Assets

- Adding new Staff Authority limits for Real Estate and Infrastructure for a Deputy Chief Investment Officer;
- Increasing Staff Authority Limits for Infrastructure;
- Removing the Cumulative Fiscal Year Staff Authority Limit for the Real Assets Managing Investment Director; and
- Reducing the minimum permitted Net Asset Value ("NAV") percentage of Infrastructure assets located in the United States and increasing the maximum permitted NAV percentage located in International Developed Markets.

→ In Appendix 2: Investment Program Related Responsibilities

- Increasing the Real Assets transaction size that requires a Prudent Person Opinion.

Meketa has had a number of discussions with Staff about these proposed policy changes, and Staff's First Reading of these proposed changes reflect meaningful feedback from Meketa on each of the modified items. The proposed revisions reflect both the growth in the CalPERS Total System and Real Asset portfolios and changes in the marketplace. They also reflect the additional flexibility that will be required to fully execute the Total Fund strategy and the most recently adopted 2021 Real Assets Strategic Plan ("RA Strategic Plan"). In recent years, the Real Assets staff has grown in number and in specialized transactional experience to pursue the expanded options these revisions support. Individually and collectively these revisions focus on increasing responsiveness by Staff to investment opportunities, which could provide increased diversification and cost savings for CalPERS.

As described herein, Meketa concurs with the proposed policy changes. We believe that the changes are appropriate in the context of the Total Fund, the increased target allocation for Real Assets approved in November 2021, and the capacity of Staff to execute the RA Strategic Plan.

September 19, 2022

Proposed Changes

Total Fund Investment Policy Section X. Real Assets (the "RA Policy")

→ ***Table 3: Staff Authority Limits - Real Assets Program (page 26 in redline)***

- Staff Authority Limits for Infrastructure: The limits for infrastructure commitments and dispositions are each raised from $1 billion for the Managing Investment Director ("MID") and $2 billion for the Chief Investment Officer ("CIO"), to $2 billion and $6 billion, respectively. In Meketa's view, it is appropriate to increase these authorities for the Infrastructure portfolio given its current scale and future target allocation. For example, the Infrastructure portfolio's NAV has increased from 1.3% of the Total Fund to 2.6% in the last year through June 2022 and the RA Strategic Plan calls for its continued growth on a relative and absolute basis.
  - Consideration: Meketa believes the MID authority for Infrastructure should be the same as for Real Estate, set at $3 billion, and notes the CIO's new authority is the same for both asset classes at $6 billion.
- Deputy Chief Investment Officer(s) Authority Limits: New limits for commitments and dispositions are proposed to be established for a Deputy Chief Investment Officer(s) ("DCIO") for Real Estate and Infrastructure (but not Forestland) at a level between the MID and the CIO: $4.5 billion for Real Estate and $4 billion for Infrastructure. Meketa views this as a reasonable proposal, and encourages further discussions among the Board, Staff, and the new CIO around roles, responsibilities, and reporting lines, among other matters, related to the DCIO position and these authorities.
  - Consideration: Meketa believes the DCIO's authority for Infrastructure should be the same as for Real Estate, set at $4.5 billion, and notes the $500 million difference is an artificial function of calculating the midpoint between the MID and CIO authorities, with the proposed MID authority for Infrastructure currently set lower than for Real Estate, as noted above.
- MID Cumulative Fiscal Year Limit for Real Assets: The MID cumulative limits on commitments and dispositions are removed, under the rationale that it was not necessary or appropriate to impose a limit only on the MID. Meketa views this as a reasonable evolution of governance under the new CIO who we understand is in the process of establishing a new layer of review and approval above the asset class investment committees, the Investment Underwriting Committee ("IUC"). Meketa understands that proposed commitments above as-yet-finalized dollar thresholds by vehicle/relationship type will be vetted by the IUC. Meketa further understands that the IUC membership will comprise the CIO, DCIOs, MIDs, and other senior leadership.

→ ***Table 5: Geography (page 27 in redline)***

- NAV Ranges for the United State and International Developed: The permitted NAV percentage ranges for two of the four geographic regions are proposed for change as follows: the minimum for the United States is lowered to 30% from 40%; and the maximum for International Developed Markets is raised to 70% from 60%. This change is consistent with the global infrastructure opportunity set and will support CalPERS competitiveness in the marketplace, as Meketa noted in our comments on the RA Strategic Plan in July 2021.

Total Fund Policy Appendix 2: Investment Program Related Responsibilities, Private Asset Class Board Investment Consultant ("PACBIC")

→ ***Unnumbered Table: Real Assets Program Related Responsibilities (page 55 in redline)***

- Prudent Person Opinion Threshold: The transaction type/size for which a Prudent Person Opinion ("PPO") is required is proposed to increase from greater than \$100 million to greater than \$250 million, with the MID's discretion on PPOs increasing from up to \$100 million to up to \$250 million. PPOs are thus required for transactions greater than \$250 million. Meketa supports this increase and believes it is consistent with the scale of the RA Program and the Annual Investment Plan process.
- Independent Due Diligence Report: The table column referring to an "Independent Due Diligence Report (Not PACBIC)" is removed, as the term is not elsewhere defined, and is believed to be an errant remnant. We also note such a report was not required for any of the specified transaction thresholds. Meketa believes this change removes inapplicable legacy language and is appropriate.
- PACBIC Transaction Role: The table column referring to a "PACBIC Transaction Role" is removed, as the Board Consultant is not permitted to have a transaction role, as it was several policy iterations ago. Meketa believes this change removes inapplicable legacy language and is appropriate.

Summary Opinion

In general, the revisions to the RA Policy and TF Policy (the "Policies") are aimed at enhancing the Real Assets Staff's ability to more fully pursue the newly adopted target investment levels, and to position the CalPERS Real Assets Program to best leverage its size and reputation in the marketplace. The Real Assets market has continued to develop, while the RA Program has grown in size, specialization, and sophistication. The Policies should be viewed both from where the Program is now, as well as where it will be in the near future. It is appropriate, and necessary, that the Policies be reviewed and modified over time.

Staff has proposed these changes to the Policies for a first reading and we understand that Staff will provide a presentation at the Investment Committee meeting that discusses the proposed policy changes. We suggest that the Board carefully review these changes and hear from Staff about their vision for how the Program would develop in the coming years. Several of the proposed changes to Policies involve expansion of Staff's delegated authority, specifically around Staff's ability to source investments and commit more capital to such investments.

We remind the Investment Committee that the Policies are designed to provide a measure of risk control, as the Staff builds the RA investment portfolio under delegation from the Investment Committee. These delegations should be viewed from the perspective of the longer-term business plan, expected market conditions and opportunities, and Staff's experience and capabilities.

Meketa believes that it is appropriate for the Investment Committee, as a policy-oriented committee, to expand Staff delegation in areas where such expansion relates to areas where Staff has shown an ability to execute successfully and where the changes align with CalPERS' strategic goals. At the same time, it is appropriate for the Investment Committee to closely monitor the expanded delegation to ensure that such delegation results in the benefits anticipated by the Policy changes. To this end, Meketa will add to its semi-annual reporting to the Investment Committee specific monitoring of Staff's activity that falls under the expanded level of delegation.

In conclusion, Meketa believes that the proposed RA Policy and TF Policy changes are consistent with CalPERS' Investment Beliefs (specifically, Beliefs 3 and 4 related to costs and internal management), will facilitate Staff's ability to implement the RA Strategic Plan, and Meketa is supportive of the changes. Meketa further suggests that the Committee consider aligning DCIO and MID authority limits for Infrastructure with those of Real Estate, as expressed on page 2 of this memorandum.

We look forward to further interactions with the Board on this, and other topics. If you have questions, please feel free to contact us at (760) 795-3450.

LB/CF/SPM/jls