Emerging Manager Five-Year Plan

Pathway to the Future

August 2012

CalPERS

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Executive Summary

The California Public Employees' Retirement System (CalPERS), headquartered in Sacramento, provides retirement and health benefits to more than 1.6 million public employees, retirees and their families, and more than 3,000 employers. CalPERS is led by a 13-member Board of Administration consisting of member-elected, appointed, and ex-officio members.

CalPERS has a legacy of leadership and innovation in emerging manager investment strategies. We have been investing with emerging managers directly and through fund of funds for over 20 years. We are proud to support the Toigo Foundation and the Altura Emerging Manager Data Base. With our new total fund approach coordinating emerging manager program reporting through the newly created Targeted Investment Programs, we are continuing our commitment to engage with the emerging manager stakeholder community, strengthen relationships with emerging managers and improve implementation of emerging manager investment strategies.

We are committed to equality of access and opportunity for our business partners and staff. As the nation's largest public pension fund, within the nation's most ethnically and culturally diverse state, we believe diversity and inclusion in our workforce, workplace, and marketplace improve business performance.

Chapter 701 of the Statutes of 2011 (SB 294 Price) requires CalPERS to complete and deliver a Five-Year Plan (Plan) that describes our efforts in emerging manager investing. A summary of the legislation appears in Appendix III. Implementation of Plan objectives centers on two major areas: Portfolio Management and External Outreach.

Organized around these two areas CalPERS has created ten work streams that will be the focus of work under the Plan. In accordance with the Legislation, CalPERS will provide annual reports on the progress of the Five-Year Plan. The Plan will examine what we have learned from over 20 years of investing with emerging managers, supplemented by data and insight from key stakeholders in our marketplace, to develop and apply an effective approach for engaging with emerging managers as a component of our investment strategy.

Introduction

CalPERS is a leader in developing and implementing emerging manager (EM) programs. In fact, we have a long history of investing in emerging fund managers. In 1991, CalPERS initiated an effort to retain EMs in underserved sectors of the United States, and in March 2000, we implemented the first formal EM program. In the first decade (2000 – 2009) of our formal EM programs, CalPERS launched multiple EM programs in several asset classes. Since 2010, CalPERS has made $900 million in new commitments to emerging managers. A timeline of CalPERS noteworthy EM investments appears in Appendix I.

EMs are generally defined as newly formed firms or firms raising first or second time funds. At CalPERS, EM definitions are based upon assets under management (AUM) and/or length of track record. An overview of current CalPERS Emerging Manager Programs and definitions across asset classes can be found in Appendix II. As of our most recent reporting period (June 30, 2011), CalPERS had almost $10 billion representing 12% of our total externally-managed net asset value (NAV) invested with over 300 EM investment firms.

CalPERS has a fiduciary duty set forth in the California Constitution, requiring our Board and staff to work at all times in the best interest of our 1.6 million members. For every dollar paid in CalPERS pensions, 66 cents comes from investment earnings, so successful returns from our investment strategies are essential.

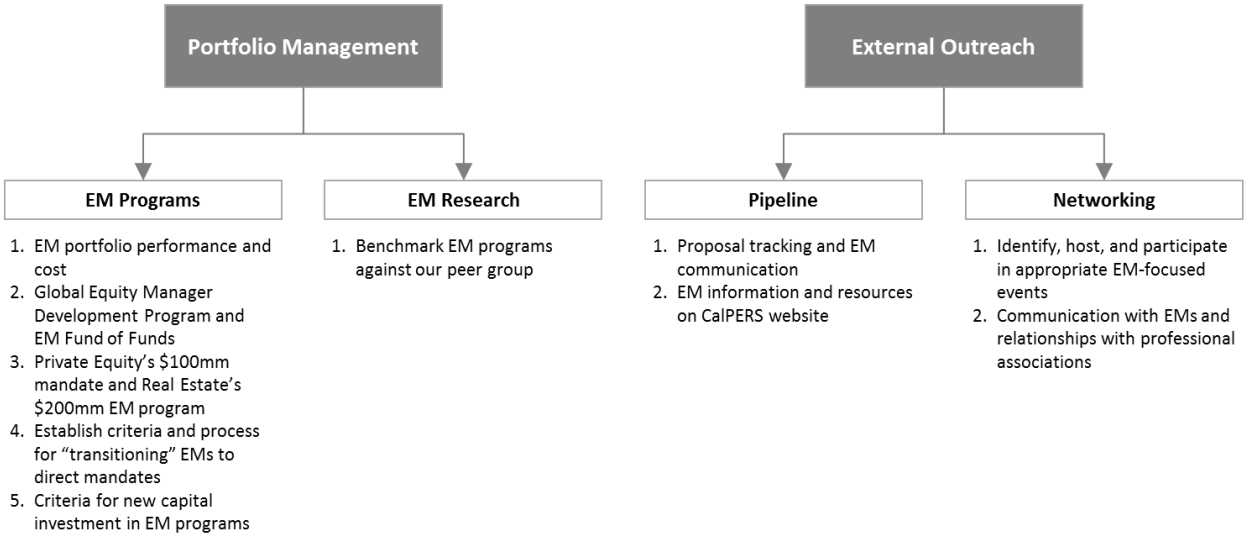
Our objective for investing in EM programs is to generate appropriate risk adjusted investment returns by identifying early stage funds with strong potential for success; accessing unique investment opportunities that may otherwise be overlooked; and cultivating the next generation of external portfolio management talent. The ultimate measure of success for our EM programs is investment performance against benchmark, and to date, performance against this metric has been mixed.

California law prohibits State agencies from discriminating against or granting preferential treatment to any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public contracting. CalPERS therefore may not grant preferential treatment to emerging managers based on the above characteristics. Women and minority managers are more likely to be emerging managers; as a result, an ancillary benefit of our EM strategies may be the increased diversification of CalPERS external fund managers.

This Plan outlines relevant components of the next era of CalPERS EM programs across two areas of focus: (A) Portfolio Management, and (B) External Outreach. As described in this report, CalPERS intends to execute ten distinct work streams organized underneath these two major topic areas (see Exhibit 1). CalPERS will monitor progress under the Plan and may make changes and adjustments to work streams as necessary. Any changes will be discussed in subsequent annual reports.

Exhibit 1

Five-Year Plan for Emerging Manager Participation Work Streams



CalPERS engaged RG & Associates, a consultant on the development, execution, marketing and communication of initiatives that serve the minority and women-owned business community. RG & Associates was retained to perform the research, analysis and key stakeholder engagement required to support the development of this Plan. The CalPERS Investment Office will fully develop the work streams, and execute this plan in consultation with internal and external stakeholders.

The Plan period commences August 1, 2012. The first annual report to the Legislature on March 1, 2014, will describe progress against the work streams depicted here over the 11-month period from August 1, 2012 through June 30, 2013 (the close of CalPERS 2012-2013 fiscal year). Future fiscal year annual reports will be due to the Legislature on each succeeding March 1 through 2017. Unless Senate Bill 294 is extended by the Legislature, the Plan and reporting requirements will end on January 1, 2018. The table in Appendix III provides full details on relevant reporting periods and dates for the Five-Year Plan.

Each asset class has set forth an approach to engaging emerging investment managers as a component of our investment strategy over the next five years. While EM strategies vary across asset classes, CalPERS objective for these programs is consistent: to achieve appropriate risk adjusted returns and harness the talent of new and emerging managers to meet CalPERS investment performance expectations.

In 2012, CalPERS created a Targeted Investment Programs (TIP) unit to improve coordination, analysis and reporting of EM programs and strategies at the Total Fund level. Accordingly, the TIP unit will be responsible for coordinating execution of this Five-Year Plan.

Work Streams

A. Portfolio Management Initiatives

EM Programs

EM Programs Work Stream 1:
Establish performance, cost, and diversity of existing EM portfolio [Years 1 – 3]

Investment performance of CalPERS emerging manager programs has been mixed. Several possible reasons for the underperformance of emerging manager strategies include CalPERS-specific issues such as lack of clearly structured programs and investment strategies; poor oversight of inexperienced managers; and poor governance rights for CalPERS. Other possible reasons for underperformance that are manager-specific include lack of discipline and focus on strategy in an escalating market cycle; key management team turnover; and lack of size and experience to withstand a market downturn. Attribution analysis of emerging manager investment performance is a key work stream of this Plan.

It is our goal, as a result of the work outlined in this work stream to better understand the business case for emerging manager strategies and deploy capital in the future based on the lessons learned from past experience.

In order to track and report on the performance of CalPERS EM portfolio, we will define a robust set of metrics, which will be useful in several ways. To manage performance, metrics will be important to set consistent and data-driven goals and identify attribution of performance drivers. A key output of this process will be identifying any common factors. To manage cost, appropriate and consistent metrics will enable CalPERS to fully understand the financial and human resources required to run EM programs, and allow these costs to be factored into key decision-making. In addition, CalPERS will track information about the diversity of our investment managers and fund of fund managers.

Led by the Targeted Investment Programs unit, CalPERS will continue to refine internal reporting processes, strengthen IT infrastructure as needed, and allocate necessary resources to efficiently capture the data required to support the focus on insightful metrics across all EM programs.

Desired outcomes within years 1-3:

- Identify and implement a consistent and clear set of metrics to assess EM program performance and cost
- Track information regarding the diversity of our investment managers
- Institute a process for evaluating EM program metrics to facilitate appropriate benchmark comparisons and guide program strategy
- Develop appropriate reporting approaches for each asset class and aggregate asset class reports into a Total Fund report

EM Programs Work Stream 2:
Review Global Equity Manager Development Program and EM Fund of Funds Program [Years 1-3]

CalPERS has a long history of investing in emerging managers across a variety of investment disciplines. In 2000, CalPERS Global Equity Unit (GEU) implemented the Manager Development Program (MDP) and in 2007 launched the Emerging Manager Fund of Funds Program (EMFOF). The MDP awards an investment mandate to an emerging manager while simultaneously positioning CalPERS as a minority stakeholder in the manager. In select instances, CalPERS provides seed capital to support or accelerate firm growth. MDP was initially structured as a closed-end limited partnership vehicle with committed capital of $3 billion. This program began the process of an orderly wind down pursuant to the partnership agreement terms during FY 2010-11. A follow-on program (MDP II) was established in 2006 and is structured with no defined investment period or committed capital, but rather designed to be invested opportunistically. As of June 30, 2011, the MDP program has a net asset value of $1.7 billion. The EMFOF program also allocates capital to fund of funds advisors who in turn select underlying small and emerging investment management firms. The EMFOF program began with a $1 billion allocation, and held $900 million in net asset value as of June 30, 2011.

In 2010, the GEU initiated portfolio restructuring to transition the traditional capital allocation model to a risk-adjusted return model. CalPERS is also currently reviewing the MDP and EMFOF programs with three key goals: to achieve superior risk-adjusted investment returns; to continue providing opportunities for new and emerging investment managers; and to incorporate emerging managers into the broader GEU capital allocation model. CalPERS expects to engage its fund-of-fund partners to better identify highly qualified managers, provide capability development guidance, and establish the process and criteria for determining whether to transition an emerging manager to a larger, direct investment mandate.

Desired outcomes within years 1-3:

- Conduct a strategic review of Global Equity MDP and EMFOF programs
- Identify a core set of high-performing emerging managers

EM Programs Work Stream 3:
Manage, track, and report progress of Private Equity's $100 million and Real Estate's $200 million Emerging Manager programs [Years 1 – 5]

Since August 2011, CalPERS has committed an additional $100 million and $200 million to its Private Equity and Real Estate EM programs, respectively. This work stream focuses on ensuring appropriate management and tracking of these recent investments.

***Private Equity**:* The EM program in Private Equity invests in first or second time funds. In April 2012, CalPERS expanded its Emerging Domestic Private Equity Program by $100 million and selected Credit Suisse Customized Fund Investment Group (CFIG) as the fund of funds manager. CalPERS staff will collaborate with CFIG to establish and maintain a robust management and reporting process, focusing both on monitoring investment performance and identifying best practices for EM management within the fund of funds structure.

***Real Estate**:* In August 2011, CalPERS approved a $200 million initial allocation for a new real estate EM program. The objectives of the program are to: 1) achieve risk-adjusted returns at or above the benchmark; 2) access investment opportunities that may not otherwise be pursued; and 3) source and mentor talented emerging investment managers, located in California, with the potential to grow and become successful institutional investment managers. In contrast to a more traditional fund of funds structure, this program will leverage one of CalPERS existing direct, external managers for program management. This "mentoring manager" will be responsible for selecting, managing, and mentoring the emerging managers that are chosen to participate. The mentoring manager has been selected, and CalPERS anticipates sourcing of emerging managers will begin in the second half of calendar year 2012.

Over the next five years, CalPERS will manage, track, and report on the progress of these new allocations in Private Equity and Real Estate. Once sufficient data is available to evaluate investment performance, cost and other relevant factors, CalPERS will assess the allocation of additional capital.

Desired outcomes within years 1-5:

- Develop appropriate metrics and approach for monitoring performance and assessing the success of Private Equity and Real Estate EM programs
- Manage, track and report progress on an ongoing basis to guide future investments
- Identify key success factors and lessons learned, to inform best practices and EM program development across asset classes

EM Programs Work Stream 4:
Establish criteria for "transitioning" emerging managers to direct mandates [Years 1 – 3]

CalPERS will establish criteria to evaluate emerging managers' potential for direct investment mandates. This approach will build upon demonstrated performance and capabilities; actively manage the risks associated with scaling up the size of the investment mandate; and provide managers a more clear understanding of what they need to do to compete for additional capital. This process will be initiated in Global Equity, and over time may apply to all of CalPERS EM programs. In addition, CalPERS will create forums and other mechanisms for sharing best practices among participating EMs in the programs.

Desired outcomes within years 1-3:

- Develop criteria for evaluating EM "transition" to direct mandates
- Through fund of fund partnerships and internal managers, engage with existing EMs to communicate the criteria for evaluation
- Track and report the number of EMs transitioned
- Create appropriate forums and mechanisms for sharing information on transitioning criteria with EMs and appropriate stakeholder groups

EM Programs Work Stream 5:
Evaluate and establish criteria for new capital to EM programs [Years 1 – 5]

Since early 2010, CalPERS has committed $900 million of new capital to emerging manager programs. What we learn from the research, analyses, outreach and strategic reviews conducted across the work streams contained in this Five-Year Plan will assist CalPERS in determining prudent targets for emerging manager participation. Factors to be considered include availability of new capital for investment, capital allocation among asset classes, percent of assets managed externally, EM program performance and costs, and the size of the viable universe of emerging managers. In addition, allocations of capital to EM programs will be adjusted to ensure alignment with CalPERS investment strategy.

Desired outcomes within years 1-5:

- Source and review data regarding EM program performance, cost and growth potential
- Design and execute targeted research and analysis efforts to develop a deeper understanding of EM performance
- Leverage internal and external insights to assess CalPERS EM programs and to inform the evolution of CalPERS EM commitment
- Establish criteria for success of EM programs
- Evaluate potential for new capital to be invested through EM programs

EM Research

EM Research Work Stream 1:
Benchmark EM program against our peer group [Years 2 – 5]

As part of a continuing commitment to maintain leadership in emerging manager programs, CalPERS will initiate a work stream to compare our EM programs against our peers. CalPERS will initially define a peer group of large public institutional plans in the United States. The consultant pool will be accessed to perform project definition, create the process and template for collecting information, and report the benchmarking conclusions.

Desired outcomes over years 2-5:

- Create and implement benchmarking analysis by asset class for EM program design and implementation

B. External Outreach Initiatives

Pipeline

Pipeline Work Stream 1:
Improve EM proposal tracking and communication [Years 1 – 3]

CalPERS is committed to providing access and opportunity for review of EM investment proposals. To facilitate this goal, CalPERS designed and implemented a new investment proposal entry system that became available through our website in July 2010. This system provides a direct route for potential managers to reach CalPERS investment decision makers within the appropriate asset class. CalPERS will initiate a work stream to educate and improve communication with potential EM partners regarding the web-based investment proposal submittal process, the decision criteria and process for evaluating investment proposals, and range of potential outcomes.

Desired outcome within years 1-3:

- Develop educational materials and more robust communication strategy regarding the process and the decision making criteria related to submittal of investment proposals.

Pipeline Work Stream 2:
Improve EM information and resources on CalPERS website [Years 3 – 5]

CalPERS will engage a consultant to review and enhance CalPERS existing external website. This evaluation will focus on the quality and completeness of the website's EM-related content and user functions related to EMs. At the end of this process, the consultant will provide an assessment and recommendations for how CalPERS can make greater use of its website to provide access to information for the EM community.

Desired outcomes over years 3-5:

- Conduct research and analysis to evaluate relevant portions of CalPERS website:
  - Outreach and analysis to understand user needs
  - Current tool capability, usability, and utilization assessment
- Define and implement required improvements for the use of the CalPERS website as a critical tool for communication and engagement with emerging managers

Networking

Networking Work Stream 1:
Identify, host, and/or participate in EM-focused events [Years 1 – 5]

CalPERS has a long history of sponsoring, hosting, and actively participating in numerous industry associations and events that champion emerging managers, including but not limited to the following representative examples:

Conferences
CalPERS attends and in some cases organizes conferences for EMs throughout the year to share information and create networking opportunities.

Webinars
The Investment Office and Office of External Affairs collaborated to design and host a webinar titled "Introducing Emerging Managers to CalPERS Investments" in June 2011. This outreach initiative explained our investment programs to new and emerging manager investment firms, including how to submit a proposal online directly to the CalPERS Investment Office.

Workshops
Also in June 2011, CalPERS hosted a workshop titled "Emerging Investment Manager Roadmaps" that afforded invitees an opportunity to ask senior staff in the Investment Office, consultants and advisors how to successfully organize their firms and build operations and compliance capabilities. Efforts such as this one assist managers in furthering their understanding of the competencies required to service the institutional marketplace. These capabilities span areas including compliance, operations, reporting and technology automation.

External events and engagement are critical to sharing information, building relationships and gaining marketplace insight required to maintain an EM program. Going forward, CalPERS will develop topics, hold workshops and webinars, and actively participate in appropriate industry conferences. This work will focus on sharing important information, improving communication with emerging managers, and strengthening relationships with professional associations.

Desired outcomes over years 1-5:

- Further strengthen CalPERS presence in EM networks through industry associations
- Co-host four emerging manager investment workshops with the Legislature and CalSTRS over two years
- Host two webinars per year focused on EMs and/or stakeholder groups
- Continue to participate in conferences and events featuring EM investment programs

Networking Work Stream 2:
Improve communication with emerging managers and professional associations [Years 1-3]

CalPERS is a longstanding supporter of industry trade associations, including those representing ethnic and gender affinity groups within the financial services industry. CalPERS believes that constructive engagement with the emerging manager community is a critical element to continuing our commitment to emerging managers. Our approach to strengthening engagement with EMs and professional associations will include four key areas: outreach, education and messaging, technology networking tools, and ongoing communication.

The education and messaging component of the work stream will include effectively communicating the range of programs and opportunities offered by CalPERS to the market. This will be accomplished through additional printed material and hosting periodic workshops for emerging managers. CalPERS intends to use the channels described above to assure that the emerging manager community is aware of new RFP and RFI opportunities.

Desired outcomes within years 1-3:

- Improve our messaging materials and website to communicate with EMs
- Engage directly with the EM community via workshops and interactions with trade and professional associations

Costs and Risks

This Five-Year Plan represents a significant commitment of resources by CalPERS to identify, source, develop the capabilities of, and communicate with emerging managers. Implementing the plan will incur costs, including staff to manage the programs, consultants to assist in program design, and incremental management fees for use of fund of fund structures. These additional Plan and program management costs create the risk of lower investment returns if the selected emerging managers do not meet performance expectations.

Conclusion

The ten work streams described in this Five-Year Plan provide a data-driven approach to evaluating current EM programs and ensuring CalPERS can access and utilize the capabilities of high-performing emerging investment managers. In aggregate, the steps outlined in this plan will ensure that CalPERS EM programs continue to serve their purpose of advancing our investment objectives while cultivating the next generation of portfolio manager talent. As required by legislation, CalPERS will report progress against this Plan on an annual basis.

Appendix I

CalPERS Emerging Manager Commitments from 1999 to 2012

May 1999:	$3 billion initial commitment to Global Equity Manager Development Program
December 1999:	$50 million commitment to the first emerging managers in the California Urban Real Estate program (California Urban Investment Partners)
April 2006:	Development of the Emerging Managers and Financial Services Database with CalSTRS
October 2006:	$400 million initial commitment to Private Equity Emerging Domestic Private Equity Manager Fund of Funds Program
February 2007:	$100 million initial allocation to Global Equity Manager Development Program Phase II
February 2007:	$350 million initial allocation to Absolute Return Strategies Fund of Emerging Hedge Funds Program
March 2008:	$150 million initial allocation to Global Equity Emerging Manager Fund of Funds Program
May 2010:	$100 million increase to Absolute Return Strategies Fund of Emerging Hedge Funds
September 2010:	$100 million increase to Global Equity EM Fund of Funds program
June 2011:	$400 million increase to Global Equity Manager Development program (Phase II)
August 2011:	$200 million initial allocation for Real Assets new Real Estate EM Program
April 2012:	$100 million Private Equity approved additional commitment to their Emerging Domestic Private Equity Program

Appendix II

CalPERS Emerging Manager Programs and Definitions

Emerging manager definitions are established by each asset class. Programs may seek emerging managers domestically or globally. All program reporting will distinguish between domestic US and international emerging manager exposure as noted on chart below.

Asset Class Parameters	Global Equity	ARS	Global Fixed Income	Private Equity			Real Assets
	Fund of Funds	Fund of Funds	Direct	Direct	Fund of Funds		Mentoring Manager
Emerging Manager Program Name	Emerging Manager Fund of Funds	Fund of Emerging Hedge Funds	None	None	Emerging Domestic Private Equity Managers		Real Estate Emerging Managers
Investment Strategy	Long Only - Publicly Traded Securities	Hedge Funds	All	Private Equity	Private Equity - Buyout and Special Situations	Venture Capital	Real Estate Separate Accounts and Commingled Funds
Product Size	None	< $1B	None	None	< $1B	< $500M	None
Firm AUM	< $2B	< $2B	< $2B	None	None	None	< $1B
Length of Track Record	None	None	None	First or Second Institutional Fund	First or Second Institutional Fund	First or Second Institutional Fund	First, Second, or Third Separate Account or Institutional Fund
Geographic Focus	None	None	None	None	Domestic US	Domestic US	Urban California

Appendix III

Summary of California Senate Bill 294 (Price)

- Commencing August 1, 2012, the board shall provide a five-year strategic plan for emerging investment manager participation across all asset classes.
- The board shall submit a report to the Legislature, commencing March 1, 2014, and each March 1 thereafter, regarding the progress of the strategic plan.
- The report shall be submitted in compliance with Section 9795 of the Government Code.
- The board shall define the term "emerging investment manager".
- Nothing in this section shall require the board to take action that is not consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution.
- This section shall remain in effect only until January 1, 2018, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2018, deletes or extends that date.

Plan Year	Plan Period	Report Date
1	August 1, 2012 – June 30, 2013	March 1, 2014
2	July 1, 2013 – June 30, 2014	March 1, 2015
3	July 1, 2014 – June 30, 2015	March 1, 2016
4	July 1, 2015 – June 30, 2016	March 1, 2017
5	July 1, 2016 – June 30, 2017[1]	January 1, 2018

[1] As the final year of this plan concludes January 1, 2018, CalPERS will deliver its final report on that date.

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