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MEMORANDUM

TO: Investment Committee, CalPERS
FROM: Steven Hartt, Judy Chambers, Stephen McCourt, Meketa Investment Group
CC: Nicole Musicco
DATE: November 14, 2022
RE: Private Equity Policy Related Revisions - Second Reading

CalPERS Investment Staff ("Staff") has provided Meketa Investment Group ("Meketa") with a First Reading of proposed revisions to the Total Fund Policy (the "Policy) and Glossary for review. Note that this memo is focused on the Private Equity-related portions of the Policy. Meketa has had several discussions with Staff about these recommendations and Staff has included Meketa's feedback in these suggested policy changes. These revisions reflect both the growth in the CalPERS private equity portfolio (the "Portfolio") and changes in the marketplace. They also reflect the expected flexibility likely to be required to more fully implement Private Equity's strategic plan as well as CalPERS' private equity strategic asset allocation target adopted in November 2021. In recent years, the Private Equity staff has grown in number and in specialized transactional experience to pursue the new options that these revisions create. Notably, many of these revisions focus on increasing opportunities for co-investments, which could provide considerable cost savings for CalPERS.

As a brief summary, Staff's recommendation includes the following revisions:

→ Increase delegated authority size across funds, Customized Investment Accounts, co-investments, and secondary purchases;

→ Add delegated authority limits for secondary sales;

→ Introduce the Deputy Chief Investment Officer delegated authority level;

→ Modify the circumstances requiring the use of PPOs in co-investments;

→ Expand the range of co-investment sources;

→ Modify limits on CalPERS' percent ownership stake in Customized Investment Accounts and funds; and

→ Adjust certain private equity strategy ranges and long term targets.

We encourage the Investment Committee to review the proposed Policy changes and continue to engage Staff in a dialog about the vision they have articulated for the Program's continued growth and execution of the Private Equity strategic plan. ***We concur with the proposed policy changes (as more fully described below), while highlighting areas that warrant additional reporting to the Investment Committee and on-going monitoring.***

We remind the Investment Committee that the Policy is designed to provide a measure of risk control, as Staff builds the Program under delegation from the Board. 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.

Below is a summary of the more significant modifications proposed by Staff and, where relevant, commentary from Meketa regarding each proposed change:

→ Increase delegated authorities. Previously, CalPERS had delegated authority limits that reflected the size of both CalPERS total fund and the Private Equity strategic target. This structure was changed to specific dollar limits during the last modification of the delegated authority limits in 2018. As we had discussed with the Investment Committee at that time, CalPERS' continued growth, as well as the growth in the Program, would necessitate a periodic revisiting of the delegated authority limits. Additionally, as part of the Private Equity strategic plan, Private Equity staff has significantly increased its activity to source and invest in no or low fee co-investments, which could provide meaningful cost savings to CalPERS. The Program is projected to continue to increase in the coming years as it grows to the 13% strategic asset allocation target. As a result, Staff will need to commit significant capital to Private Equity investments in the coming years. In summary, Staff is proposing the following changes to delegated authority:

	Funds ($B)	Co-Investments ($B)	Customized Investment Accounts ($B)	Secondary Market Purchases ($B)
MID	0.5 to 1.25	0.3 to 1.0	1.3 to 2.0	0.9 to 1.0
CIO	1 to 3	0.6 to 1.5	1.9 to 4.0	1.7 to 3.0

We believe the increase in delegated authorities is appropriate given the growth of both the Total Fund and the PE Program, as well as the increase to a 13% strategic asset allocation target. In several cases, the increase in delegated authority proposed above is in-line with delegated authority Staff would have had under the prior (pre-2018) structure. For context, we note that in June 2018 the Program NAV was $27.2 billion, or 7.2% of CalPERS total plan. As of the June 30, 2022 report, the Program had grown to $52.8 billion and represented 12.0% of CalPERS' total fund. Additionally, Meketa will monitor activities in this area of expanded delegation and report to the Committee in its semi-annual reviews, ensuring the Committee is prudently monitoring any emerging risks that are not properly compensated.

→ Introduction of Deputy Chief Investment Officer ("DCIO") to Delegated Authority structure. New delegated authority limits are proposed to be established for a Deputy Chief Investment Officer(s) ("DCIO") at a level between the MID and the CIO.

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.

→ Addition of Secondary Sales of funds and CIAs to Delegated Authority structure. The secondary market has evolved and grown meaningfully in recent years. As a result, Staff has been more active in considering sales of certain investments in the secondary market to modify the Program's exposures. The proposed PE Policy would have specific delegated limits related to secondary sales – MID $2 billion, DCIO $4 billion, and CIO $6 billion.

We believe the addition of secondary sale delegated authorities is appropriate given the developments of the secondary market, and Staff's potential use of secondary sales to adjust the Program's exposures.

→ Elimination of the MID Fiscal Year Limit. These limits 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.

→ Increase the co-investment investment level that would require the use of a PPO. As a part of a review of certain investment opportunities, CalPERS utilizes third party Prudent Person Opinions ("PPOs") to review and opine on the quality of an investment opportunity. However, in the case of co-investments, the time necessary for a PPO provider to engage and review an investment can hinder CalPERS' ability to meet the transaction timeline established by the GP, and, as a result, CalPERS could be excluded from being able to consider some co-investments. Staff has proposed increasing the co-investment size threshold required for PPOs from $200 million to $500 million.

We believe the increase in co-investment transaction size required for a PPO appropriate given the growth the Program, and the development of Staff's skills and experience in executing co-investments in recent years. Additionally, Meketa will monitor activities in this area of expanded delegation and report to the Investment Committee in its Trust Level reviews, ensuring the Investment Committee is prudently monitoring any emerging risks that are not properly compensated.

→ Expand the range of co-investment sources. Staff has made significant efforts to grow and develop its co-investment program in recent years. Additionally, recent performance of the co-investment program has been strong. Staff has proposed expanding the set of institutional investors from which it can seek co-investment opportunities, in order to provide CalPERS with a larger set of potential investments. Currently, CalPERS can only make co-investments alongside GPs where it also has a fund commitment. This condition allows Staff to benefit from the research and due diligence it has done to understand the GP's strengths and weaknesses, particularly as it can apply to co-investments (e.g., the GP is relatively strong in technology investments, but relatively weak in the consumer sector). Additionally, because the GP has a significant amount of CalPERS capital committed to their comingled fund, it is further aligned with CalPERS.

Staff's proposed PE Policy change eliminates the requirement that a co-investment be sponsored by a GP in its portfolio, but rather that the co-investment be completed alongside an institutional investor. However, the policy changes include the addition of PPO requirement for all co-investment opportunities with non-portfolio institutional investors greater than $250 million. Additionally, procedures for reviewing the non-portfolio institutional investor and co-investment opportunity will be added to the Private Equity Policy Related Procedures ("PRP"), which Meketa will be able to review.

Meketa believes that expanding the co-investment opportunity set to include institutional investors with which CalPERS does not have a fund investment expands Staff's ability to source and execute more co-investments. While this change has the potential to add risk due to less knowledge of, and alignment with, the non-portfolio institutional investors, Staff will utilize PPO providers for co-investments greater than $250 million from a non-portfolio institutional investor. Staff will add specific procedures to review non-portfolio institutional investors in the Private Equity PRP. Meketa will monitor activities in this area of expanded delegation and report to the Investment Committee in its Trust Level reviews, ensuring the Investment Committee is prudently monitoring any emerging risks that are not properly compensated.

→ Clarify that single asset GP secondaries will be treated as co-investments. GP secondaries involve transactions where the GP decides that it wants to hold a particular asset (often one that has and is expected to continue to perform well) for a longer period of time, while providing existing investors the opportunity to exit the investment. GPs will then seek additional capital, often from third parties, to provide the liquidity necessary to finance the exiting investors. These single asset transactions involve specific company risk and thereby could be viewed more like co-investments.

We concur with Staff's proposed characterization of single asset GP led secondaries as "co-investments" for purposes of delegated authority and PPO requirements.

→ Adjustment to certain sub-asset class range and long-term targets. Staff seeks to modify the ranges and long-term targets for certain sub-asset classes. Specifically, the range for Growth/Expansion and Venture Capital would be increased, while targets to Buyouts, Credit Related, and Opportunistic would be decreased.

We believe these incremental changes to sub-asset class ranges and long-term targets are appropriate and reflect CalPERS' Private Equity strategic plan.

→ Modify the Customized Investment Account ownership requirement. Currently, a CIA is required to have CalPERS as the only investor, other than the GP. Staff has recommended modifying this requirement such that CalPERS would have at least a majority ownership stake in the CIA. In this way, CalPERS could partner with other investors in a CIA and potentially increase the vehicle's scope and provide additional "eyes" on the CIA. We note that CIAs tend to have lower fees and expenses than the commingled funds that they invest alongside of, thereby providing CalPERS with reduced fees and expenses.

We concur with Staff's proposed change, which could expand the range of attractive CIAs available to CalPERS.

→ Increase the Private Equity Program's aggregate Net Committed Capital to any one general partner from 10% to 15%. To ensure manager diversification of underlying GPs the Private Equity Policy limited the concentration in portfolio commitments, with a higher maximum concentration to Blackstone, Carlyle, and Apollo at 15%. In recent years, Staff has built relationships with several high conviction managers, beyond the three specifically identified, that could provide access to attractive co-investment and CIAs, in addition to fund commitments.

We concur with Staff's proposed change as the number of high conviction relationships has increased. Additionally, we note that CalPERS' Private Equity Portfolio has significant manager and underlying diversification. Further, with several firms having become multi-asset class alternative managers, such manager-level exposures may also be monitored on a pan-CalPERS basis.

→ Increase the percent share CalPERS can obtain in a commingled fund from 25% to 35%. In order to ensure that a fund has a broad investor base, CalPERS is limited to be no more than 25% of the fund's commitments. In some cases, CalPERS may be offered a larger share of a particular fund, or the fund may be from a manger focused on smaller investments and thereby not raising a very large fund, improving economics for CalPERS.

We concur with Staff's proposed change. By increasing the commitment limit to 35%, CalPERS could have the opportunity to be a more significant investor in a potentially attractive fund.

Conclusions

In general, the revisions to the Private Equity-related sections of the Total Fund Policy and Glossary are aimed at empowering the Private Equity Staff to be better able to achieve the Private Equity strategic plan as well as achieve the 13% strategic asset allocation target. Additionally, these changes help the Program to best leverage its size and reputation in the marketplace. The private equity market has continued to develop, while the Program has grown in size, specialization, and sophistication. The Policy 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 Policy be reviewed and modified over time.

Staff has proposed these changes to the Policy for a first reading. We suggest that the Investment Committee 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 the Policy involve expansion of Staff's delegated authority, specifically around Staff's ability to source investments and commit more capital to such investments.

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 changes to the Policy. To this end, Meketa will add to its semi-annual Trust Level reporting to the Investment Committee specific reporting on the policy changes that have the potential to elevate risk in the Program.

In conclusion, Meketa believes that the proposed changes to the Policy should facilitate Staff's ability to implement Private Equity's strategic plan and the Program's strategic asset allocation target and is supportive of the changes.

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

SH/JC/SPM/jls