



MEMORANDUM

To: Members of the Investment Committee, California Public Employees' Retirement System

Date: April 25, 2012

From: Stephen McCourt, David Altshuler, Meketa Investment Group

Re: 2011 Infrastructure Program Annual Review

In our role as Private Asset Class Board Investment Consultant for Infrastructure, Meketa Investment Group reviewed CalPERS' Staff Infrastructure Investment Performance Report for Calendar Year ("CY") 2011, in the preparation of our Annual Review of the Program.

BACKGROUND

CalPERS created its Infrastructure allocation in 2007 as part of the Inflation Linked Asset Class Program. In 2011, Infrastructure became a component program of the Real Assets asset class. The program has a target allocation of two percent of the total plan, which was equal to approximately \$4.5 billion at year-end.¹

Aggregate Portfolio (12/31/2011)	
Number of Investments	5
Committed Capital	\$870.0 million
Called Capital	\$619.1 million
Distributions	\$158.2 million
Reported Value	\$789.8 million
IRR ²	19%

Compliance with Policy Parameters

Per the Infrastructure Policy approved by the Investment Committee in August 2011, key Policy parameters related to diversification are applicable only when the Program NAV exceeds \$3 billion. As of December 31, 2011, the Program NAV was \$790 million. While the Policy guidelines are not yet applicable, a dollar cap by allocation applies at all times.³ For 2011, the Program was in compliance with these caps.

¹ As of 12/31/2011, the market value of the total plan was \$225 billion.

² IRR is net of fees, since inception.

³ According to Policy, Risk and Geographic allocations are not to exceed, on a dollar basis, the upper end of a range multiplied by the Program Allocation Target.

Memorandum
April 25, 2012
Page 2 of 5

Below, we provide a comparison of Program investment activity with Policy guidelines, based on the data prepared by Staff:

- **Risk:** The Infrastructure Program utilizes a three-part risk classification system comprised of Defensive, Defensive Plus, and Extended categories, and has assigned long-term strategic ranges and limits for each. At year-end, 0% of investments were classified as “Defensive,” (compared to a Policy range of 25-75%); 62.6% of investments were classified as “Defensive Plus” (compared to a Policy range of 25-65%) and 37.4% of investments were classified as “Extended” (compared to a Policy limit of range of 0-10%). Extended investments are represented by a commitment to the CIM Infrastructure Fund, a 2007 partnership. Per the Strategic Plan, which the Investment Committee approved in April 2011, we expect Staff to focus on Defensive and Defensive-Plus investments in the future.
- **Region:** The Infrastructure Program targets investments in the U.S., OECD countries ex U.S., and Less Developed regions. At year end, 34% of program assets were invested in the U.S. (compared to a Policy range of 40-80%) and 66% of Program assets were invested in OECD countries ex U.S. No assets were invested in Less Developed regions. The non-U.S. exposure is weighted towards Canada, through the CIM Infrastructure Fund, with additional exposure predominantly to Europe and the U.K., through both commingled funds and the Direct Investment allocation. Although the Program was slightly underweight to the U.S., in 4Q 2011 CalPERS agreed to acquire a direct stake in a submarine transmission line connecting New Jersey and New York. Over time, we expect increased investment activity in the U.S., both through the Direct Investments allocation, and CalPERS California Infrastructure outreach initiative.
- **Leverage:** The combined leverage ratio on the Program’s investments was 41.1% at year end (compared to a limit of 65% leverage on the overall Program portfolio). The leverage level is prudent and consistent with the Program objective of targeting low-risk investments with efficient levels of leverage.
- **Concentration:** Program commitments are all within the long-term concentration ranges, including private and public equities, debt, commitments to single funds, direct investments, and single fund investments.¹

Performance

The Infrastructure Program is focused on achieving stable performance over the long-term through commitments to a combination of illiquid private market partnerships and direct investments. The Program is still in an early stage, with less than 20 percent of the target allocation invested. And, as a new program, performance of the majority of investments is unrealized.

¹ Staff noted that the portfolio includes one investment made by the Real Estate Program prior to the existence of the Infrastructure Policy that would not have met the current concentration limits.

Performance vs. Policy Benchmark¹

	4Q 2011 (%)	1-Year (%)	3-Year (%)	Since Inception (%)
Infrastructure Program	0.5	42.5	26.2	8.0
Program Benchmark	0.4	7.6	7.3	6.8
Value-Added	0.1	34.9	18.9	1.2

The Infrastructure Program benchmark is CPI +4%. For CY 2011, the benchmark was equal to a nominal return of 7.6%. Infrastructure investments significantly outperformed the Program benchmark during CY 2011.

- **Total Program** For CY 2011, the Program returned 42.5%, which outperformed the benchmark by 34.9%.
- **Partnerships** The portfolio contains four partnerships, which represent 78.5% of the Total Program NAV at the end of 2011.² Strong performance among partnership commitments was driven primarily by the CIM Infrastructure Fund, which returned 105.4% for CY 2011 and represented 37.4% of the Total Program NAV.
- **Direct Investments** At year-end, the Program held one direct investment, which represented 21.5% of the Total Program NAV. The Direct Investment Portfolio had a net return of 54.7%, which outperformed the benchmark by 47.1%.

Investment Selection

The Infrastructure Program did not close on any new investments during CY 2011. However, Staff devoted significant time during the year reviewing several potential investments, screened from a large pool of opportunities. One opportunity advanced to final approval and was closed in early 2012.

Potential Investments Reviewed in 2011

	Direct	Commingled Funds	Separate/Custom Accounts
Advanced Screening	13	5	4
Due Diligence	5	-	-
Approved	1	-	-
Total	19	5	4

¹ All returns are time weighted. The Program benchmark is CPI + 4%.

² Partnerships include commitments to funds that were made by the AIM and Real Estate Programs, which were subsequently transferred to Infrastructure.

Memorandum
April 25, 2012
Page 4 of 5

During 4Q 2011, Staff substantially completed due diligence on Neptune Regional Transmission System ("NTRS"), a 65-mile submarine electric power transmission line connecting New Jersey and New York. The transaction, through which CalPERS acquired 75% of Class C shares of NTRS, reached financial close in 1Q 2012. Staff disclosed details on the transaction to the Investment Committee. Staff classified the asset as Defensive, due to its operational status and an existing 20-year, fixed-price capacity contract with the Long Island Power Authority, which provides cash yield through a monthly payment mechanism. This investment is consistent with the key Policy parameters, including a focus on U.S. based, cash yielding investments.

Monitoring Processes

Staff's monitoring processes are sufficient. There were no significant changes to the processes used by the Infrastructure team during CY 2011. Monitoring activities consist of ongoing review of the Program's partnerships, quarterly reporting and communication with General Partners regarding significant developments with portfolio companies, and Advisory Committee attendance, as appropriate. For the Program's direct investments, Staff attends most Board meetings. In addition to ongoing monitoring activities, Staff prepares a Quarterly Report, which is presented to the Chief Investment Officer and Senior Investment Officer - Real Assets. This report provides an overview of the program, detail on individual investments, and key developments at portfolio companies, and discussion includes performance drivers and results. The performance data comes from the AREIS system and is supplemented by materials from Advisory Committee and Board Meetings attended by Staff.

Internal Control Process

For processing all cash movements and record keeping, the Infrastructure Program utilizes the AREIS system, which is populated by external managers and validated by the Portfolio Analytics Unit. Depending on the size of the contribution to be funded, either Program Staff or the SIO has authority to approve transactions. The Internal Control Process was enhanced in 2011, when ARIES was updated to report on Program Investments by key Policy parameters, including Risk Classification and Region. In our view, this enhancement is positive and allows Staff to monitor compliance with relevant Policy guidelines.

The Internal Control Process utilized by Staff is sufficient for the size of the current Program commitments. However, as the portfolio grows in size and complexity, we expect that additional resources will be required, including enhanced capabilities for the analysis and management of a portfolio comprised of partnership and direct investments.

Staffing

Progress is being made on recruitment of staff resources to support planned growth of the Program. Recruitment progress is in line with the staff resources plan outlined in the *Infrastructure Strategic Plan (April 11, 2011)*.

Memorandum
April 25, 2012
Page 5 of 5

In 2011, the Infrastructure Program filled one IO III position and one IO II position. In April 2012 one PM position was filled. Staff is presently recruiting for two IO III positions (one new and one replacement) and one PM position.

Conclusion

Based on our review of information provided by Staff, Meketa Investment Group finds that Infrastructure Program activity during CY 2011 was consistent with guidelines outlined in the Infrastructure Policy, and annual investment performance exceeded the Program benchmark of CPI + 4%.

Please do not hesitate to contact us, should you have questions or require additional information.

Sincerely,



David Altshuler
Senior Vice President



Stephen P. McCourt, CFA
Managing Principal

DA/SPM/mah