CalPERS

Investment Committee

Agenda Item 5a

November 14, 2022

Item Name: Revisions to the Total Fund Policies – Private Asset Classes – Second Reading

Program: Total Fund

Item Type: Action

Executive Summary

This item is seeking approval from the Investment Committee (Committee) regarding the proposed revisions to the Total Fund Investment Policy resulting from the Asset Liability Management (ALM) adoptions at the 2021 November Committee meeting.

Strategic Plan

This agenda item supports the CalPERS Strategic Plan goal to strengthen the long-term sustainability of the Fund.

Investment Beliefs

This item supports the following Investment Beliefs:

- Investment Belief 5 – CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution
- Investment Belief 6 – Strategic asset allocation is the dominant determinant of portfolio risk and return
- Investment Belief 7 – CalPERS will take risk only where we have a strong belief we will be rewarded for it
- Investment Belief 10 – Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives

Background

In November 2021, the Board approved a new Strategic Asset Allocation (SAA), which included increased allocations to Private Equity and Real Assets and the inclusion of Private Debt. The proposed revisions to the policy will support the Committee’s adopted return rate and SAA, as well as strengthen and facilitate the Fund’s governance and accountability to achieve the CalPERS goals and objectives.

Analysis

In order to facilitate achievement of the 6.8% expected return, this policy review is centered on supporting the implementation of the Private Asset Classes as it relates to the Strategic Asset Allocation adopted at the November 2021 Committee meeting.

Proposed changes include:

1. *Total Fund* ***(unchanged from 1st Reading)***
    a. Updates to the Staff Delegation Limits for Private Assets
    b. Revise Prudent Person Opinion (PPO) requirements for Private Equity and Real Assets and establish PPO requirements for Private Debt
    c. Updates to the Private Equity Program limitations and constraints
    d. Updates to the Real Assets Program limitations and constraints

Additional ministerial changes were made to reflect clean-up and formatting changes. For a more detailed summary of the proposed changes, refer to Attachment 2.

Board Direction

The Board asked for additional information with respect to the cost of missed opportunities associated with having today's lower delegation limits vs. the higher limits that staff proposed in the September Investment Committee first read of policy changes.

It is difficult to provide a complete picture of opportunity cost because our General Partners are typically not bringing potential deals to CalPERS that are larger than we can do. Said differently, when the GPs pick up the phone on a larger deal, they are calling their other clients and we see our peers doing larger deals than we can participate in. That said, even with today's limits, Private Equity and Real Assets have come across attractive deals in which they would like to commit in excess of their delegated authority and the commitments have been scaled back.

While this is by no means scientific, for the reasons mentioned above, the following information and statistics help give some perspective regarding the cost of having lower delegated authority limits.

Private Equity Co-Investments

- Co-investments are important to the Private Equity program due to the cost savings. The substantial majority of co-investments are effectively fee-free and carry-free, therefore investing $1 billion in co-investment is estimated to generate costs savings of $335 million over 10 years, relative to investing $1 billion in fund commitments through avoiding management and incentive fees.

- As the Private Equity program has ramped over the past few years, there has been a steady trend in General Partners offering larger deal sizes. In fact, a number of General Partners have asked if we could participate in deals at a size above our delegated authority limit. While it is difficult to quantify the specific opportunity size above our current delegated authority threshold, since we have not sought opportunities of that size, we believe it is substantial given General Partners' active offers of larger deals and peer institutions experience co-investing at that larger scale.

- Further, it will be challenging to ramp our co-investment program and achieve our targeted level of cost savings on the current trajectory. For example, the Private Equity team would have to look at as many as 50 deals per year to get close to our annual co-invest commitment target. Even at this pace, we will be looking to do larger co-investment deals than we have in the past. Small deals lead to a heavy monitoring burden, while larger deals will allow the team to scale the co-investment program.

Private Equity Funds

- Looking backward, the team made 116 fund commitments in 5 years and about 50% have exceeded the delegated authority of the MID. Two recent investments exceeded the CIOs authority and were scaled down.

- Going forward, given the current pacing, we expect that 70% of commitments will exceed the MID delegated authority limits.

- The team expects to commit to ~20 funds/year leading to ~70+ core managers over time, stretching team capacity limits. Higher delegated authority limits will allow the PE program to scale commitments to high-conviction managers.

Infrastructure

- 19 commitments were made in 5 years and 32% were above the MID delegated authority and were approved by the CIO. Two deals exceeded the CIOs authority and were scaled down to meet the CIO's delegation limit.

- Going forward, the team needs to commit $5 billion per year to infrastructure and the average commitment size is $1.25 billion per deal. Therefore, the majority of the infrastructure commitments will exceed the MID delegated authority.

While difficult to assess the specific impact of missed opportunities, we have ambitious targets for deploying capital in private markets, and higher delegated authority will help us to achieve them.

Budget and Fiscal Impacts
Not Applicable.

Benefits and Risks
The changes support maintenance of a strong governance framework for the management of the System's assets. There are no anticipated risks.

Attachments

Attachment 1 – Policy Revisions Review – Second Read Presentation
Attachment 2 – Inventory of Policy Revisions – Summary of Key Changes
Attachment 3 – Proposed Total Fund Policy (mark-up view)
Attachment 4 – Proposed Total Fund Policy (clean view)
Attachment 5 – Proposed CalPERS Glossary (mark-up view)
Attachment 6 – Proposed CalPERS Glossary (clean view)
Attachment 7 – Consultant Opinion Letter – Wilshire Associates (General Pension Consultant)
Attachment 8 – Consultant Opinion Letter – Meketa Investment Group (Private Equity)
Attachment 9 – Consultant Opinion Letter – Meketa Investment Group (Real Estate and Infrastructure)

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