

Targeted Investment Programs and Manager Restructure Update Report

CalPERS' Investment Office Manager Restructure

The Investment Office is taking the next step in its multi-year effort to reduce risk, cost, and complexity in our portfolio so we can deliver the investment returns necessary to meet our obligations to our beneficiaries in the most efficient way. Reducing the risk, cost, and complexity of our portfolio has meant restructuring our relationships with external managers. As a result of this restructuring, we will have fewer, more strategic relationships, improved manager selection and oversight, and reduced costs while generating returns for the portfolio. An element of this restructuring is a new program providing the opportunity to transition emerging managers to direct relationships. Additional information about the transition plan follows in the report. Our goal through this ongoing restructure is more meaningful relationships with those external managers who are most aligned with CalPERS' investment strategy.

Targeted Investment Programs Update Report

The Targeted Investment Programs continues to make progress on the CalPERS Five-Year Plan for Emerging Managers, the Responsible Contractor Program, Diversity and Inclusion initiatives, and Investment Office External Communication efforts. This report provides highlights of recent work done in each of the work streams.

CalPERS' Five-Year Plan for Emerging Managers

This update highlights recent work done reflecting CalPERS' Investment Belief 3 that CalPERS' investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries. Progress on the CalPERS Five-Year Plan for Emerging Managers (Five-Year Plan) initiatives is provided in the following sections.

Emerging Manager Programs Work Stream 1: Establish performance, cost and diversity of existing emerging manager portfolio

Emerging Manager Performance

The efforts outlined under the Five-Year Plan for this work stream are complete. However, staff has undertaken a follow-on initiative to establish consistent emerging manager performance reporting in the semi-annual Chief Investment Officer's Trust Level Review Report. The report will delineate total emerging manager performance by asset class. This information will appear for the first time in the August 2015 Trust Level Review Report.

Emerging Manager Programs Work Stream 3: Manage, track, and report progress of Private Equity's \$100 million and Real Estate's \$200 million Emerging Manager Programs

Five new investments have been made in Private Equity's Emerging Manager Program managed by Grosvenor Capital Management, Customized Fund Investment Group since the last report.

- Avante Mezzanine Partners SBIC II, LP: Avante Mezzanine Partners, a women/minority-owned firm, looks to partner with private equity sponsors as well as invest directly with entrepreneurs and owners/managers in mezzanine transactions to finance buyouts, acquisitions, growth, minority recapitalizations, and refinancing.
- NovaQuest Pharma Opportunities Fund, LP: NovaQuest primarily focuses on expansion/late stage investments in clinical assets and commercial phase biopharmaceutical products.
- Stellex Capital Partners: Stellex Capital Partners, a minority-owned firm, invests in and manages distressed and special situation corporate assets, with a particular focus on middle-market companies in the United States and Europe that have revenues of \$2 billion or less.
- Revelstoke Capital Partners Fund: Revelstoke Capital Partners focuses on acquiring controlling stakes in platform companies primarily focused on healthcare and business services.
- EIV Capital Fund II: EIV Capital, a women-owned firm, provides growth capital to the energy industry.

In September 2014, Real Estate committed \$100 million to AGI Resmark Housing Fund (AGI Resmark), a multi-family residential apartment development fund focused in the San Francisco Bay Area. AGI Resmark is a co-investment partnership between AGI Capital and Resmark. AGI Capital is a woman and minority owned San Francisco-based, emerging manager real estate investment company. Resmark is a full service real estate investment firm who is serving as an advisor and mentor to AGI Capital.

In January 2015, CalPERS increased its initial commitment of \$200 million to Canyon Catalyst Fund to \$275 million. The Canyon Catalyst Fund is a joint venture between CalPERS and Canyon Capital Realty Advisors aimed at developing the next generation of real estate managers. As of March 31, 2015, Canyon Catalyst Fund invested \$170 million of its \$275 million commitment with four emerging managers.

In January 2015, Canyon Catalyst Fund increased its commitment to Pacshore Partners from \$30 million to \$50 million. Pacshore Partners is a Los Angeles based real estate firm specializing in commercial office and mixed use properties in Southern California.

In February 2015, Canyon Catalyst Fund increased its \$50 million commitment to Sack Properties to \$80 million. Sack Properties is a San Francisco based woman-owned firm specializing in multifamily properties in California.

Emerging Manager Programs Work Stream 4: Establish criteria for “transitioning” emerging managers to direct mandates

Emerging Manager Transition Plan

Many of CalPERS’ large established external managers started managing CalPERS’ capital as emerging managers. Over the past two decades all asset classes have transitioned emerging managers to direct relationships. This work was done on an informal case-by-case basis as newer emerging managers demonstrated successful track records.

As staff engaged with stakeholders on the development of the Five-Year Plan, stakeholders expressed concern over firms that grow beyond the definition of emerging manager but are not large and experienced enough to compete against established firms for direct investment mandates. In response to this concern, a work stream to establish program parameters and criteria for transitioning emerging managers to direct mandates was included in the Five-Year Plan.

In addition to responding to stakeholder concerns, the establishment of an emerging manager transition program is timely as we take the next step in a multi-year effort to reduce risk, cost, and complexity in our portfolio. This portfolio-wide restructuring effort will result in fewer relationships with larger investment managers. The establishment of a formal Emerging Manager Transition Program will provide an opportunity for CalPERS to continue to invest with successful emerging managers as they grow their businesses to scale and compete with established managers capable of managing large capital commitments on behalf of CalPERS.

The objectives of the Emerging Manager Transition Program are to generate appropriate risk adjusted investment returns by investing with managers with demonstrated Fund I and II success; continued access to investment opportunities with successful firms and increased representation of women and minority owned firms in the CalPERS portfolio; and to provide a path of growth and opportunity for emerging managers to build their firms to a size large enough to compete for entry into our pool of larger established managers.

The development of the Emerging Manager Transition Program started with a survey of asset class staff to gather information on their observations and experience with transitioning emerging managers in the past. Staff also gathered information from our pension peers, external advisors, and stakeholder groups. Key findings from this information gathering process include: A formal program is needed to provide specific program parameters and review criteria so emerging managers can anticipate and grow to scale appropriately; definitions need to be revisited so as not to restrict manager participation as assets under management restrictions typically found in emerging manager definitions can restrict follow-on fundraising efforts; and greater communication is needed on the opportunity to transition emerging managers to direct relationships. The

new Emerging Manager Transition Program addresses each of the issues identified in the survey and engagement process.

The Emerging Manager Transition Program will be established in the three asset classes with emerging manager programs: Private Equity, Real Estate, and Global Equity. Starting July 1, 2015, asset classes will be able to review potential transition candidates from our emerging manager programs as well as 'outside' managers who qualify under the definitions of the Transition Program. Over the course of the next five years, the Transition Program will in total commit up to \$7 billion to approximately 15 transitioning managers. Transition Program commitments will be direct relationships with CalPERS, managed by asset class staff. The evaluation criteria to determine transition candidates are the same as for all other manager selection decisions. The criteria are largely the same across asset classes and include the following key categories for review and due diligence: historical performance, strategy and value creation, management team and talent, asset allocation and portfolio fit, and alignment of interest.

The Emerging Manager Transition Program definitions and parameters vary by asset class and should be viewed as general guidelines in order to provide each asset class with flexibility in administering the Emerging Manager Transition Program. The definitions and approximate commitment amounts are as follows:

- Private Equity – 3rd, 4th, 5th, and 6th institutional funds; \$50 - \$300M allocations in direct relationship and CalPERS' staff oversight. Private Equity Transition Program will be up to \$2B in total capital allocations over the next five years.
- Real Estate – 4th, 5th and 6th separate accounts; \$200 - \$500M allocations in direct relationship and CalPERS' staff oversight. Real Estate Transition Program will be up to \$2B in total capital allocations over the next five years.
- Global Equity – Minimum \$2B assets under management with CalPERS representing no more than 25% of firm assets under management; \$500 - \$1B allocations in direct relationship and CalPERS' staff oversight. Global Equity Transition Program will be up to \$3B in total capital allocations over the next five years.

Networking - Work Stream 1: Identify, host, and/or participate in Emerging Manager-focused events

CalPERS Private Equity Women Investor Network Roundtable

The Investment Office held a roundtable discussion in collaboration with the Private Equity Women Investor Network (PEWIN) in March 2015 in Half Moon Bay. The event was sponsored by CalPERS and Grosvenor Capital Management. The discussion provided CalPERS with an opportunity to strengthen our relationships with senior women in the private equity industry.

New American Alliance (NAA) 2015 National Tour

The Investment Office hosted a roundtable discussion in May 2015 at CalPERS' headquarters in Sacramento. The roundtable discussion was part of the New American Alliance 2015 National Tour. This event provided CalPERS with an opportunity to strengthen our relationship with members of the New American Alliance.

CalPERS Emerging and Diverse Manager Day September 2015

The Investment Office, in collaboration with External Affairs, is planning the second CalPERS Emerging and Diverse Manager Day to take place on September 9, 2015. The event will provide participating managers with an opportunity to meet with CalPERS' senior staff in the Private Equity, Global Equity, and Real Estate asset classes. The event will feature scheduled meetings that allow emerging and diverse managers to introduce their firm, discuss an investment opportunity, and receive direct feedback from senior staff.

Participation in Emerging Manager Focused Events

Staff participated in 12 other emerging and diverse manager events from December 2014 – June 2015.

Responsible Contractor Program/Labor Update

This update highlights recent work done reflecting CalPERS' Investment Belief 4 that long-term value creation requires effective management of three forms of capital: financial, physical, and human. The following report provides an update on the amended Responsible Contractor Program Policy (RCP Policy or Policy) and labor issues that have occurred since the December 15, 2015 Annual Responsible Contractor Program Report.

Update on Amended RCP Policy

On March 16, 2015 the Investment Committee approved amendments to the Statement of Investment Policy for the RCP Policy. The revised RCP Policy will go into effect July 1, 2015. The new Policy has been posted to the CalPERS website and all applicable Real Assets managers have been notified. The Investment Office will host a meeting, in July 2015, for Real Assets managers to discuss the revised and enhanced Policy.

SEIU Campaign

SEIU has reached out to staff to discuss their current and upcoming labor contract negotiation process for janitorial and security workers in markets across California. SEIU's contract negotiations are focused on United Protection Security Group, Inc. (UPS). UPS has unionized workers in markets with union representation and non-unionized workers in non-union markets notably Silicon Valley, San Diego, and Orange County. SEIU is seeking to unionize those areas that are not currently under union contract agreements. SEIU has asked CalPERS staff to reach out to two external managers with assets in these areas to request that they meet with SEIU and keep open lines of communication throughout the contract negotiation process. Staff has made the requested contact with the managers.

Other Labor Engagement

Cambodia/Yakjin/Carlye

On February 26, 2015, the Coalition of Cambodia Apparel Workers informed Private Equity manager The Carlyle Group (Carlyle) and CalPERS of unfair labor practices and health and safety issues at Yakjin Trading Corporation (Yakjin). CalPERS' Private Equity unit holds a minority investment in Yakjin through a commingled fund managed by Carlyle.

Staff engaged with Carlyle to better understand the issues. During the course of that engagement, Carlyle reported that Yakjin has presented a unionized contract offer to workers and has addressed the health and safety issues raised by the union. SEIU has confirmed that the Coalition has received a contract offer from Yakjin and that no further CalPERS engagement was necessary at this time.

Unite Here/Hilton

Unite Here has informed staff of unfair labor practices and National Labor Relations Board filings at certain Hilton hotels across the United States. CalPERS holds a minority equity position in Hilton through Blackstone. Blackstone has facilitated a meeting between Unite Here and Hilton. The National Labor Relations Board announced it will hear complaints of unfair labor practices at one of the hotels, Hilton New Orleans Riverside.

Diversity and Inclusion

The following report provides an update on Investment Office Diversity and Inclusion (D&I) initiatives that have occurred since the last update June 16, 2014. The Investment Office D&I initiatives focus on three areas: Corporate Boards, External Managers, and Investment Office talent management.

Diversity and Inclusion Steering Committee

To lead D&I efforts the Investment Office has established a Diversity and Inclusion Steering Committee (Steering Committee). The Steering Committee is guided by Investment Belief Number 10, "Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives. *Diversity of talent (including a broad range of education, experience, perspectives and skills) at all levels (Board, staff, external managers, corporate boards) is important.*"

The Steering Committee is comprised of the Chief Investment Officer, Chief Operating Investment Officer, a Senior Investment Officer, two Senior Portfolio Managers, and two Investment Officers. The Steering Committee develops D&I goals and priorities and provides direction and oversight on the three D&I work streams. To assure that Investment Office initiatives are aligned with CalPERS as a whole, the Steering Committee collaborates with the broader enterprise including Human Resources, the Diversity Office Program, and the Legal Office.

CalPERS Diversity Forum September 2015

The Investment Office is planning the up-coming CalPERS Diversity Forum to take place on September 10, 2015. The event will focus on the lack of diversity in the investment and finance industries. Panel discussions will focus on identifying best practices and

initiatives that will result in increased diversity on corporate boards, executive leadership teams, ownership of external manager firms, and company staff.

Corporate Boards

CalPERS invests in over 10,000 companies worldwide and we have a voice as owners. We view board quality and diversity as critical to a company's performance. We promote diversity in the boardroom through advocacy, engagement, and outreach.

Diverse Director DataSource (3D)

CalPERS is the co-founder of the 3D Database focused on providing a pool of diverse talent for companies looking for skilled individuals to serve as board members. This August, Morgan Stanley Capital International (MSCI) completed its acquisition of GMI Ratings – the previous owner and operator of the 3D Database. CalPERS and CalSTRS continue to work closely with MSCI through this transition. The database has grown to over 750 searchable candidates from across the globe.

Board Quality & Diversity Event – Council of Institutional Investors

On March 31, 2015, CalPERS, CalSTRS and North Carolina Retirement System hosted a side event at the spring Council of Institutional Investors Conference on Board Diversity. A number of topics were covered such as the 30% Coalition and the California Initiative, a new SEC Petition on Enhanced Disclosure.

New Securities and Exchange Commission Petition on Enhanced Disclosure

On March 31, 2015, CalPERS alongside eight other pension funds, called on the Securities and Exchange Commission (SEC) to strengthen disclosure of corporate board diversity. A joint letter was sent to the SEC urging the adoption of a rule requiring corporate disclosure of board nominees' gender, racial, and ethnic diversity, as well as the mix of skills, experiences and attributes.

Board Accountability Project – Proxy Access

Proxy Access gives shareowners in the United States the right to nominate director candidates on a company's ballot or proxy statement. This has been longstanding priority for CalPERS, to ensure board accountability. NYC Funds have filed proxy access shareowner proposals at 75 companies. Companies have been selected based upon specific criteria that include Board diversity issues. CalPERS' staff has been assisting NYC funds by engaging with shareowners and companies, to endorse a favorable outcome. Of the companies where a diversity proposal was filed, two have recently gone to a vote and neither passed although there was significant shareholder support.

- VCA Inc. – received 46% of the “for” vote cast
- Paccar Inc. – received 42% of the “for” vote cast (preliminary number)

Global Governance Principles

On March 16, 2015, the Investment Committee amended the Global Governance Principles to include sexual orientation and gender identity when assessing Board talent and diversity.

External Managers

CalPERS deploys approximately \$90 billion of capital through external investment managers. As part of our commitment to equality of access, we seek to understand and report the diversity of our external managers, as well as the broader investment industry. We engage with our external managers, our pension peers, and the investment industry broadly on these important issues through our Emerging Manager Five-Year Plan, industry research, and industry conferences and organizations.

External Manager Engagement

The Investment Office sent the Investment Manager and Consultant Survey Report to CalPERS' investment managers and consultants. CalPERS' external investment managers, consultants, and stakeholders took part in a webinar in September 2014. During the webinar staff presented findings of the Investment Manager and Consultant Diversity & Inclusion Survey¹. As noted in the Emerging Manager Update, staff participated in 12 emerging and diverse manager events from December 2014 – June 2015. At these events, staff engaged with investment industry and stakeholders on these issues.

Global Equity Internal Equity Brokerage

CalPERS Global Equity trading activity is implemented through a number of brokerage relationships. The brokerage community may apply to be selected as a broker through a web based questionnaire available on CalPERS external website. Semiannually, each brokerage is evaluated based on qualitative performance measures.

Staff and Mosaic Investment Advisors established enhancements to the broker selection process to better identify and report women and minority-owned brokerage firms. CalPERS definition of a diverse equity brokerage business was developed, along with a series of voluntary questions to improve identification and reporting of consistent information about women and minority ownership of brokerage firms. The semiannual posting of selected brokers on the Investment Office website now includes identification of women and minority-owned brokerage firms. Currently 24% or five of the 21 brokers authorized to trade for CalPERS are women or minority owned firms.

Investment Office Talent Management

CalPERS views diversity within its workforce as a competitive advantage. Our differences with respect to culture, life experience, gender, and ethnicity enable us to more effectively meet the needs to the CalPERS diverse member base. The appointment of competent and talented employees is critical to CalPERS continued success. We believe that diversity and inclusiveness enriches CalPERS as a workplace and we are dedicated to providing equal opportunity to all employees and applicants for employment.

The CalPERS Investment Office, Diversity Outreach Program, and Human Resources Division initiated a project aimed at identifying leading diversity practices to attract, retain, and develop diverse talent for the Investment Office. CalPERS goal is to implement best

¹ Report of the survey results can be accessed at <http://www.calpers.ca.gov/eip-docs/about/committee-meetings/agendas/invest/201406/item07c-03.pdf>

practices and establish relationships with diverse organizations. This initiative is ongoing and continued progress will be reported to the Investment Committee.

Investment Office Demographics

In order to establish baseline demographic information, staff has engaged Heidrick and Struggles to survey the gender, race, and ethnicity of Investment Office staff. The survey is expected to be conducted this summer with results published later this year. The survey results will provide baseline for comparison as future Talent Management D&I initiatives are implemented.

Investment Office Strategic Partnerships

The Investment Office is developing strategies and establishing partnerships with diverse organizations to work on Talent Management initiatives. An extensive research and interview process led consultant Heidrick and Struggles to recommend five diverse organizations for partnership with the Investment Office. The results of these partnerships are intended to better align CalPERS with industry best practices, staff development, and improved access to a diverse pipeline of talent. This work is in the early stages of development of goals and milestone of success.

Toigo Foundation

One of the five strategic partners, Toigo, is the only partner with a well-established relationship with CalPERS. CalPERS has a place on Toigo Foundation's Advisory Board, attends Toigo diversity forums, and works with Toigo on issues of mutual interest in the finance industry. CalPERS advertises positions on Toigo's website, and has employed Toigo interns including one who will work with Global Governance this summer.

In October 2014, the CalPERS Investment Office, in conjunction with the Toigo Foundation, hosted a webinar entitled Careers with a Difference – Working in the Public Sector. The purpose of the webinar was to educate Toigo fellows about CalPERS Investment Office and careers.

Diversity Recruitment Efforts

The Investment Office advertises open positions through State and investment focused job sites. In 2014, advertisements were expanded to posting on job boards and newsletters with our diverse stakeholders including New America Alliance, National Association of Investment Companies, National Association of Securities Professionals, Association of Asian American Investment Managers and the Toigo Foundation.

Pipeline of Talent – MBA Statistics

In 2014, staff surveyed all CalPERS investment managers and consultants to better understand the participation of women and minorities in those firms. The survey found very limited participation of women and minorities, particularly in managerial and executive positions. The low representation of women and minorities was compared to, and found to be consistent with Equal Employment Opportunity Commission data on the investment and finance industry broadly.

The results of the survey raised the question: What is the diversity of the pipeline of talent leading to the investment and finance industries? Staff researched Master's in Business Administration (MBA) program enrollment at business schools in California and across the United States. For enrollment year 2011-12², staff found the following information:

Table 1: Gender at Top Tier California vs All California MBA Programs³

	<u>Men</u>	<u>Women</u>
Top Tier California Business Schools	70%	30%
All California Business Schools	59%	41%

- Men outnumber women more than 2 to 1 in Top Tier California MBA Programs
- Enrollment in University of California, Stanford, and University of Southern California business schools was less gender diverse than other California MBA Programs.

Table 2: Ethnicity at Top Tier California vs. All California MBA Programs³

	<u>Caucasian</u>	<u>African American / Black</u>	<u>Latino / Hispanic</u>	<u>Asian</u>	<u>Other / Unknown</u>
Top Tier California Business Schools	49%	2%	6%	33%	10%
All California Business Schools	42%	7%	10%	21%	20%

- Black and Hispanic students in California are less represented at top tier institutions. Hispanics are not entering MBA programs at a rate representational of their percentage of the California⁴ population.

Table 3: Gender at California vs. U.S. MBA Programs

	<u>Men</u>	<u>Women</u>
California Business Schools ³	59%	41%
U.S. Business Schools ⁵	71%	29%

- California MBA programs are more gender diverse than national programs.

² The most recent year statistics are available.

³ SOURCE: U.S. Department of Education, National Center for Education Statistics.

⁴ Not all students report race/ethnicity; therefore, statistics are not definitive.

⁵ SOURCE: United State Government Accountability Office analysis of Association of Advance Collegiate Schools of Business international data.

Table 4: Ethnicity at California vs. U.S. MBA Programs

	<u>Caucasian</u>	<u>African American / Black</u>	<u>Latino / Hispanic</u>	<u>Asian</u>	<u>Other / Unknown</u>
CA Business Schools ³	42%	7%	10%	21%	20%
US Business Schools ⁵	71%	9%	7%	11%	2%

- California MBA programs are more racially diverse than national programs.

Investment Office Communication

Investment Proposal Tracking System

In the past quarter, staff conducted a review of the Investment Proposal Tracking System (IPTS) in order to identify key issues and areas requiring improvement. Staff focused efforts on two main IPTS work streams:

External Stakeholder Improvements

Staff identified three areas of enhancement the external stakeholder and user experience:

- Rename IPTS to Investment Proposal Submission
- Include introductory language that assures proposers that investment proposals are thoughtfully and carefully considered using consistently applied criteria by investment office staff as part of a larger investment decision making process

Internal Stakeholder Improvements

Staff has identified several projects to enhance the utilization of the Investment Proposal Submission within the Investment Office. The identified enhancements, when implemented, will increase efficiencies and streamline processes and operational improvements in the Investment Office. The identified enhancements include:

- Revise the governance of the Investment Portal and transition the administration of the system from a development approach to a methodology of continued improvement and maintenance.
- Automation of placement agent disclosure tracking
- Enhance the investment solicitation process allowing for more flexibility when conducting an investment manager search

CalPERS Website Usability Improvement Initiative

In coordination with the Office of Public Affairs website improvement team, Targeted Investment Programs led a cross asset class team in content development for the new Investment Office webpages. Content development was carried out through five categories in the Investment Office: About the Investment Office, Asset Allocation, Business Opportunities, Engagement & Governance, and Policies & Principles. After a “mock up” site was created by Public Affairs, content develop meetings were held, followed by meetings with Investment Office subject matter experts in each area. The content was loaded on a CalPERS pilot site for review and refinement. Final edits are

underway and the new CalPERS website is on track to launch on June 28, 2015 with a new look, content, and feel.

Public Records Act & my|CalPERS Requests

Targeted Investment Programs oversees all Public Records Act requests and responses to questions received through the my|CalPERS system for the Investment Office. Staff works with all asset class and program areas to facilitate the gathering and distribution of all materials for fulfillment of requests and responses to questions. Below is a summary of Public Records Act and my|CalPERS requests by quarter since July 1, 2014.

Table 5: External Requests by Quarter

	<u>1Q 2014</u>	<u>2Q 2014</u>	<u>3Q 2015</u>
Total Number of PRAs	27	22	16
Total Number of my CalPERS	404	170	134

Investment Office Liaison with Legislative Affairs Division

In coordination with the Legislative Affairs Division, the Targeted Investment Programs leads the Investment Office response to California focused legislative inquiries, bill analysis, and presentations to elected officials and staff. Since the beginning of the new legislative session, staff has engaged on the following legislative proposals:

Table 6: Summary of Current Legislative Proposals

<u>Bill Number</u>	<u>Author</u>	<u>Topic</u>
AB 1052	Cooley	Investments: Contracts
AB 1410	Nazarian	Turkey divestment
SB 185	De Leon	Coal divestment
SB 216	Pan	Housekeeping bill
SB 574	Pan	Investment Fund Disclosure
SB 588	De Leon	Wage Theft