MEETING

STATE OF CALIFORNIA

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

BOARD OF ADMINISTRATION

INVESTMENT COMMITTEE

OPEN SESSION

ROBERT F. CARLSON AUDITORIUM

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SACRAMENTO, CALIFORNIA

MONDAY, AUGUST 17, 2015

9:30 A.M.

JAMES F. PETERS, CSR
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A P P E A R A N C E S

COMMITTEE MEMBERS:

Mr. Henry Jones, Chairperson

Mr. Bill Slaton, Vice Chairperson

Mr. Michael Bilbrey

Mr. John Chiang, also represented by Mr. Frank Moore

Mr. Richard Costigan

Mr. Rob Feckner

Mr. Richard Gillihan, represented by Mr. Ralph Cobb

Ms. Dana Hollinger

Mr. J.J. Jelincic

Mr. Ron Lind

Ms. Priya Mathur

Ms. Theresa Taylor

Ms. Betty Yee

STAFF:

Ms. Anne Stausboll, Chief Executive Officer

Ms. Ann Boynton, Deputy Executive Officer

Ms. Cheryl Eason, Chief Financial Officer

Mr. Ted Eliopoulos, Chief Investment Officer

Mr. Matthew Jacobs, General Counsel

Mr. Eric Baggesen, Managing Investment Director

Mr. Scot Blackledge, Assistant Chief, Legislative Affairs Division

A P P E A R A N C E S   C O N T I N U E D

STAFF:

Mr. Réal Desrochers, Managing Investment Director

Ms. Cheryl Edwards, Committee Secretary

Ms. Christie Gogan, Investment Director

Mr. John Rothfield, Investment Director

Mr. Wylie Tollette, Chief Operating Investment Officer

ALSO PRESENT:

Ms. Julia Bonafede, Wilshire Consulting

Mr. Andrew Bratt, Pension Consulting Alliance

Mr. Dan Crowley, K&L Gates(via teleconference)

Ms. Christy Fields, Pension Consulting Alliance

Mr. David Glickman, Pension Consulting Alliance

Mr. Andrew Junkin, Wilshire Consulting

Mr. Tom Keck, StepStone

Mr. Mike Moy, Pension Consulting Alliance

Mr. Michael Ring, Service Employees International Union

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1 P R O C E E D I N G S
2 CHAIRPERSON JONES: I would like to call the
3 Investment Committee meeting to order. The first order of
4 business is roll call, please.
5 COMMITTEE SECRETARY EDWARDS: Henry Jones?
6 CHAIRPERSON JONES: Here.
7 COMMITTEE SECRETARY EDWARDS: Bill Slaton?
8 VICE CHAIRPERSON SLATON: Here.
9 COMMITTEE SECRETARY EDWARDS: Michael Bilbrey?
10 COMMITTEE MEMBER BILBREY: Good morning.
11 COMMITTEE SECRETARY EDWARDS: John Chiang
12 represented by Frank Moore?
13 COMMITTEE MEMBER CHIANG: Good morning.
14 COMMITTEE SECRETARY EDWARDS: Richard Costigan?
15 COMMITTEE MEMBER HOLLINGER: John Chiang is here.
16 COMMITTEE MEMBER EDWARDS: Oh, I'm sorry.
17 (Laughter.)
18 COMMITTEE SECRETARY EDWARDS: Richard Costigan?
19 CHAIRPERSON JONES: Excused.
20 COMMITTEE SECRETARY EDWARDS: Rob Feckner?
21 COMMITTEE MEMBER FECKNER: Good morning.
22 COMMITTEE SECRETARY EDWARDS: Richard Gillihan
23 represented by Katie Hagen? Not --
24 THE COURT REPORTER: Ralph Cobb.
25 COMMITTEE SECRETARY EDWARDS: I'm sorry?

1 THE COURT REPORTER: Ralph Cobb.
2 COMMITTEE SECRETARY EDWARDS: By Ralph Cobb, I'm
3 sorry?
4 ACTING COMMITTEE MEMBER COBB: Here.
5 COMMITTEE SECRETARY EDWARDS: Dana Hollinger?
6 COMMITTEE MEMBER HOLLINGER: Here.
7 COMMITTEE SECRETARY EDWARDS: J.J. Jelincic?
8 COMMITTEE MEMBER JELINCIC: Here representing
9 myself.
10 COMMITTEE SECRETARY EDWARDS: Ron Lind?
11 COMMITTEE MEMBER LIND: Here.
12 COMMITTEE SECRETARY EDWARDS: Priya Mathur?
13 COMMITTEE MEMBER MATHUR: Good morning.
14 COMMITTEE SECRETARY EDWARDS: Theresa Taylor?
15 COMMITTEE MEMBER TAYLOR: Here.
16 COMMITTEE SECRETARY EDWARDS: Betty Yee?
17 COMMITTEE MEMBER YEE: Here.
18 CHAIRPERSON JONES: Okay. Thank you very much.
19 The next item on the agenda is the Executive Report, Chief
20 Investment Officer briefing. Mr. Ted Eliopoulos.
21 CHIEF INVESTMENT OFFICER ELIOPOULOS: Good
22 morning, Mr. Chairman.
23 CHAIRPERSON JONES: Good morning.
24 CHIEF INVESTMENT OFFICER ELIOPOULOS: Good
25 morning, Investment Committee members. I'm going to focus

1 my comments today -- this morning on a subject that has
2 definitely been well covered in the media over the course
3 of the last few months and that's private equity industry,
4 in general, and, in particular, private equity fees and
5 carried interest.
6 I will cover -- as I usually do, I'll start from
7 our Investment Beliefs, then talk about our PEARS Project,
8 talk a little bit about the complexities of private equity
9 for CalPERS and then end with a discussion of the
10 alignment of Board and staff around the private equity
11 portfolio.
12 So with that, I'll start with Investment Beliefs.
13 And as was highlighted in last December's Private Equity
14 Program review, private equity does have, and clearly has,
15 some characteristics that are clearly aligned with CalPERS
16 Investment Beliefs, such as our long-term time horizon,
17 and our willingness to take risk where we expect to be
18 adequately rewarded.
19 Over the long term, our Private Equity Program
20 has generated absolute returns in line with our
21 expectations. Currently, private equity is the only asset
22 class in our portfolio that is expected to exceed our
23 seven and a half percent target rate of return on a net
24 basis. As such, private equity remains an important
25 component of our portfolio and the overall sustainability

1 of the CalPERS system.
2 You may also recall, however, that in that same
3 program review, and from other conversations we've had in
4 this Committee, there are elements of private equity that
5 are not as well aligned with our Investment Beliefs. In
6 fact, it was the only asset class during last year's
7 program reviews that had a red component in the program
8 review in December.
9 By its very nature, as a private investment
10 class, this asset class challenges CalPERS commitment to
11 transparency, and clear alignment of interests and
12 accountability between ourselves and our managers. It is
13 also our most expensive asset class, both in terms of the
14 base management fees, as well as the profits that we share
15 with our managers in the form of carried interest.
16 Turning to our PEARS Project, I want to emphasize
17 that staff recognized these challenges and has been
18 seeking to address them in a very deliberate and
19 thoughtful manner to help move the ball in some of these
20 areas of focus. For over the past three years, staff has
21 been working on a comprehensive accounting and reporting
22 package to improve transparency and alignment in our
23 private equity investments.
24 Starting in 2012, the Investment Committee --
25 this Investment Committee has been apprised regularly on

1 the PEARS Project effort, our progress, and the status of
2 its implementation. We are pleased to report that earlier
3 this year we went into live parallel testing on the
4 system, and we have been successful in collecting the
5 requisite information from our managers to ensure improved
6 transparency and more accurate accounting of costs and of
7 profit sharing.
8 This is a significant milestone and positions
9 CalPERS to more fully report on private equity fees and
10 total profit sharing later this year. A key component of
11 the PEARS Project was receiving the information from our
12 general partners in a consistent, usable form. CalPERS
13 has partnered with the Institutional Limited Partners
14 Association, otherwise known as ILPA, since 2012 on the
15 development, use, and widespread adoption of a data
16 template to capture this information at the partner level.
17 This effort has born fruit, where we now have
18 excellent best practices provision of the information by
19 approximately 94 percent of the general partners in our
20 portfolio. More recently, CalPERS has been working with
21 other limited partners and the I-L-P-A, ILPA, to expand
22 the types of fee information provided on our private
23 equity investments. We plan to provide an update on this
24 effort later this year during the program review for
25 private equity.

1 The goal of all these efforts is to move some of
2 the red zones I mentioned in last year's program review to
3 yellows and even greens in the future. And that brings me
4 to some of the complexities of private equity for limited
5 partners and for CalPERS. And in that regard, one
6 outstanding question that has been raised, I believe, and
7 our entire staff believes requires attention. That is why
8 we have not provided estimates of carried interest or
9 profit sharing in the past.
10 In fact, a question was raised about this in the
11 media about whether staff was actually hiding this
12 information around this topic. I can assure you that that
13 is not the case. In large part, the direct answer to that
14 question was exactly why we identified the problem back in
15 2012 and initiated the PEARS Project.
16 To offer some context, the calculation of carried
17 interest paid on a portfolio of CalPERS size, its age, and
18 complexity is a massive undertaking. And given the size
19 of our private equity portfolio, the expected error in any
20 estimation could be even larger than some entire pension
21 plans.
22 Later in open session, Réal will present an
23 information item that will provide an example and some
24 examples of private equity cash flow that we hope will
25 help illustrate some of these complexities, hence our

1 hesitancy to provide estimates. Our goal around this
2 since 2012 has consistently been to produce and disclose
3 an accurate figure based on reliably complied information,
4 and we are pleased to be around the corner from doing just
5 that.
6 And in this regard, with respect to private
7 equity as an asset class, alignment amongst Board and
8 staff is crucial. Given that private equity has elements
9 that CalPERS likes and elements that make it a challenge,
10 given our Investment Beliefs, continued investment in
11 private equity requires continued alignment by our
12 institution.
13 In closing, I'm very proud of the work we have
14 done so far and recognize that there is still much to do.
15 But the fact that we are here today spending part of our
16 day talking about private equity cash flow is a good
17 thing. CalPERS is leading in this conversation. We have
18 a long history of fighting for the best possible terms and
19 conditions in our private equity transactions. We will
20 continue to do that.
21 This conversation and the attention it is
22 generating in addition may result in greater introspection
23 by the private equity industry, by its array of limited
24 partners throughout the globe, and regulators on the topic
25 of fees. What is an appropriate management fee? What

1 level of profit sharing adequately recognizes a manager's
2 skill and expertise, and also fairly compensates the
3 limited partner for assuming the risk?
4 These are questions that deserve renewed
5 attention and consideration, and we look forward to being
6 part of that conversation. In the meantime, we remain
7 focused on providing the most accurate and open look at
8 our investments as possible. We'll continue working to
9 complete our initial report of private equity carried
10 interest, and look forward to presenting you with the
11 final results later this year.
12 Mr. Chair, thank you for the time.
13 CHAIRPERSON JONES: Okay. Thank you for the
14 presentation and comments.
15 Next item on the agenda is we have one consent
16 action item, approval of the June 15, 2015 meeting
17 minutes.
18 Do we have a motion?
19 COMMITTEE MEMBER MATHUR: Move approval.
20 VICE CHAIRPERSON SLATON: Second.
21 CHAIRPERSON JONES: Moved by Mrs. Mathur, second
22 by Mr. Slaton.
23 All those in favor, aye please?
24 (Ayes.)
25 CHAIRPERSON JONES: Opposed?

1 Hearing none.
2 The item passes.
3 The next item consent information items. No one
4 has requested additional information on any of those
5 items, but just a second.
6 Mr. Jelincic.
7 COMMITTEE MEMBER JELINCIC: I had a number of
8 questions about C, but the deal with performance, and
9 we're going to review that later, so I'm perfectly willing
10 to put those off, if that's the --
11 CHAIRPERSON JONES: Okay. Please do.
12 COMMITTEE MEMBER JELINCIC: But on D, the
13 compliance, I did have one relatively short question that
14 I'd like to ask.
15 CHAIRPERSON JONES: Okay. Go ahead.
16 COMMITTEE MEMBER JELINCIC: And this is on
17 attachment 2, page 10 of 17. And I've given you the heads
18 up it was coming.
19 The third one from the bottom is a contract PEARS
20 - change manager to create and implement change management
21 plans and -- you know, changing the manager this late kind
22 of struck me as kind of strange. So can you -- and
23 then -- can you clarify what that actually was intended to
24 mean?
25 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:

1 Wylie Tollette, CalPERS staff.
2 Yes, I can clarify. Occasionally, staff will
3 hire what is known as a change manager to help develop new
4 procedures when we implement a new investment system.
5 Basically, it allows us to sort of change our workflow and
6 our process. So this doesn't actually refer to -- it's
7 rather inelegant wording in the document, but this doesn't
8 refer to changing any manager within the plan. It refers
9 to actually a discipline within the System's
10 implementation of change management.
11 COMMITTEE MEMBER JELINCIC: And there's been no
12 resistance by staff to this change?
13 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: No,
14 not at all. In fact, staff is enthusiastic about the
15 PEARS program coming on board.
16 COMMITTEE MEMBER JELINCIC: Thank you.
17 CHAIRPERSON JONES: Okay. Thank you.
18 The next item on the agenda is the Global
19 Governance Policy Ad Hoc Subcommittee Report. And for
20 that, I call on the Vice Chair of the Global Governance
21 Policy Ad Hoc Subcommittee report, Mr. Bill Slaton.
22 VICE CHAIRPERSON SLATON: Thank you, Mr. Chair.
23 The Global Governance Policy Ad Hoc Subcommittee
24 did meet on June 17th of this year. The Subcommittee
25 approved the plan to revise the Global Governance

1 principles incorporating the CalPERS Investment Beliefs
2 and the Global Governance Program's core issues.
3 There is no meeting this month. The Subcommittee
4 will meet in September to review the -- to review the
5 revised draft of the Global Governance principles.
6 CHAIRPERSON JONES: Thank you, Mr. Slaton.
7 Next item on the agenda is Item 6, Asset
8 Allocation, Performance, and Risk, CalPERS Trust Level
9 Review.
10 Mr. Eliopoulos.
11 (Thereupon an overhead presentation was
12 presented as follows.)
13 CHIEF INVESTMENT OFFICER ELIOPOULOS: Thank you,
14 Mr. Chair. If you may, we're going to give a minute for
15 your CalPERS staff to assemble, as well as our consultants
16 are going to make their way up to -- yeah, make their way
17 up to the bar here. I think we have enough seats.
18 (Laughter.)
19 CHIEF INVESTMENT OFFICER ELIOPOULOS: We're
20 trying a new choreography to our biennial trust level
21 review here. We will have -- rather than bringing each
22 consultant up individually as the time comes, it was, we
23 thought, better to have everyone seated, so the Committee
24 can ask questions. And the presentation after this minute
25 or two at the beginning we think will go better by not

1 having such a flurry of activity as we turn to each
2 consultant.
3 We're going to begin here with Agenda Item 6A.
4 And as is our custom in reviewing every six months the
5 performance and risk positioning and general market
6 conditions prevailing in the global economy, the first --
7 --o0o--
8 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- the
9 staff and the consultants switch who will present to you
10 first. So for August, it's your Investment staff's turn
11 to go first with our presentation. And that will be
12 covered here by myself, Wylie Tollette, Eric Baggesen, who
13 are relatively frequent fliers before this Committee for
14 sure. And then you will remember John Rothfield our
15 Investment Director, within fixed income, which is his day
16 job. And he also provides and is the CalPERS economist
17 for the total fund. And John presents much of this
18 information that you'll be seeing today as part of our
19 senior investment review meetings monthly within our
20 program. So welcome, John, thank you for being here again
21 with the Committee.
22 I'm going to -- actually, before I turn it over
23 to you here, John --
24 --o0o--
25 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- I'm just

1 going to -- hopefully, I won't -- we've divided the
2 presentation today, so that you'll be hearing, first, from
3 John on the macroeconomic environment prevailing. And
4 given the volatility in the markets and the interesting
5 developments throughout the globe, we're going to present
6 with -- start presenting with that first. And then we'll
7 be returning to myself to look at the return for the total
8 fund and our affiliate funds for the fiscal year. And
9 then we'll be turning to look at the risk positioning of
10 the fund, both first by Wylie Tollette, and then we'll be
11 looking -- Eric will lead a rather detailed look into our
12 risk attachment that is presented to the Committee during
13 this review. So I wanted to give a brief highlight of
14 what to expect for the Committee.
15 After that, during questions and answer period,
16 once we've concluded the staff presentation, then we'll
17 turn it over to the array of consultants that are here.
18 First, Wilshire, then PCA, and then StepStone will be
19 presenting information on the total fund on real estate
20 and on infrastructure. So that gives you a sense of the
21 flow of the day.
22 Of course, for particular questions, the
23 Committee, feel free to ask any questions directed to
24 either the staff or consultants during the pendency of
25 this review.

1 Before I turn it over to John, I really wanted
2 to --
3 CHAIRPERSON JONES: Ted, before you get started,
4 Mr. Jelincic has a --
5 COMMITTEE MEMBER JELINCIC: Yeah. Ted, I would
6 actually like to back up one slide. As you know, we've
7 changed some classifications and the -- many of the people
8 looking at this will not know what a Managing Investment
9 Director is versus what it used to be. And so I was
10 wondering if you can describe those titles and compare
11 them to the old classes so people have a context in which
12 to look at this.
13 CHIEF INVESTMENT OFFICER ELIOPOULOS: Sure.
14 COMMITTEE MEMBER JELINCIC: Thank you.
15 CHIEF INVESTMENT OFFICER ELIOPOULOS: We're still
16 getting used to the new classifications ourselves. So as
17 the Committee is aware and I think the public is aware, we
18 have a new classification system that was approved by
19 CalHR and put into use both by CalPERS and CalSTRS at the
20 beginning of this fiscal year beginning in July.
21 The Managing Investment Director title, Mr.
22 Baggesen holds here --
23 (Laughter.)
24 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- is the
25 title formerly known as the Senior Investment Officer. So

1 we've converted now the SIO, or Senior Investment to the
2 title Managing Investment Director.
3 Investment Director is the title now,
4 classification now, for what was the Senior Portfolio
5 Manager, or SPM. And then for the Portfolio Manager
6 position, it's now Investment Manager.
7 Thank you. So that's the classification summary.
8 CHAIRPERSON JONES: Thank you.
9 COMMITTEE MEMBER JELINCIC: Thank you.
10 --o0o--
11 CHIEF INVESTMENT OFFICER ELIOPOULOS: I was
12 wondering, I said I don't think there was a page before
13 this, but you're right there was.
14 (Laughter.)
15 CHIEF INVESTMENT OFFICER ELIOPOULOS: So for
16 here, just as the preamble going into John's macroeconomic
17 review, which I think is important, because I think one of
18 the questions the Investment Committee always has in its
19 mind and we have in our mind is why does all that matter?
20 What does it mean?
21 And looking at this incredibly executive
22 summarized summary, it's important for you to look at the
23 big points. The total return for the fund moderated this
24 year, as we've been talking about. Boy, last February and
25 March I was before the Committee and said expect

1 moderating returns in the coming years coming off what was
2 then a six-year bull market. And certainly a 2.4 percent
3 return for the total fund reflects that environment, at
4 least for this past fiscal year.
5 We'll take a look at the economic and market
6 conditions now going into year seven of that bull market.
7 And we'll spend quite a bit of time discussing that. But
8 what I wanted to highlight is something I think the
9 Committee knows well, but it's important as we both
10 consider the macroeconomic environment, but also look at
11 the positioning of the portfolio from a risk perspective.
12 And in that regard, the total fund from a
13 strategic asset allocation side has a heavy emphasis on
14 growth assets. We have a -- you know, a dominant
15 positioning in global equity and private equity. And that
16 will continue and has continued and is a dominant feature
17 of the risk positioning of the portfolio.
18 In addition to that, that's on a strategic basis,
19 from a tactical perspective for the course of this last
20 fiscal year, and certainly for the last five years, we've
21 had an overweight position to this equity exposure, which
22 generally, you know, reflected our view of the bull market
23 and prevailing market conditions that are now moderating.
24 And much of our discussion now, looking and now turning to
25 John, as you see his slides, you can see on his summary

1 page --
2 --o0o--
3 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- which I
4 promised to get back to before -- when we started, you see
5 a more balanced positioning of both positive and negative
6 news. And if you look back at these slides over the
7 course of the last six years, we had a much more
8 positively weighted slide presentation, which reflected --
9 which reflected that conditioning.
10 So with that, I will turn it over to John to lead
11 this next part of the discussion.
12 INVESTMENT DIRECTOR ROTHFIELD: Thank you, Ted,
13 and good morning to everyone. I appreciate the
14 opportunity to be able to give some color on the
15 macroeconomic back-drop. And obviously, my role here, as
16 part of this trust level review, is to highlight elements
17 of the business cycle and maybe the policy cycles here and
18 abroad that may be relevant to fund and asset class
19 performance.
20 And I think Ted made a key point that when we've
21 presented this table that I think the Board knows pretty
22 well every month for maybe the last six years, there have
23 been more things in the positive column than the negative
24 column. We're now more evenly balanced. And we are into
25 the seventh year of an economic expansion. The last

1 expansion only lasted exactly six years, according to the
2 National Bureau of Economic Research, which has a business
3 cycle dating committee. So that expansion was six years.
4 The prior one to that was 10 years. But again,
5 we're starting into the seventh year of an economic
6 expansion. And this time in the last expansion, the --
7 basically the business cycle flamed out and asset markets
8 began to rapidly underperform.
9 The overall theme though is still that some of
10 the imbalances that derail the last expansion that lasted
11 from 2001 to 2007 are not with us in the current cycle.
12 And I'll elaborate that on one of the other slides that I
13 cover in a minute, but we are entering a point of the
14 expansion where macro fundamentals are perhaps saying that
15 the returns on financial assets and housing assets may not
16 be as aggressive as we've seen in the first part of the
17 cycle when the Feds had very easy monetary policy and
18 expanding the monetary base.
19 So again, turning directly to slide five, which
20 is the positives versus the negatives in the economy and
21 going through a few of these. Firstly, the economy is
22 doing better than the aggregate data suggests. The data
23 for the first half of the year showed that the economy
24 only grew by a little over one percent. That's actually
25 going to be revised up a little bit with the data that's

1 came out since we produced this table a few weeks ago.
2 And then we've had a pretty good start to the economy in
3 the third quarter.
4 So I would say overall, for the first three
5 quarters of the year, we're just in the third quarter now,
6 the economy has grown in the high ones. One of the other
7 factors which me and other economists thought would be a
8 positive for the economy is that benchmark revisions which
9 happen every year and revise five years of economic data
10 for the economy were expected to be revised up, because
11 we've had such strong employment growth in the last couple
12 of years. In fact, the bench mark revision showed a small
13 downward revision to GDP.
14 And I think it's very relevant that following on
15 that downward revision the Congressional Budget Office
16 announced new estimates of what's the potential growth of
17 the economy. So not what's the actual growth, but how
18 quickly can the economy grow given what's happening to the
19 labor force, what's happening to productivity, which is
20 essentially the growth we're getting per unit of labor
21 that's added to the economy.
22 And in this expansion, again the six-year
23 expansion, the potential growth of the economy has only
24 been 1.35 percent per year. A very, very low number. To
25 put that in context, in the last expansion, the potential

1 growth of the economy was 2¾ percent. So we essentially
2 got half of the potential growth. This is why in an
3 expansion, which we've only had 2¼ percent growth per
4 year, we've managed to get a significant reduction in the
5 unemployment rate.
6 It's essentially saying that we've got low growth
7 of the labor force. We have -- we're in a low
8 productivity world, and therefore, you know, the bar on
9 getting a decline in the unemployment rate is much lower
10 than it used to be.
11 So it is a positive for the economy that it's
12 doing better than perhaps some of the aggregate data would
13 suggest. But we're also in an environment where one has
14 to recognize that we're just in a slow growth environment
15 overall. We could get a more sustained and extended
16 expansion, but it's going to be a low growth one.
17 A second significant positive for the economy is
18 a strong housing market. In the year to the June quarter,
19 there were 1.6 million households formed in the U.S.
20 That's people going into vacant and newly built houses,
21 and creating households. That creates a lot of
22 expenditure on related items like furniture and other
23 things.
24 In that year to the June quarter, there were 1.6
25 million households formed. In the prior two years, there

1 were only 800,000 a year. So we're finally at the point
2 now where folks are starting to form households. The
3 economic expansion is extending a little bit into younger
4 and lower income earners, and they're managing to get out
5 and form households. And also, there's been a supply
6 response to the demand for housing.
7 So the production of multi-unit dwellings in the
8 U.S., rather than single-family homes, is very, very
9 strong now. And we're finally getting the market
10 satisfying the demand for rental properties. Again,
11 that's causing people to move out of large households into
12 new households and creating a new form of spending in the
13 economy.
14 And also, if you read consumer sentiment, despite
15 the fact that house prices are rather high right now,
16 mortgage rates are still low, plans to buy a house in the
17 populous still remain quite strong. Another positive is
18 strong household balance sheets. The household sector is
19 not spending its new found improvement in wealth or its
20 gradual improvement in income.
21 Again, that's kind of a double-edged sword,
22 because it means that top-line revenue growth is not as
23 aggressive -- aggressively strong as would otherwise be
24 the case, but it's good for the longevity of the economic
25 expansion.

1 We have well-supplied commodity markets. So I
2 think last year there was something like one million
3 barrels per day excess supply over demand in the energy
4 market. That's gone up to two this year, and could easily
5 be two and change next year.
6 Now, weak energy markets have some problems
7 globally with creating some financial instability for
8 sellers of energy. But the U.S. is still a net importer
9 of energy to the tune of about 15 percent of its demand.
10 And therefore, ultimately the U.S. is a net beneficiary
11 from lower energy prices, even though it causes some
12 problems in the U.S. with lower CapEx in the energy
13 sector.
14 It's also the case that pre the El Niño event
15 that's likely to hit the U.S. in the year ahead, food
16 stuff prices have come way down, so wheat, corn, things
17 like that, which again is interesting in itself for both
18 dis-inflation in the economy, but it's also helpful to the
19 consumer sector who's facing lower gasoline prices, and
20 lower prices for the food stuffs that it consumes, which
21 overall, if you take those two together, it's about a ¼ of
22 the household budget.
23 And then finally, we continue to have supportive
24 public policy. So the European Central Bank and the Bank
25 of Japan continue to purchase bonds in those countries.

1 And that's creating a demand for assets, both risk assets
2 both within Japan and Europe, and also outside. And so
3 some of that demand for securities has come to the U.S.,
4 and that's helping to suppress bond yields and keep our
5 stock market going higher.
6 The People's Bank of China is also doing the same
7 thing by cutting interest rates and reducing its reserve
8 requirements. Of course, the latest move by the Bank of
9 China, which is to allow currency to move into a more
10 managed float, and devalue its currency again is not as
11 supportive of growth around the rest of the world, as some
12 of their other policy changes, but it's all part of the
13 effort by China to start to stabilize their economy.
14 Moving across quickly to discuss some of the
15 negatives in the economy. Yes, it was a very soft half --
16 first half of the year for economic growth. It's a little
17 under one percent on the first reading. That's going to
18 be revised up. But again, you have to put that in the
19 context of these very low numbers for potential growth of
20 the economy.
21 Another issue in the economy right now is CapEx
22 and investment intention. So capital spending by
23 businesses, which actually did quite well in the first six
24 years of the recovery, in a two percent growth economy,
25 CapEx was growing about five percent a year. So CapEx was

1 growing kind of consistent with a slow growth economy.
2 But in the first half of this year and looking
3 forward, capital investment intentions by businesses and
4 their orders for capital equipment have come down. A lot
5 of that has again been in the energy sector, where some of
6 these new suppliers of energy in the U.S. are facing
7 issues around low oil prices and cash flow related to the
8 production of this new form of energy, but also CapEx in
9 other sectors like aircraft has also slowed down a bit.
10 Another factor which is highlighted is weak
11 spending by State and local governments, and also the
12 federal government. So if you took out federal and State
13 and local government, growth in the economy over this last
14 six years would have actually been quite a healthy three
15 percent. So federal and State and local government
16 spending have actually taken almost a percent off growth
17 over that period of time.
18 Now, actually one could argue that the weaker the
19 public sector spending has been, that's allowed, what they
20 call, crowding in, which is more private sector spending.
21 It's help keep interest rates low. It's allowed private
22 sector growth to be higher than expected. But overall,
23 that's been a key feature of the recovery so far.
24 There are some encouraging signs that State and
25 local spending on both CapEx and labor hiring has started

1 to improve. So we may actually see an improvement in that
2 element in the economy going forward.
3 A key negative in the economy right now is tight
4 labor markets. So the government produces a report each
5 month, which is how many job openings there are in the
6 economy, which is a little over five million. The number
7 of persons available to fill those jobs has fallen to a
8 very low level. That's the number of people who are
9 actually unemployed and those who aren't even looking for
10 a job that would like a job. That number has fallen very
11 low. So again, in this low growth environment, we've
12 already reached the point where we may not have enough
13 labor, given current immigration policies, and given
14 current willingness to participate in the labor force to
15 keep growth going at a pretty good rate. So the
16 unemployment rate in the economy has come down to only 5¼
17 percent.
18 Corporate debt is another thing that we're
19 watching, because corporate debt is growing at about a six
20 percent rate right now. That has picked up. It doesn't
21 seem to be excessive against company valuations of -- both
22 in the stock market and government estimates of what
23 corporates are worth, but it is something to watch out
24 for.
25 And then the tail-risks. Greece -- I think when

1 we spoke here last time, Greece was a significant
2 tail-risk. They have a third program now with the
3 international community. I still think Greece is going to
4 be an issue, because ultimately they need to create some
5 exports to go along to help pay for the future of their
6 debt repayment, and their exports growth has been very
7 weak.
8 They're also being required to run a very onerous
9 budget surplus. So ultimately, I think Greece will come
10 back onto the radar screen of global risk assets, but it's
11 not going to be for now. And as I've already mentioned, I
12 think China and Asia has become more of an issue for
13 global growth. China is slowing down. They're
14 deregulating, but having to do a managed deregulation.
15 And the Asian currency, called the ADXY is down about
16 eight percent. That's forcing up the value of the U.S.
17 dollar.
18 So I just wanted to quickly go on to page
19 seven --
20 --o0o--
21 INVESTMENT DIRECTOR ROTHFIELD: -- which is
22 looking at the -- this theme that the expansion can go on
23 for longer, because we haven't had any leverage and
24 imbalances, which derailed the last expansion in 2007, but
25 we are getting into an environment where we're -- it may

1 be a little bit more challenging for market returns.
2 So going through a couple of these elements of
3 the table. In the last expansion, household debt rose
4 from 102 to 135 percent of disposable income. In this
5 expansion, we've actually come down from 128 to 106
6 percent. The only growth of the -- the only leverage
7 going on in the household sector is student debt and auto
8 credit.
9 Corporate debt as I mentioned is growing at six
10 percent, but at the end of the last cycle, it was growing
11 at 12 percent. Foreign trade. In the last expansion, our
12 trade deficit blew out to six points of GDP, which
13 typically an unstable situation. Right now, our foreign
14 trade deficit with the rest of the world is only 2½ points
15 of GDP.
16 There are three reasons for that. One is the
17 responsible household sector is creating a domestic pool
18 of savings, so we don't have to borrow from abroad. The
19 government has been much smaller in this expansion, so
20 we're not having to borrow to fund government. And then
21 the third element is that we have this energy boom, which
22 has taken about a point off the foreign trade deficit. So
23 it's very good for the longevity of the expansion.
24 The federal budget, the deficits come down to a
25 third of what it had been. So all of those things suggest

1 that the imbalances, which typically derail an economic
2 cycle -- the last few economic cycles have been longer
3 than back in the seventies and eighties. We're not at
4 that point anywhere near it.
5 And if you look at the chart on the top right,
6 you can see that total leverage in the economy, which is
7 all non-financial debt to GDP has just been very stable
8 since the recovery started in 2009, very much like the
9 leverage free expansion -- the 10-year expansion that we
10 had in the nineties.
11 In the two different expansions in the 1980s and
12 the 2000s, we saw a rapid rise in leverage in the economy,
13 which ultimately derailed the expansion.
14 So -- and then the final point I guess is that
15 why are we in a more challenging environment overall for
16 asset markets than we have been before?
17 One is, as I mentioned before, the unemployment
18 rate has gotten very low. So at some point, you start to
19 get a worsening tradeoff between growth, hiring and
20 growth, and inflation as companies have to bid up wages to
21 start to attract workers. That's typically not
22 particularly good, because the fed has to start to react
23 to inflation and raise interest rates, which could well
24 happen as early as September.
25 The other thing is a measure that a lot of

1 economists look at, which is net worth to income, so
2 that's the chart on the bottom of that page, which shows
3 that the valuation of household net worth, which is the
4 value of all stocks and houses that the household sector
5 owns, X liabilities, which is essentially mortgages,
6 that's got up to 6.4 times one year's income.
7 And you can see that in 2000 and 2006, those
8 valuations proved to be roughly the top in terms of how
9 high valuations on financial assets and houses had gotten
10 relative to household disposable income. The good news is
11 that the U.S. valuation, which is 6.4 times one year's
12 income is lower than most other countries. In Canada, I
13 think it's 7.7 times. Japan it's eight. The UK it's
14 eight. But in the U.S. every time we've got to these
15 levels, you start to get financial assets in house --
16 prices growing only about the same pace as income, not
17 faster than income
18 So to summarize, we are in a point now, six years
19 into the economic expansion, where we're seeing more even
20 positives and negatives that are affecting fund and asset
21 class performance. The good news is we're not seeing the
22 imbalances that typically derail an expansion. So
23 overall, it looks to be still a pretty good environment
24 for risk. However, market returns become probably more
25 challenging at these elevated valuations.

1 Thank you
2 CHAIRPERSON JONES: Thank you very much. We have
3 a couple of questions.
4 Mrs. Mathur.
5 COMMITTEE MEMBER MATHUR: Thank you, Mr. Chair,
6 and thank for your report, Mr. Rothfield.
7 My question is really about some of the longer
8 term issues that could impact the economy over not just
9 the next one, two, three years, but over the longer term,
10 issues such as climate change, the drought here in
11 California, which is -- you know, even with the upcoming
12 El Niño that's projected, could still be a long-term
13 problem for California. Dislocations in the labor market,
14 where people have permanently dropped out of the labor
15 market, which you've mentioned labor tightening, but I
16 think some significant component of that is that people
17 have completely dropped out of the labor market as opposed
18 to just there not being people.
19 So could you talk about some of those longer term
20 issues. Income inequality is also another factor I think
21 that could impact our economy over the long term.
22 INVESTMENT DIRECTOR ROTHFIELD: Yeah. I think a
23 key element, of course, is the aging of the population
24 too, if you throw that in there as well. So the
25 proportion of folks 55 and older in the population has

1 started to rise. Currently, those folks are all staying
2 employed for longer. In fact, most of the job growth in
3 this expansion, including the past year, has actually come
4 from people 55 and older.
5 But as their worth gets restored, and as they
6 start to get 65 -- you know, the proportion of 55 and
7 older -- that 65 and older is starting to rise as well,
8 those folks are going to drop out of the labor force. So
9 there's been quite a bit of discussion about given the
10 aging of the population, given income inequality, and
11 climate change, things like that, are we ever going to see
12 the improvement in productivity that we've had in past
13 cycles.
14 I guess another factor probably is the fact that
15 we're more of a service-based economy than we had been in
16 previous expansions. Another one is that where the growth
17 measures a -- fail to capture technology as well. So the
18 Congressional Budget Office essentially, as I mentioned
19 it, has 1.35 percent potential growth for the expansion.
20 They see the economy eventually getting to a running rate
21 of about 2 to 2½ percent. But that's well below kind of
22 the four percent potential growth that we used to have in
23 the old economy, which was based on manufacturing. We had
24 the Baby Boomers and all that kind of stuff adding to the
25 labor force.

1 So it clearly -- you know, I think that even the
2 Congressional Budget Office, and those in government see
3 this as a longer term issue.
4 Another issue related to that, of course, is that
5 the calls on the budget as people get older and start to
6 take out medical and social starts to become very high.
7 So the government has got to tighten up in other areas,
8 and that becomes a burden again on the younger parts of
9 society. So, yeah, I think that it's fair to say that the
10 next few decades are going to result in significantly
11 lower potential growth. And so far, it's been a -- it's
12 even been a more negative surprise than the Governor had
13 originally projected. I think people would have been very
14 surprised that potential growth had gotten as low as it
15 has in the economy, but I think it is going to continue to
16 be an issue going forward.
17 COMMITTEE MEMBER MATHUR: And some of the climate
18 change drought issues.
19 INVESTMENT DIRECTOR ROTHFIELD: I mean, things
20 like, you know, emission controls and things like that on
21 the economy, I'm not quite sure of what overall impact
22 that's having on actual and potential growth, but, you
23 know, the Kyoto targets and things like that, I think, is
24 generally considered that globally growth will have to be
25 a bit lower than would otherwise be the case. So that has

1 impacts on both us and the international.
2 COMMITTEE MEMBER MATHUR: And have you looked at
3 sort of the up -- what's coming up at the Paris talks and
4 the UN, and sort of what the two degree economy and what
5 that -- how that might impact --
6 INVESTMENT DIRECTOR ROTHFIELD: No, but I think
7 that probably is a good area for -- to look at. Again,
8 we've been just focused on how low productivity growth has
9 become in the economy potential growth, but I think that's
10 a good area that maybe we could bring back to the Board
11 next time.
12 COMMITTEE MEMBER MATHUR: Terrific. Thank you.
13 CHAIRPERSON JONES: Thank you.
14 Mr. Chiang.
15 COMMITTEE MEMBER CHIANG: John, in regards to the
16 net worth to income ratios, do you know the deviation,
17 right, because we talk about this most recent recovery and
18 the wealthy have gotten wealthier, those in the bottom
19 strata have not recovered as well. And then secondly, I
20 don't know if you ever -- if you look at these numbers and
21 additional numbers, not only net worth to income, but
22 retirement savings to income. And then we've been
23 referencing the Baby Boom generation or older generations.
24 Do we know what those numbers look like?
25 INVESTMENT DIRECTOR ROTHFIELD: Yes. The

1 government does a survey every three years. The last one
2 was 2013, so we won't get new data till 2016. The 2013
3 survey was kind of based on -- you know, 2010 survey was
4 based upon the collapse of everything after the financial
5 crisis. 2013 was a slight recovery. 2016 will probably
6 give us a better idea about where net worth and retirement
7 savings stands for different income and age groups.
8 But clearly, the point that you're making is very
9 important, which is that most of this improvement in net
10 worth has come for the top 20 percentile of income
11 earners. So those who are renters and those who don't
12 have -- didn't have many financial assets to start with
13 just haven't participated in this recovery. This is part
14 of the reason that the national savings rate is five
15 percent.
16 In the previous recovery, it got down to one to
17 two percent. A lot of folks had a huge increase in their
18 worth and just haven't spent it. Whereas, the low income
19 earners pretty much spending still everything that they
20 get. So that is an issue.
21 And the retirement savings issue is an
22 interesting one as well, trying to break that household
23 net worth down into income groups. Again, that's
24 something I could try and break down for you.
25 COMMITTEE MEMBER CHIANG: And then energy prices.

1 So the energy prices have dropped, and so there is that
2 immediate benefit to consumers or households. But as you
3 pointed out, the -- and some people have done the tie, you
4 did -- that you had less CapEx investments. Do you have a
5 specific breakdown for California as to -- right, because
6 you talk about a bump -- a small bump up with increased
7 consumer spending, but a long term -- a longer term drag,
8 because less CapEx spending. How did that impact
9 California, if you have those numbers?
10 INVESTMENT DIRECTOR ROTHFIELD: I can -- we can
11 get those numbers for you.
12 Overall, the initial impact on CapEx has been
13 much more aggressive than the uplift in consumer spending.
14 And that's partly because we've had a very strong driving
15 season in the U.S. The latest decline in energy prices
16 we've seen in the first couple of months of our fiscal
17 year hasn't translated into lower gasoline prices. It
18 will by the end of the year, but, yeah, we can get those
19 numbers on the impact on CapEx nationally and in
20 California.
21 COMMITTEE MEMBER CHIANG: Thank you.
22 INVESTMENT DIRECTOR ROTHFIELD: Sure.
23 CHAIRPERSON JONES: Okay. Mrs. Yee.
24 COMMITTEE MEMBER YEE: Thank you, Mr. Chairman.
25 A couple of thoughts. And I just wanted to also

1 echo, particularly as we look at long-term decisions, the
2 aging of our population, longer life expectancy, and
3 obviously all of the attendant issues associated with
4 that. And I don't know that we've done that in any kind
5 of systematic way, but it just seems to me that whether
6 we're looking at risks with respect to, you know, health
7 care needs, and -- I know there's a lot of attention now
8 focused on alzheimer's disease and the lack of any kind of
9 response in terms of, you know, getting out ahead of, you
10 know, some of these types of things that are going to
11 happen with an older population.
12 So I'd just like to see us maybe kind of look at
13 that whole kind of area with a little bit more of a
14 systematic examination as we go forward.
15 With respect to the energy markets - and I really
16 appreciate this economic overview - it seems to me that
17 aside from the long-term types of issues or maybe even
18 long term and short term that Ms. Mathur had identified,
19 given the state of the energy markets, I'm wondering if it
20 would not be appropriate to revisit, given that it is a
21 buyer's market, where California currently is with coal.
22 And a lot of attention focused on that. But I would like
23 to, Mr. Chairman, if possible, to just kind of have a
24 focused conversation on that at our next meeting and
25 agendize that, particularly since the United States seems

1 to be a place where we've got other alternatives. And I
2 think the -- I mean, the way we've been managing this has
3 been appropriate, although, I don't want to miss any
4 opportunities in terms of just not having the lines cross
5 where we're going to end up spending more just with
6 respect to our engagement process and not really taking
7 the opportunity to -- I don't know, I'll say divest that I
8 think coal is unique, in terms of where else we may be
9 able to put our assets.
10 CHAIRPERSON JONES: Okay.
11 COMMITTEE MEMBER YEE: So if we could agendize an
12 item specifically on that, I would really appreciate that.
13 CHAIRPERSON JONES: Okay. Ms. Taylor.
14 COMMITTEE MEMBER TAYLOR: Yes. Thank you, Mr.
15 Chairman. I just wanted to comment on I think you did a
16 great job of giving us an idea of what our short-term
17 investments and trust level review is, but I wanted to
18 echo what Ms. Mathur was saying and say that we kind of
19 need to look more into the long term. You know, we have
20 some income inequality issues. And you had mentioned I
21 think on that, that you had savings figures that are
22 coming up, like five percent savings.
23 And I was just -- what concerns me, is that a
24 short-term savings figure? Where is that coming from and
25 who's that -- and you also said that because there's an

1 increase in income. So how is that being figured?
2 INVESTMENT DIRECTOR ROTHFIELD: In the last
3 expansion, we got gradual improvements in income growth,
4 more employment, wage growth started to pick up. But
5 folks in that last expansion started to take equity out of
6 their home loans. They started to take out mortgages, et
7 cetera. So if they were owning $100, they were spending
8 99 of those dollars.
9 In the current environment, they're spending only
10 95 out of $100 that they earn. And that's actually good
11 for the economy, because essentially it's creating a pool
12 of savings that enables, you know, borrowing costs to be
13 held down in the economy. It means we're not relying on
14 foreign savings. So it's a number that actually comes out
15 each month. It shows how much income is growing in the
16 economy, and how much spending is growing and it's the
17 residual between the two.
18 COMMITTEE MEMBER TAYLOR: What's that inclusive
19 of? So you're talking about mortgage equity. So is that
20 part of that? So you're saying that mortgage equity is
21 part of our savings, Americans in general overall?
22 INVESTMENT DIRECTOR ROTHFIELD: How much of our
23 income is being spent on servicing a mortgage, that part
24 of it, goes into the spending that's happening in the
25 economy.

1 COMMITTEE MEMBER TAYLOR: Okay. And there -- but
2 are there other factors involved in that -- in the savings
3 that you were talking about or is it just mortgages?
4 INVESTMENT DIRECTOR ROTHFIELD: No. It's really
5 residual. It's just the difference between what people
6 are spending and saving. So actually the mortgages is
7 actually part of their spending, right. The savings is
8 what's left over after that. So they're putting that in
9 brokerage accounts, checking accounts, things like that.
10 So this is a different kind of expansion where we're not
11 seeing -- we're not seeing households as a unit, as an
12 aggregate, drawing -- you know, spending all of their
13 income. And again, I think --
14 COMMITTEE MEMBER TAYLOR: I'm just curious as an
15 American myself how do you get that information, like how
16 do you know what I'm spending and not spending, you know
17 what I mean?
18 INVESTMENT DIRECTOR ROTHFIELD: Yeah. The
19 government data on this might not necessarily be good.
20 And the saving's rate is actually residual. They observe
21 from survey what the income in the economy is, whether
22 it's wages, dividend income, transfer payments that people
23 receive. They make an estimate of that. They make an
24 estimate of savings across all different consumer spending
25 categories. And they say the difference is the savings

1 rate.
2 COMMITTEE MEMBER TAYLOR: Right. So that could
3 actually be a misnomer, because --
4 INVESTMENT DIRECTOR ROTHFIELD: They could be
5 wrong. I mean, they revise it -- they revise it quite
6 often, but I still think the point remains that even if
7 the errors between different periods consistent with each
8 other, we're saving about four percent of income more than
9 we had previously. And again, I think that's partly
10 because most of the income gains and the wealth gains have
11 gone to the rich, who are already spending about as much
12 as they can. So I think that's why we probably -- that's
13 part of the reason that we haven't had the savings rate
14 come down.
15 COMMITTEE MEMBER TAYLOR: Right. Okay. That
16 makes sense. Thank you.
17 CHAIRPERSON JONES: Okay. Mr. Chiang.
18 COMMITTEE MEMBER CHIANG: Yeah. I want to probe
19 deeper on Theresa's line of questioning. So in that data
20 that the -- you reference that the government collects, do
21 they segment that data as to long-term savings or
22 short-term savings? Because right, there's a lot of
23 research that's being done, St. Louis Fed, New York
24 University, professors. And so the poor now are saving,
25 but it's not long-term savings, because they are more

1 subject to the vacillation of their daily lives and what's
2 happening with the economy. So do we have a better sense
3 of that?
4 And then my second question actually was towards,
5 Henry, Betty in regards to looking at coal. So we were
6 referencing California, but are we looking at coal as an
7 investment from a general perspective or are we just
8 looking at it from California, because China has -- as you
9 cited -- referenced, right, they under -- they're becoming
10 more environmentally sensitive. They understand -- you
11 just look at -- go to Beijing and have a hard time
12 breathing for many. And so they understand and reduced
13 impacts.
14 So I don't know what that line of -- how
15 extensive that line of discussion for the next hearing on
16 coal would incorporate. So, John, on that data in regards
17 to savings do we have a sense of a period of time?
18 INVESTMENT DIRECTOR ROTHFIELD: Again, that kind
19 of breakdown happens in the triennial survey. And again,
20 I think it is fair to say that that lower income cohort,
21 or the younger cohort, is putting in shorter term shavings
22 rather than longer term savings. The other thing to note
23 is that many people think that with the fed having zero
24 interests rates for such a long period of time, as people
25 are getting older, they're not getting any return on their

1 more stable fixed Income investment, so they're having to
2 increase their investments in riskier assets, and have a
3 higher savings anyway, because they don't have a
4 guaranteed form of return on their income through interest
5 rate -- you know, interest income. So I think that's
6 another element there as well.
7 But again, I can do a deeper dive into that data
8 that came out of the last survey and get you the numbers.
9 COMMITTEE MEMBER CHIANG: Yeah. So I'm just
10 seeking clarification. So they do try to measure how long
11 those dollars are being saved for. Do they segregate it
12 by --
13 INVESTMENT DIRECTOR ROTHFIELD: Not the
14 longevity, but the type of financial product that the
15 savings is being distributed to.
16 COMMITTEE MEMBER CHIANG: The -- then I would
17 encourage you to look at JPMorgan Chase. They started a
18 think tank as they're using data analytics --
19 INVESTMENT DIRECTOR ROTHFIELD: Okay.
20 COMMITTEE MEMBER CHIANG: -- as to how they --
21 and I'm not sure if Wells Fargo or the other big
22 institutions are doing the same. We certainly ought to
23 encourage them so that we have a better sense of how we
24 lift people out of poverty, and how they're spending, how
25 they're saving, automatic timing of payments, because

1 the -- I understand our charge, but the more we better
2 understand, the better we can help our beneficiaries.
3 INVESTMENT DIRECTOR ROTHFIELD: Sure. And I
4 realize every time I've been before the Board that income
5 distribution and different spending patterns by different
6 levels of income has always been a very important factor,
7 so I'll, you know, do some more work into that.
8 COMMITTEE MEMBER CHIANG: And then the -- I'm
9 sorry, the last line, if we could look at the volatility
10 of people's wage hours and the productivity, right,
11 because the productivity doesn't get fully reflected with
12 what's happening with technology, so a lot of those
13 numbers are off. So I know we have productivity
14 discussions, but the -- I'm not going to speak for the
15 other Board members, where those misses are and the gaps
16 with the increased productivity, technology, and how it
17 impacts the workforce and hours. That discussion would
18 help me.
19 INVESTMENT DIRECTOR ROTHFIELD: Okay. Sure.
20 Will do.
21 COMMITTEE MEMBER CHIANG: Thank you.
22 CHAIRPERSON JONES: Okay. Before I call on the
23 next Board member, Ted did you want to make a comment.
24 CHIEF INVESTMENT OFFICER ELIOPOULOS: With
25 respect to coal, as I think the Committee knows, there is

1 pending legislation with respect to divestment of coal by
2 CalSTRS and CalPERS. As part of our engagement with the
3 legislature on that pending legislation, we have not
4 planned on bringing an item to this Committee until the
5 law has become enacted, and that -- we're expecting that
6 once that happens, that will trigger a whole series of
7 evaluations, evaluations for this Committee, divesting of
8 coal or not, a whole series of engagements that staff
9 would undertake with coal companies.
10 That legislation is not targeted just to coal
11 companies in California. It's a revenue based definition
12 of divestment of certain coal companies. So we would
13 start and use that definition as part of the presentation
14 we'd be bringing to the Committee later this year early
15 next year.
16 In addition to that, timed with that review of
17 potential divestment of coal, we are also planning to
18 bring to the Committee in October and November reviews of
19 the current divestments within the portfolio, so that the
20 Committee would have full information before it with
21 respect to the current customizations within the
22 portfolio.
23 CHAIRPERSON JONES: Okay. Yeah. Ms. Yee.
24 COMMITTEE MEMBER YEE: Thank you, Ted for the
25 update. I guess I don't want the legislation to kind of

1 drive our timeline on how we look at this issue. I think,
2 given the presentation we had this morning, and what's
3 happening in the energy markets, I would like to see us,
4 independently from the legislation, take a look at what
5 our options are. And I would -- and I think part of that
6 presentation would be about our engagement with coal
7 companies.
8 But I just feel like we're going to miss
9 opportunities here. It's a dynamic field. There's global
10 impacts. I think as we're getting this presentation this
11 morning, I'm convinced that the short term and the long
12 term are kind of really interrelated, and that we just
13 really can't separate the discussion. And so I would like
14 to see a discussion on where we are with coal, separate
15 and apart from the legislation.
16 There's a lot of pressure, obviously, on
17 divestment. I want to be sure that we're making good
18 decisions around how we handle our coal holdings. I
19 certainly hope that we're not increasing our coal holdings
20 at this point in time, given the pressure, and -- but
21 those are all things that I think would be worthy of a
22 public discussion as the legislation continues.
23 CHAIRPERSON JONES: Okay. I'm going to comment
24 in a, but Mrs. Hollinger, do you want to --
25 COMMITTEE MEMBER HOLLINGER: Thank you. Thank

1 you FOR the report.
2 I just wanted to clarify regarding Theresa and
3 John. I wasn't clear whether the increase in savings is a
4 result of equity in the home, if that's being factored in.
5 And the other thing I think I'd like you to add in that,
6 which just initially seems a little bit counterintuitive
7 to me on the lower end when we have had no real wage
8 growth, how that impacts savings? I don't.
9 INVESTMENT DIRECTOR ROTHFIELD: Yeah. So on the
10 home equity loans. I mean, the data that the New York Fed
11 and then the Federal Reserve Board puts out every quarter
12 shows that in the last economic expansion, we had a big
13 buildup in home equity loans. We actually haven't seen
14 that. We've seen a drawdown in home equity loans. So as
15 they runoff, people have just been paying them off and
16 there's been no regeneration of a new around of home
17 equity loans. So people aren't taking out those home
18 equity loans.
19 So what that obviously means is that if people
20 are taking out a home equity loan, they would have better
21 cash flow and they would spend more. And that would show
22 up in spending in the economy and bring down the savings
23 rate. So that -- again, we just haven't seen that in this
24 cycle.
25 With regard to --

1 COMMITTEE MEMBER HOLLINGER: But then
2 theoretically they wouldn't qualify for increased home
3 equity loans, because their wages have remained flat.
4 INVESTMENT DIRECTOR ROTHFIELD: Yeah, I think
5 part of the reason we've had very low interest rates,
6 there have been some regulatory factors that have, you
7 know, raised credit scores to be able to get any,
8 whether -- a mortgage loan or a line of credit. I think
9 there's been both a supply and demand issue. Financial
10 institutions have been less inclined to lend for home
11 equity, given what happened in the recent memory in the
12 housing cycle, but also demand for those loans has come
13 down as well.
14 People have just been more cautious. They saw
15 volatility in their net asset position and they're being
16 more cautious. And they want to retain that equity in
17 their home as a form of, you know, cushion and future
18 consumption rather than consuming now, which is what we
19 did in the 2000s.
20 With regard to your other element of about, you
21 know, employment growth and wages, we actually have
22 recently seen a little bit of pick up in employment 16 to
23 24 year olds, and also folks who just have a high school
24 degree, and also, of course, there's been an increase in
25 minimum wage in many states as well, which is starting to

1 show up a little bit in the wages data. Again, the
2 aggregate wages data on the economy doesn't really
3 bifurcate between high and low income earners. But just
4 by looking at where the jobs growth is coming and the
5 improvement in the minimum wage, we are starting to see a
6 little bit of an uplift in that group.
7 The other piece of evidence there is that
8 household formation has increased. So this is a lot of
9 young people who now feel more confident. Maybe they've
10 gone from part-time to full-time work, which is another
11 way to increase your income. That group has become more
12 emboldened to get out of a larger family, maybe leaving
13 their parents into particularly rental properties.
14 So we are starting to see that bubble up in the
15 economy, but in no way is this kind of reducing the
16 disparity in income and wealth growth that's occurred in
17 this the expansion.
18 COMMITTEE MEMBER HOLLINGER: Thank you.
19 CHAIRPERSON JONES: Okay. Thank you. Yes, a
20 number of requests have been made, and in some you -- or
21 in the affirmative said that you can get that information
22 and bring it back, and I've been jotting down notes. And
23 so I think we need to look at our agenda going forward and
24 see which one of these is information based, that is
25 relatively easy to provide to the Committee.

1 On the divestment, you mentioned that's already
2 scheduled to come to the Committee, the divestment report.
3 And that perhaps is where the discussion of coal can be
4 addressed from an informational point of view, as opposed
5 to a policy decision, because as you mentioned, that
6 legislation is pending, and we don't want to try to have a
7 position on legislation that we don't know what the
8 outcome may be. So what is your response to that
9 approach, Mr. Eliopoulos.
10 CHIEF INVESTMENT OFFICER ELIOPOULOS: Well, I
11 think we'll we look -- we can look at the calendar to see
12 when might be a good point in time to bring back a
13 discussion on coal. It's a relatively small portion of
14 the overall equity portfolio. The reason I'm hesitating
15 is the global equity review is set to begin next month. I
16 don't know that we can put together a presentation that
17 quickly on the coal assets, but we'll look to see whether
18 there's a logical spot to put it in the current agenda,
19 and then consult with the Chair to see whether there's a
20 time period that we can bring it forward, prior to when we
21 were expecting to do it some time in early next year.
22 CHAIRPERSON JONES: Okay. Thank you. And then
23 on the other items that you've indicated an affirmative,
24 that -- such as the net wealth to income, the income
25 inequality issues, where there's research data that may be

1 available, then that can be provided to the Committee
2 going forward. So we appreciate and look forward to
3 getting that kind of information.
4 We have a couple more questions. I had a
5 question on the -- to John on the comments about the 1.6
6 million new households. We have is it BlackRock is
7 becoming the largest mortgage holder in the U.S.?
8 INVESTMENT DIRECTOR ROTHFIELD: Yeah, I think one
9 of the reasons that the outstanding mortgages to the
10 household sector haven't been rising, yet we've had a lot
11 of household formations, is essentially BlockRock and
12 other institutional investors have been, you know, pooling
13 resources, buying dwellings, and renting them out to
14 people.
15 The home ownership rate has come down to a level
16 we haven't seen since the fifties and sixties. A lot
17 more -- a lot higher percentage of the population is
18 representing, and usually the landlord is somebody like
19 BlackRock.
20 CHAIRPERSON JONES: And some economists have
21 indicated that this approach that BlackRock is using could
22 lead to another mortgage disaster. And so what are your
23 views? I mean, this is -- various economists are making
24 comments about this may lead to another disaster. What
25 are your views in this area?

1 INVESTMENT DIRECTOR ROTHFIELD: Well, I think one
2 of the issues is that we formed a lot of households in the
3 2000s. There were a lot of subprime borrowers. Number
4 one, the household ownership rate went up very
5 aggressively; secondly, you know, folks who typically
6 would be renting or owning; and, then the number of
7 households formed each year became very, very elevated.
8 What we've done over the last six years is we've
9 drown all those numbers down. So if you look at the
10 typical household formation pattern over the long term,
11 and I know that slowed down because of lower population
12 growth, et cetera, we still have -- we still have a way to
13 catch up in terms of household formation to get back to
14 where we were before the recession.
15 So, yeah, I mean, if you add some of the
16 borrowing that some of the investors in housing have been
17 doing and put it on top of the outstanding mortgages,
18 maybe that's growing faster, but nothing is growing as
19 fast as it was during the subprime crisis. And we just
20 haven't had the household formation or the change in
21 status from rental to ownership that would suggest that
22 we're going to have a repeat of what happened in the late
23 2000s.
24 In fact, now we have a very low home ownership
25 rate, and we have relatively low rate of household

1 formation over the last six years. So if anything, I
2 think there's still a potential upside for housing, rather
3 than the cycle that we've -- the financial cycle that we
4 went through in the 2000s.
5 CHAIRPERSON JONES: Okay. Thank you.
6 Mr. Jelincic.
7 COMMITTEE MEMBER JELINCIC: In a couple of the
8 slides you're talking about corporate growth. But one of
9 the things you said was there was modest CapEx improvement
10 is consistent with the slow growth economy, but then
11 investment in -- to GDP is high. If you're going to
12 comment on that later, I'll hold off that question. If
13 not, let me ask it.
14 And the other thing is you've talked a lot about
15 the current status. Do you think these trends are going
16 to continue, since, you know, investments is forward
17 looking? You know, when you look at five, I mean, is
18 that -- that's a snapshot of where we are. Do you see a
19 change coming forward?
20 INVESTMENT DIRECTOR ROTHFIELD: Well, with regard
21 to CapEx, I think that, you know, we've -- in the six-year
22 expansion, CapEx has grown at a five to six percent rate
23 in an economy that's only been growing at about two
24 percent. So CapEx went from a relatively low contribution
25 to the economy to be a driver of growth. And we're at the

1 point now where it's contribution to the economy is about
2 where we typically reach at a peak.
3 So I think naturally you're going to start seeing
4 a little bit of a lower rate of growth in CapEx. So, you
5 know, I don't think CapEx is a problem, and I think a lot
6 of this borrowing that corporates is doing is switching
7 between debt and equity. And if you look at some of the
8 debt valuations in the corporate sector relative to the
9 valuation of those companies, it's -- we're still not at
10 excessive debt levels for corporate.
11 So the corporate sector has become a little bit
12 more of a borrower and spender. But against valuations of
13 companies, it doesn't look to be too excessive at this
14 point.
15 With regard to the future of the economy, I think
16 the key issue is, you know, we're in a six-year expansion,
17 which was how far we got last time before it flamed out.
18 But again, I think the prognosis is that we're probably
19 more likely to be two-thirds of the way through a low
20 leverage expansion, which is what we had last time.
21 I think one of the key issues, which gets back to
22 Ms. Mathur's point was, you know, what kind of potential
23 growth can we have in that environment where we're not
24 getting any growth in the labor force?
25 So, you know, I think that probably the most

1 likely thing to happen over the next few years is fairly
2 similar growth rates than we've had in the early part of
3 the expansion, numbers in the low 2s, if you like.
4 Ultimately, we'll hit a very unemployment rate, which will
5 curtail the expansion of that point, but we still have a
6 way to go. The unemployment rate can still come down
7 another point and a half.
8 More people can go from part-time work to
9 full-time work to keep the expansion going. So, you know,
10 my guess is we're kind of two-thirds of the way through
11 this expansion. Some of the drivers of growth may change
12 a little bit. I think residential construction, other
13 forms of construction could become a little stronger.
14 Once we start to get some wage growth and lower income
15 growth, consumer spending could do a little bit better.
16 And government should go from being a negative in the
17 economy to be at least neutral, maybe positive, if State
18 and local revenue starts to improve.
19 So State and local government has been
20 underinvesting in a lot of their social -- you know, some
21 of their spending obligations as a highlight on one page
22 of that report. I think maybe State and local government
23 will start to become a little bit more of a driver of
24 growth as well.
25 So, again, I think, you know, on balance, we are

1 going to the next two, three, four years continue to see
2 the economy going upward, but it will continue to be a
3 slow growth grind in the economy, rather than, you know,
4 taking off in a major way. And probably it will continue
5 to be a recovery and expansion that doesn't have much
6 leverage in it.
7 COMMITTEE MEMBER JELINCIC: Thank you.
8 CHAIRPERSON JONES: Ms. Taylor.
9 COMMITTEE MEMBER TAYLOR: Thank you, Mr. Chair.
10 I just wanted to echo Ms. Yee and Mr. Chiang's --
11 Mr. Chiang's request, and thank you for asking that we go
12 ahead and move forward with looking at coal and having a
13 discussion on coal. I understand that we don't want to
14 derail the legislation that's occurring, but I also think
15 that we may be looking at an asset that's not good for us
16 to have anymore, because it's gotten so low.
17 So I just -- I would like -- I know you guys have
18 a lot on your plate, and I hate to ask for more, but I
19 would really like to see that discussion coming up soon,
20 if we could. And so I appreciate it.
21 CHAIRPERSON JONES: Mr. Chiang.
22 COMMITTEE MEMBER CHIANG: I'm sorry, I wasn't
23 making a request.
24 CHAIRPERSON JONES: Okay. Well, it appears that
25 there are no further questions at this time. And John, we

1 appreciate -- we always appreciate your insights and your
2 views of the world economy, and so -- your thoughtfulness
3 and straightforwardness. So we appreciate your comments.
4 INVESTMENT DIRECTOR ROTHFIELD: Appreciate that.
5 Thank you.
6 CHAIRPERSON JONES: Ted.
7 --o0o--
8 CHIEF INVESTMENT OFFICER ELIOPOULOS: Thank you.
9 So now we'll continue on to the next portion of the
10 review, the trust level review. And here, I'll try and
11 maybe pick up a little time as we go forward.
12 Here, just underscore something that we've seen
13 and know, and it's key. The broad diversification of our
14 assets across all asset classes, and then even within the
15 individual securities. So while we'll -- as we take up
16 and look at the entirety of the portfolio, and asset class
17 by asset class in the coming months, the topic and notion
18 of diversification and broad diversification of assets is
19 important.
20 And in that regard, divestment will be, you know,
21 a very -- as always, a very interesting discussion and
22 topic. But certainly selling out of assets at times when
23 their prices are low is a difficult decision and risky
24 decision to make in looking at long-term performance over
25 the time.

1 --o0o--

2 CHIEF INVESTMENT OFFICER ELIOPOULOS: Moving
3 forward to our current benchmarks, I'll just underscore
4 the point again. And now that you've heard from Mr.
5 Rothfield and our macroeconomic look, you can see why we
6 underscored at the beginning, we have a very heavy
7 strategic allocation to growth assets, our global equity
8 and private equity portfolios, and offset by hopefully the
9 diversification benefits that we receive from our income
10 and real assets portfolios, most strategically.

11 --o0o--

12 CHIEF INVESTMENT OFFICER ELIOPOULOS: I'll skip
13 over our investment organization pieces that you've seen
14 many times before.

15 --o0o--

16 CHIEF INVESTMENT OFFICER ELIOPOULOS: This is
17 important. We talk about the PERF total size of, you
18 know, 300 billion, 301.9, and talk separately about the,
19 you know, affiliate or other funds that we're responsible
20 for, which add another $10 billion of assets under
21 management. And we think in this total trust level
22 review, we try our level best to include information about
23 all the assets that we have under management.

24 --o0o--

25 CHIEF INVESTMENT OFFICER ELIOPOULOS: I'll skip

1 over the trending of the various asset classes and their
2 size and scaling over time. You've seen this slide many
3 times before --
4 --o0o--
5 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- turn
6 really into the investment review and want to stop and
7 land on this page. It's something that we look at last
8 year. And this is a three-year look at the risk and
9 return of the total PERF, as well as the individual asset
10 classes. And for this three-year period, which includes
11 this last one fiscal year return, which is a fairly
12 moderate return, what we still look at on the three-year
13 return is that the PERF, as a whole, in many of the asset
14 classes, not all, but many or most, are in this -- still
15 in this three-year look Goldilocks type era, where the
16 actual returns of the asset classes and the total fund are
17 above our expected rate of return, and the levels of risk
18 that, at least expressed by volatility, are lower than
19 what we forecast in our asset allocation.
20 As we said last year and continuing into this
21 year and building on the really terrific conversation that
22 just concluded on the macroeconomic conditions, that kind
23 of Goldilocks environment, you know, can't last forever.
24 And I think what we're seeing now in this year's fiscal
25 returns and going into this next run -- few-year run, we

1 expect moderating returns from the portfolio as a whole
2 and from the individual asset classes.
3 --o0o--
4 CHIEF INVESTMENT OFFICER ELIOPOULOS: Here is the
5 snapshot look at the PERF performance summary. I think we
6 gave, in our bullet points on this page, a bit of short
7 shrift to some important things to underscore, which is
8 our three- and five-year returns, both on an absolute
9 basis, but also the relative return versus our benchmark.
10 We had passed, for the past few years, positive relative
11 return on a three-year basis was a milestone we noted.
12 This is the first time since 2007 that the fund total PERF
13 on a five-year basis has outperformed our benchmark.
14 Important markers in our overall effort to realign and
15 reform the investment portfolio over time.
16 I think the bullet points do a good job of noting
17 both the one-year muted return as well as noting for the
18 first time in a few years a slight underperformance versus
19 the benchmark nine basis points for the fiscal year, and
20 while continuing our three- and five-year performance.
21 It's something that we have our eye on for sure.
22 --o0o--
23 CHIEF INVESTMENT OFFICER ELIOPOULOS: Now turning
24 to the affiliate fund performance summary. Lots of green
25 numbers here, which is a nice chart to look at. The one,

1 three, five, and 10 year numbers of the affiliate funds
2 all boasting terrific relative returns versus their
3 individual benchmarks, as well as comparatively good and
4 strong total returns on the three- and five-year -- three-
5 and five-year time periods, and a similar story on the one
6 year and the 10 year as the total fund.
7 --o0o--
8 CHIEF INVESTMENT OFFICER ELIOPOULOS: I think
9 with that, Mr. Tollette, I think I'll turn now to the risk
10 portion of the presentation. First Wylie --
11 CHAIRPERSON JONES: Okay. Before we go forward,
12 we have some -- a couple questions.
13 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- and then
14 Baggesen will be covering that.
15 CHAIRPERSON JONES: I have Mr. Jelincic.
16 COMMITTEE MEMBER JELINCIC: Yeah, I -- looking
17 back at slide 26, the three-year net return. And that
18 actually gets to the question I had back in 4C, the
19 performance. In here, and then on page three of four in
20 4C, attachment 3, we have a net return -- a three year net
21 return of 10.9 percent. On page four of four, back in 4C,
22 we have a gross return for three years of 12.5. That
23 would suggest that our costs of the portfolio is about 1.6
24 percent, which would be roughly $4.8 billion.
25 And where I got confused was, at Finance, we were

1 being told that our costs are about 1.1 billion a year.
2 When you look at the CEM report, it says we were about 60
3 basis points, even though that year was inflated because
4 of the catch-up in the real estate. So I'm kind of
5 curious where did this -- you know, where did the $3.7
6 billion in costs go?
7 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
8 Thank you for the question. I honestly think
9 we're going to have to come back to you with the details
10 on that. I'm not -- to be honest with you, I'm not
11 exactly sure which pages you're referring to. So if
12 you'll allow us, we'll come back with something.
13 COMMITTEE MEMBER JELINCIC: Okay. Well, let me
14 give you the pages, so that you can look. It's in -- this
15 is 26 of 36 in this presentation. The other one is in
16 item 4C. It's attachment 3, which is part of the
17 performance. It's pages three of four, which shows a net
18 cost of 10.9, and a four of four of Attachment C that
19 shows 12.5 as the gross. And the difference between the
20 gross and the net should be our costs. And that's
21 inconsistent with what we've been told at both Finance and
22 in the CEM report. So obviously something somewhere is
23 missing, and I'm confused.
24 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
25 We'll come back with some answers.

1 COMMITTEE MEMBER JELINCIC: Okay.
2 CHAIRPERSON JONES: Okay. Mrs. Hollinger.
3 COMMITTEE MEMBER HOLLINGER: No.
4 CHAIRPERSON JONES: Okay. Continue.
5 --o0o--
6 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
7 Thank you, Mr. Chairman. Thank you, Ted. This
8 slide works to decompose the one-year returns overall,
9 which was 2.4 percent, as Ted mentioned earlier. You can
10 see that on the bottom of the table.
11 I think it's -- before I attempt to do that, I
12 think it's probably important to note that one-year
13 returns are important to look at, because over the long
14 term, a lot of short-term returns combine to become the
15 long term. But it's also important to not spend too much
16 time or attach to much weight to a one-year return,
17 particularly in longer term markets. Our Investment
18 Belief number 2 indicates that CalPERS is a long-term
19 investor. Long-term investment requires some comfort with
20 volatility, and in a variety of asset classes in returns.
21 And so let's talk about that.
22 So starting at the top with public equity that's
23 our largest asset class at more than 53 percent of the
24 plan. You can see that for the one-year returns were
25 quite muted with one percent total return for the year.

1 That was impacted primarily by exposure to non-U.S.
2 markets, and emerging markets in particular. Those were
3 challenged both on a local basis, local equity returns, as
4 well as the strength of the U.S. dollar. So when we
5 translate foreign stocks, non-U.S. stocks back to the
6 U.S., we have to do that to -- in the context of the
7 exchange rates that are in existence at the time. And the
8 U.S. dollar appreciated strongly during the year versus
9 most currencies. So that really kept our equity market
10 returns subdued. We have a large non-U.S. allocation
11 within our index and within our global equity portfolio.
12 The next line, private equity, at around 10
13 percent of the plan had a comparatively strong year at 8.9
14 percent return. And as you can see, I think we generally
15 count on something like a 300-basis point liquidity
16 premium to private equity. And this year, we roughly
17 achieved that.
18 Fixed income also had a restrained year in terms
19 of total return at 1.3 percent for the year, as the
20 market, particularly in the late spring, began
21 anticipating an increase in interest rates in the near
22 future.
23 So adding up -- if you add up our public equity
24 and income asset classes, it roughly means that over 70
25 percent of the portfolio returns just over one percent for

1 the year. So with 70 percent of your portfolio returning
2 just over one percent for the year, it's difficult to
3 really achieve significant or double digit returns.
4 Real assets, however, delivered solid returns for
5 the year, as you can see from the table. The asset class
6 continues to recover from the difficult 2008/2009 period.
7 And finally, I'll highlight the inflation asset
8 class. There's a significant commodity component of
9 inflation. And that was negatively impacted this year by
10 the weakness in the price of many commodities, oil in
11 particular.
12 --o0o--
13 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: The
14 next slide highlights the long-term actuarial return, as
15 well as the cumulative return of the policy and the
16 cumulative return of the portfolio. As you can see,
17 there's a gap between the actual returns and the policy
18 returns.
19 I think this chart highlights really how
20 difficult it can be. And this was a subject that came up
21 at the July off-site how difficult it can be. You need
22 exemplary returns for a number of years to recover from a
23 financial crisis. And I think you see that sort of
24 illustrated graphically here on this.
25 --o0o--

1 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: On
2 the next slide, you'll see again a highlight of the fact
3 that the long term is really composed of a series of short
4 terms. You've got a one-year return where we very
5 slightly underperform the policy benchmark by nine basis
6 points. However, as Ted mentioned, over the three year,
7 our three year rolling return is now over the policy
8 benchmark. And that continues to outperform. So every
9 year that that occurs, we continue to try to make up that
10 gap that I mentioned on the previous slide.
11 --o0o--
12 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
13 This chart highlights the sort of one year and 10
14 year, so short term and long term. Unfortunately, the
15 three and the five, where we actually outperformed, are
16 not on this chart. If you look on the left side, absolute
17 returns, what you can see -- a couple of interesting
18 points. You can see global equity at over half the plan
19 returned 6.6 percent for the 10 years. That's almost
20 exactly in line with the capital -- long-term capital
21 market assumptions that I believe Wilshire will be
22 covering in their deck. So interesting that the 10-year
23 returns for global equity are very closely lined up with
24 where the long-term return expectations are.
25 The other thing that I'll highlight on that chart

1 is that private equity over the 10-year cycle has returned
2 11.9. So solid returns for that asset class.
3 On the right-hand side, you can see excess
4 returns. And what pops off the page there is the real
5 assets return for 10 years. And that is the continuing
6 impact of a very, very difficult time period for the Real
7 Estate Program from 2008 through 2010.
8 The current year outperformance of 90 basis
9 points for that program is chipping away at that long term
10 underperformance, but it has a ways to go.
11 --o0o--
12 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
13 Finally, talking about risk very briefly, the
14 total fund forecast risk is 9.11. That's significantly
15 lower than the long-term volatility assumptions that are
16 built into the asset liability management program. Those
17 are closer to 12. This is lower because for the last few
18 years, many markets have actually been -- have had lower
19 levels of volatility than they normally do. And that has
20 embedded itself into our risk modeling tools, and is now
21 reflected in our expected predicted risk. That can very,
22 very quickly change.
23 On the bar -- or the bell graph that's below, I
24 think it's important to highlight that that is the
25 potential probability distribution of returns. However,

1 it implies a symmetry to those returns that doesn't
2 actually exist in the markets. We know for a fact that
3 that symmetry -- that bar chart does not actually look
4 like that. It has, what are called, fatter tails, where
5 we can be subject to more frequent and larger downside
6 risks. And I think that's just important. And Eric will
7 be covering risk in much more detail when he gets to
8 Attachment 3.
9 And my last slide here is contribution to risk.
10 --o0o--
11 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: I
12 think the Committee has seen this slide before, but it
13 echoes something that Ted mentioned in his opening
14 comments relative to the contribution to risk. And as you
15 can see, the vast majority of the risk in the plan, close
16 to 90 percent, is really coming from public equity and
17 private equity. And when I'm speaking of risk there, I
18 was speaking specifically about volatility. There are
19 many other types of risks that are -- other than
20 volatility that our plan is subject to.
21 Risk -- volatility happens to be the one that we
22 can measure most easily and quantifiably, so that's why
23 we're presenting it. We obviously are focused on other
24 risks. And as I said, Eric will be covering some of those
25 when we get to Attachment 3. So with that, I think I'm

1 turning it back to Ted.
2 CHAIRPERSON JONES: Okay. Before you do, we have
3 a couple questions.
4 Mrs. Mathur.
5 COMMITTEE MEMBER MATHUR: Thank you. And Wylie
6 actually your -- or Mr. Tollette, your last comment sort
7 of addressed my issue and that is that we continue to sort
8 of use risk and volatility interchangeably, but they're
9 actually not the same thing. And the risks facing our
10 fund are much more diverse and varied and some are easier
11 to measure and some are more difficult to measure.
12 So to the extent that we can in future
13 presentations sort of be a little bit more precise in our
14 language, I think that would be helpful to the discussion.
15 Thank you.
16 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
17 Yeah, I concur. I think that's true.
18 CHAIRPERSON JONES: Mr. Lind.
19 COMMITTEE MEMBER LIND: I didn't push that
20 button.
21 (Laughter.)
22 COMMITTEE MEMBER JELINCIC: My mistake. I pushed
23 the one next to it.
24 COMMITTEE MEMBER LIND: He likes to talk so much
25 he wants to push two buttons.

1 (Laughter.)
2 CHAIRPERSON JONES: Mr. Jelincic.
3 COMMITTEE MEMBER JELINCIC: Yeah, I covered my
4 button and pushed Ron's. Sorry about that.
5 Back on 32, where we have the bell curve, have we
6 tried to have a curve that's more reflective of what we
7 think it actually is, rather than a normal distribution?
8 And if we have, why don't we use that more often than
9 we --
10 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
11 Well, I can talk to that and I would ask Eric as
12 well to add his comments. The risk modeling tool we use,
13 the BarraOne software, that estimates some of these
14 figures, it does what's called a Monte Carlo simulation,
15 where it goes through thousands of potential market
16 scenarios and tries to basically estimate the size of that
17 risk.
18 And the picture doesn't reflect it, but the
19 numbers actually do reflect the impact of that Monte Carlo
20 simulation. That does a better job of modeling fat tails
21 and non-normal distributions, but it's still a statistical
22 model. And invariably a statistical model is sampling
23 from the history that it has. One can very easily gain
24 too much comfort from that type of prediction. I tend to
25 believe that these are helpful pieces of information to

1 understand the risk and -- excuse me, the volatility in
2 the portfolio, but they're incomplete. There's a lot
3 of -- there's a lot to be gained from a qualitative
4 assessment of risk in the portfolio that is beyond
5 volatility and beyond statistical modeling.
6 But the numbers here do reflect the impact of a
7 Monte Carlo simulation, so that has a better -- it does a
8 better job of estimating fat tails, for example, than just
9 a straight normal distribution does, but it's still highly
10 imperfect.
11 COMMITTEE MEMBER JELINCIC: Well, I have said
12 numerous times the market will do what it has to to make
13 most people wrong.
14 But in terms of the diagram, why don't we use --
15 if we have a diagram that we think is better, and
16 particularly since we use those numbers from what we think
17 is better, wouldn't it make sense to show the better
18 diagram?
19 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
20 Yeah, that's something that we can work to
21 incorporate into future diagrams. In fact, I actually
22 believe another sort of potential improvement to this
23 slide is this presents a snapshot of risk, just a point in
24 time.
25 COMMITTEE MEMBER JELINCIC: A snapshot of

1 volatility.
2 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
3 Excuse me, a snapshot of volatility. There I go.
4 I actually think the trend of risk over time is both
5 actual and realized would be more helpful. So that's a
6 change that you'll be seeing in this presentation going
7 forward, which is a trend line of the risk -- excuse me,
8 the volatility, in the portfolio. There I go again.
9 COMMITTEE MEMBER JELINCIC: We do get that in one
10 of the presentations.
11 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: You
12 do. And you're going to see that in Eric's presentation
13 as well.
14 COMMITTEE MEMBER JELINCIC: Thank you.
15 CHAIRPERSON JONES: Okay. Thank you.
16 Yeah. Before we move on Mr. Tollette, on one of
17 the charts I think it -- well I don't need to refer to it,
18 but it -- you refer to inception date. And my question is
19 when you refer to inception date, not just in here, but
20 other reports we get, is it always based on when the
21 Committee has adopted our given authority to use that
22 asset class or to use that policy or differences in terms
23 of when staff made a decision on inception versus a
24 Committee made a decision on inception?
25 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: The

1 inception date, as it relates to the returns, actually
2 start with the first dollar invested in that asset class.
3 CHAIRPERSON JONES: Okay. But so then does it go
4 back to the policy, because like on the chart that I was
5 referring to is inflation. So was that when the Board
6 adopted that asset class or --
7 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: I
8 think I understand you question, and I think I'll have to
9 come back with a precise answer.
10 CHAIRPERSON JONES: Okay.
11 CHIEF INVESTMENT OFFICER ELIOPOULOS: Yeah, I
12 think a precise answer is always good for sure. So I was
13 pausing whether to add to it. But typically, and what I
14 expect will have happened is, the Board approves a policy
15 to invest. With staff there's sometimes steps to be taken
16 in between the adoption and the actual implementation of a
17 program or an asset class. And then the actual
18 measurements are as Mr. Tollette was saying are from the
19 first dollar invested. So there is a lag between the time
20 of the policy adoption and the first dollar, but we'll
21 clarify that and make sure.
22 CHAIRPERSON JONES: Okay. Thank you.
23 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
24 That's right. And one thing I will add to is
25 when an asset class is added or changed and the motion is

1 approved by the Board, the asset class is added to the
2 policy benchmark based on the Board's action. So the
3 policy benchmark will reflect that based on the Board's
4 decision, not the dollar invested.
5 Staff's performance is based on the timing of our
6 dollar investment. So as an example of that, in the
7 liquidity asset class, the Board recently approved a
8 change from two percent to one percent. That change was
9 reflected in the policy benchmark effective July 1,
10 because that's the date the policy became effective.
11 CHAIRPERSON JONES: Okay. Thank you. Okay.
12 Proceed.
13 CHIEF INVESTMENT OFFICER ELIOPOULOS: We're going
14 to now turn directly to Mr. Baggesen to go through the
15 risk report. Will continue the risk theme here, which
16 he's trying I think mightily to get to Attachment 3.
17 MANAGING INVESTMENT DIRECTOR BAGGESEN: Okay.
18 We'll try to get the audio/visual material together.
19 Good morning. I'm Eric Baggesen. I'm the
20 Managing Investment Director, in contrast to the Senior
21 Investment Officer, for Asset Allocation and Risk.
22 Basically, the material that we're going to go
23 through hopefully fairly briefly today is the risk
24 attachment, which is Attachment 3 under Agenda Item 6A.
25 So if you can follow that along in the iPad material.

1 As Wylie noted in his discussion, we tend to use
2 this construct of volatility as being the proxy for risk.
3 And obviously, that is not the only dimension of risk.
4 And this report gets into some of the other dimensions
5 that do attach to risk.
6 One of the implications, if you recall a couple
7 of months ago, we had a discussion about VAR, or value at
8 risk. And VAR, in essence, is a recasting of those
9 volatility measures into actual dollars and cents. And I
10 think that that's one of the elements that is important is
11 to think of this in terms of dollars and cents. And that
12 was noted on the prior risk page that Wylie had on the
13 screen.
14 Just briefly in relation to that normal
15 probability distribution, the standard bell curve, what
16 that bell curve is really trying to illustrate is a --
17 it's the expectational set around a single point in time,
18 the periodic return that could accrue, given again that
19 normal probability distribution.
20 So it doesn't say anything necessarily about the
21 long-term returns. It's simply what could be reasonably
22 expected on an individual period. So maybe a year, for
23 example, is the individual period since all of the
24 volatility statistics and the return expectations tend to
25 be annualized to a year's interval, if you will.

1 To get to the point I think that Mr. Jelincic was
2 making, one of the things that -- the greatest asymmetry
3 that happens around that isn't necessarily in the shape of
4 the distribution, even though there is a higher incidence
5 of left-hand side or negative risk occurrences.
6 Statistically, that's a very small probability, if you
7 will.
8 What tends to happen is the magnitude of those
9 returns. So you would never be able to see it in a chart
10 just exactly how far left that could go. It would be a
11 very, very tiny thin line, but it would stretch out fairly
12 significantly on the left-hand side of the chart. So I'm
13 not sure that changing the chart representation would
14 really change the interpretation of that data.
15 I think what is more relevant to the thinking
16 about what does it mean for the fund is the asymmetry that
17 was identified at the July off-site, where a negative
18 return requires us to have a much higher rate of return
19 going forward to recoup from that loss. That's obviously
20 one of the things that have caused that gap between the
21 benchmark return and the realized return back in the
22 material that Wylie covered.
23 We've had a hard time in closing that gap once it
24 opened up because of the very negative returns that
25 happened in the real asset area, and in not just the real

1 assets, it happened in a number of segments of the fund in
2 the 2008/2009 time period. It is very difficult to
3 reclose that gap once it opens up. And I think that it's
4 that sort of -- it's the impact of those negative returns
5 that I think is potentially more illustrative of what this
6 stuff actually means for the fund. Although we can
7 certainly look at whether or not a different picture of a
8 chart. I'm not sure that that would really convey the
9 real negative impact that happens when you have a
10 shortfall.
11 Anyway, to go through this material, the first
12 page of the risk report gets into some of the VAR metrics.
13 And these VAR metrics are very sensitive to the
14 volatilities. And if you recall from the material that
15 Wylie put up in front of the Board, our volatility numbers
16 have been drifting lower. And you'll see that as I flip
17 over to the next page in just a moment. But right now,
18 these VAR numbers are predicated off of -- and these
19 numbers are generated as of May 31st. The number that
20 Wylie just put up, the 9.11 volatility number, is a June
21 30th number. So there's a little bit of a calendar
22 mismatch between some of the reports and that calendar
23 mismatch, Mr. Jelincic, is also one of the elements in the
24 observation that you made about gross versus net returns.
25 We have a June period and a May period, so that will --

1 that's partly -- potentially one of the explainers in
2 that. Although, we'll ultimately identify what that is.
3 Anyway, you can see this -- the kind of VAR
4 metrics that are attached to this. We still, with a
5 10-day VAR measure, we have the expectation that we could
6 easily lose anywhere from 9 to 11 billion dollars in a
7 10-day period, and that's with the volatility in the 9
8 percent range. So you can imagine if volatility spiked
9 back up again to something like the 20 percent range,
10 what -- which is equivalent to what we were seeing in the
11 kind of 2008/2009 time period, these VAR numbers would
12 explode if the volatility is increased as well.
13 And this is just a statistical model again. And
14 we use statistical models, not because they tell us what
15 is going to happen, but at least they give us a framework
16 for having a discussion about it.
17 Also, as Wylie pointed out, approximately 90
18 percent of the risk of the fund still comes from the
19 growth related assets. So we have made some changes in
20 the last allocation effort. We will potentially make more
21 changes. We are not likely to have a material movement
22 away from this growth related risk in anything like the
23 near-term time frame. There simply are no other sources
24 of return that we've been able to identify in order to
25 expose this capital in the effort to try to make a 7½

1 percent long-term rate of return with the fund.
2 --o0o--
3 MANAGING INVESTMENT DIRECTOR BAGGESEN: Page two
4 of the attachment gets into the trend series or the time
5 series that Wylie alluded to. If you look in the chart at
6 the upper left-hand side, you see the forecast risk for
7 the fund and the forecast risk for our policy benchmark.
8 So these are two forecasts, one for the
9 benchmark, one for the fund. The redline, which is a
10 little bit more volatile, and coming out of the 2008/2009
11 period, the red line was elevated over the more solid
12 benchmark related line. The main message in this though
13 is you can see how over time the risk levels coming out of
14 the 2008/2009 time period have been coming down pretty
15 significantly.
16 That's what has related or ultimately results in
17 this nine percent kind of volatility number that we're
18 currently estimating against our actual exposure. You
19 also see in the right-hand chart the tracking error of the
20 fund. The tracking error has come down along with the
21 volatilities and also declining correlations between the
22 assets. As the markets have more normalized coming out of
23 the 2008/2009 time period, correlations have been tending
24 to drift lower, and that creates more effect from
25 diversification of having different types of assets. The

1 danger in this correlation is though that in a stressed
2 period, correlations tend to increase, and you lose the
3 benefits of diversification, at least in a shorter term
4 time construct.
5 And this comment is exactly why I believe that
6 one of our greatest risk management efforts has got to be
7 that we are able to retain our risk position through
8 almost any market environment, because in a given stressed
9 and market environment, we may be -- the fund may be
10 getting hurt greatly in that time period in the valuation
11 of its assets. But if you're able to hold that risk
12 position, if correlations and volatilities then drift back
13 into a more normal environment, you start to regain and
14 recoup the damage to the valuation that was done.
15 And ultimately, I think that that's one of the
16 aspects of taking a risk in an investment portfolio. We
17 should never take a risk that we would be afraid that we
18 would not be able to maintain in an adverse environment.
19 And I cannot emphasize that strongly enough from my own
20 personal point of view. And I believe that it's shared by
21 the rest of the Investment Office.
22 We do not want to recommend risks to be taken by
23 this organization, unless they can be maintained in almost
24 any market environment. And I just think that's a highly
25 important construct.

1 On the bottom of this page, you see the realized
2 versus forecast risk, both at a total risk level, those
3 are the top two lines, the dashed line and the solid line.
4 And then also on a tracking error forecast versus
5 realized, those are the two bottom lines that almost lay
6 in on top of one another at the bottom of the chart.
7 One the things I would note to you is that if you
8 look back in the 2008/2009 time period, where this
9 graph -- it's the left-hand side of the graph in the
10 origin, you'll notice that the realized risk was higher
11 than the forecast. And this is a reflection of the
12 long-term nature of this risk model, where it's estimating
13 volatilities and correlations over a very long term time
14 period, in trying to, in essence, generate what is the
15 normal - whatever that means - market environment.
16 Now, you see, for example, that the realized risk
17 is significantly less than the total risk forecast by the
18 risk model, the BarraOne model. So our realized risk is
19 coming in significantly less. And that's the residual
20 effect of the 2008/2009 both volatility measures and
21 correlation measures that are still carrying forward in
22 that risk model.
23 So until that stuff rolls off -- and this risk
24 model is kind of like a nuclear half-life, it takes a long
25 time for it to decay. So until that happens, we're not

1 surprised by this picture. But you can obviously see you
2 get some radical shifts that happen in the kind of 2009
3 time frame with these numbers both bounced up and the
4 lines crossed each other. So we need to be a little bit
5 cautious about the interpretation of that data.
6 And note also that there's a significant
7 difference between the volatilities that we're estimated
8 within the asset allocation and asset liability management
9 exercise versus the actual realized volatilities. A part
10 of that difference is the presence of the private assets.
11 So you have the private assets. One, they have
12 calendar differences in their pricing, so you have this
13 tend to -- private equity, for example, and real estate
14 tend to be priced in arrears, at least ¼, in some cases
15 even longer time periods than that, and you also have the
16 effects of appraisal pricing, rather than actual market
17 value pricing.
18 The Barra risk system attempts to take all of our
19 private assets and proxy those exposures into things that
20 it can actually observe price change. So the Barra risk
21 system is overstating the degree of volatility that we
22 will see in the actual pricing, unless something very,
23 very strange were to happen within the actual operation of
24 those private asset exposures.
25 So it's important to recognize that, and it's

1 also important to recognize that the volatilities we use
2 in the ALM process, which give us our kind of 12-ish
3 percent risk expectation, those include volatilities, for
4 example, to private equity. And this was illustrated on
5 the scatter chart that Ted put up, the difference between
6 the realized risk between private equity and the forecast
7 that went into the ALM process.
8 The private equity risk forecast, for example,
9 comes in with a volatility expectation of over 20 percent.
10 And that risk expectation is driven by the leverage
11 attached to private equity, and the proxying process of
12 moving that into the public market exposures.
13 So you need to recognize when we talk about
14 volatilities and all this, we have two, three, four
15 different constructs where these numbers are assimilated
16 from. And these things are virtually never exactly
17 identical between the different constructs, but we'll try
18 to point out, as we go through the different activities,
19 where -- which construct we're talking about in an effort
20 to hopefully help you make sense of all of this
21 information, because in some cases, this data could be --
22 it can lead to the point you can get very conflicted or
23 very confused as to exactly what it is that we're talking
24 about.
25 --o0o--

1 MANAGING INVESTMENT DIRECTOR BAGGESEN: To speed
2 along here, we have our liquidity analysis and liquidity
3 snapshot. The one thing I would point out in relation to
4 this data is that we assume that in a market -- a normal
5 market environment that we could liquidate almost half of
6 the CalPERS asset portfolio in the space of a month. That
7 is a tremendous degree of actual excess exposure to very
8 liquid assets. So the liquidity profile we should not run
9 into problems in managing our cash flow exercise, as long
10 as we have this kind of a profile, but it is without a
11 doubt that the fund maintains a tremendous exposure to
12 assets that are very, very liquid.
13 For example, this chart tells us that
14 approximately 90 percent of the public equity portfolio
15 could be liquidated in the space of a month, but heaven
16 forbid if we were actually doing that, because we would
17 have a tremendous impact on the actual pricing of that
18 activity.
19 --o0o--
20 MANAGING INVESTMENT DIRECTOR BAGGESEN: On the
21 next couple of pages, we get into some of the other
22 elements of risk. This is where it's not just volatility.
23 So we have counterparty risk. This is a keen topic that
24 is ricocheting around in the Investment Office.
25 Certainly, this is a topic that's currently being affected

1 also by the activities of counterparties in the markets
2 and in relation to the regulators. So we're changing our
3 perspectives.
4 But our main counterparty risk assessment though
5 relates to credit default swaps, and the credit default
6 pricing. And that's what the chart in the upper left-hand
7 side of the upper center of this page represents. And
8 what you see for the last couple of years is the credit
9 default pricing has been very muted, which is indicative
10 that these entities are not having a tremendous amount of
11 credit stress, so they're not having a problem, in
12 essence, financing their activities. And that's sort of,
13 in essence, our primary indicator so far is credit
14 worthiness of counterparties that we deal with.
15 The other comment in relation to this is that our
16 counterparty risk has been coming down because we've been
17 moving to a daily mark to market processes on
18 collateralization with many of our counterparties, and
19 we're pushing that really through all of the structure of
20 counterparty risk that we have. So our counterparty risk
21 has really diminished significantly over the last couple
22 of years.
23 --o0o--
24 MANAGING INVESTMENT DIRECTOR BAGGESEN: The next
25 page is leverage, which is another element of risk, not

1 necessarily measured by volatility. The main point I
2 would make here is that if you look at the two columns
3 related to it says policy leverage and policy limit,
4 they're kind of along though about two-thirds over to the
5 right-hand side of this chart, you'll note that all the
6 leverage levels are actually below the limits, so there's
7 no leverage area that is in excess of the limit. And this
8 is a report that will need to change in order to
9 accommodate the borrowed liquidity concept that we talked
10 about in relation to the liquidity asset class.
11 So before we can actually utilize that borrowed
12 liquidity, we'll bring back a modified version of this
13 report, so you'll see how that would be reflected.
14 --o0o--
15 MANAGING INVESTMENT DIRECTOR BAGGESEN: And I
16 think the very last thing I would just comment on the next
17 couple of -- the next couple charts and couple of pages
18 relate to concentrations. And these are -- I'm sorry.
19 Before concentrations, we have risk scenarios. And
20 scenario analysis is another dimension of risk situation.
21 I think the only comment I would make in relation
22 to this is if you look at particularly the tables of
23 numbers, the far right-hand column denote the impact on
24 excess return. And what you see is the negative impacts
25 are greater than the positive impacts. So this again gets

1 back to that asymmetry that exists when you have a
2 risk-seeking portfolio, such as CalPERS does, on the
3 damage that can happen to those risky assets in an adverse
4 environment.
5 And then when you get into the scenario analysis
6 down below, if you look, the most positive scenario that
7 was identified -- and these are all historic time periods.
8 And this is actually really important to recognize that
9 the actual outcomes to different kinds of events will
10 probably never be exactly the same. The most positive
11 scenario we had in this situation was the 1997 through
12 1999 oil price decline. Now, we've just had a tremendous
13 oil price decline for the last year, and we certainly have
14 not seen that coincident with a explosion in asset prices.
15 So just a point of reference, this scenario
16 analysis always tends to be historically driven, and the
17 actual causality of different things happening typically
18 is something radically different than existed in the
19 historical time periods.
20 But again, you see the asymmetry, where we have
21 more identifiable negative effects than we have positive
22 effects. And that is again indicative of that sort of
23 downside risk that I think is really important to be aware
24 of.
25 --o0o--

1 MANAGING INVESTMENT DIRECTOR BAGGESEN: And then
2 the next couple pages are the concentration reports, which
3 get into issuer, industry level, and regional
4 concentrations. The one thing I would point out is that
5 our largest corporate exposure is Apple, which represents
6 just under one percent of the fund. That's a pretty big
7 exposure. And the other thing I would point your
8 attention to related to the whole coal and fossil fuel
9 discussion is that outside of banks, the energy industry,
10 oil and gas, is basically the biggest industry exposure
11 that we have. And you are not going to radically modify
12 the exposure to that industry without having a significant
13 effect on the portfolio, whether that's positive,
14 negative, or whatever it is. It's going to have an
15 effect. And I think with that, I would ask if you have
16 any questions
17 CHAIRPERSON JONES: Yeah, we have Mrs. Mathur.
18 COMMITTEE MEMBER MATHUR: Thank you.
19 I do have a couple questions. One is you made
20 what I think is a very important point about retaining --
21 making -- taking risk positions that we can sustain in
22 down markets, and in any market environment. What you --
23 I just want to make sure that it's understood what you
24 mean by that. You mean that we shouldn't make investment
25 decision that we would have to unwind in a difficult

1 period, is that right?
2 MANAGING INVESTMENT DIRECTOR BAGGESEN: That's
3 exactly right. And, in essence, to the extent that we had
4 an effect, for example, in the 2008/2009 outcome, part of
5 that effect was the fact that we were not able to maintain
6 our growth asset related exposure, and we basically had to
7 raise liquidity out of those growth assets. That probably
8 had the biggest effect, irrespective of the pricing of any
9 of that kind of activity.
10 So if our target allocation to equity - let's
11 just say public equities - is 50 percent, if that
12 allocation drops down to 35 percent, we're in a very much
13 risk-off relative position. So I would suggest that we
14 always want to be able to maintain something that
15 approximates that 50 percent. Albeit, you may drift up or
16 down. You know, a range around that is a seven percent,
17 plus or minus. Our actual equity exposure dropped below
18 that.
19 So it is -- it's somewhat -- you have to be able
20 to manage and understand the actual liquidity profile of
21 the fund and where demands of liquidity come. And this
22 gets into the whole treasury management exercise. So
23 there's been a tremendous amount of work done, so that
24 we're not stuck in that same kind of a scenario again.
25 And I think we're all pretty confident that that's

1 something we could avoid. But that's really what
2 maintaining the risk profile would really entail.
3 COMMITTEE MEMBER MATHUR: Thank you. Now, the
4 other -- another piece of this report obviously focuses on
5 volatile. You spent quite a bit of time on volatility.
6 It is an area that we can measure. And then you also
7 talked later about industry exposure. And it seems to me
8 that, you know, some of our biggest industry exposure are
9 in -- is in a very volatile sector. And one of the things
10 you talked about is that volatility hurts us -- tends to
11 hurt us more on the downside than it helps us on the
12 upside.
13 So I'm wondering how that -- how that influences
14 any overall sort of active risk taking on the
15 portfolio-wide level? I mean, I know we are significantly
16 indexed, but should we think about what that means for us
17 over the long term in terms of our exposure to certain
18 industries that do tend to drive volatility.
19 MANAGING INVESTMENT DIRECTOR BAGGESEN: You know,
20 that's a great point. And I think that -- I think the
21 opportunity outside of active risk, you know, and whether
22 people are making in essence an idiosyncratic bed on any
23 specific company or industry group, I think that the real
24 place that this will come up in the discussions that we'll
25 be having with you in the near future is in relation to

1 the whole portfolio priority discussion.
2 And to the extent that we identify, as a
3 priority, potentially trying to mitigate some of the
4 downside risk, because of the negative effect and the
5 asymmetry attached to that, that may be a place where you
6 start seeing the potential of changing some of this in the
7 construct of our benchmarks, because the benchmarks
8 themselves and the absolute level of risk that we're
9 taking is far more important than any individual active
10 bed around that -- that benchmark, but I think that would
11 be a place that you -- we'll see how that discussion
12 evolves. But that might be one of the elements that we
13 really try to understand that. But also be careful, in
14 some instances some of -- it's very hard to forecast --
15 COMMITTEE MEMBER MATHUR: Sure.
16 MANAGING INVESTMENT DIRECTOR BAGGESEN: -- going
17 forward what elements are going to be accretive or harmful
18 to the returns of the fund. If we knew that with any
19 certainty, I mean we would have no problems obviously in
20 meeting the rate of return expectation. But
21 unfortunately, the ability to actually forecast that
22 happening is -- we need to be very, very cautious about
23 assuming that we have that ability.
24 COMMITTEE MEMBER MATHUR: Thank you. You
25 mentioned the benchmarks. And, you know, clearly, we do

1 spend a lot of time looking at our relative performance,
2 active risk, et cetera, excess return, tracking error,
3 and -- but over the long term what really matters to us is
4 whether we hit our target rate of return.
5 And I'm wondering if there's some to -- and we
6 are talking about this obviously in our funding risk
7 mitigate work. But if there's someway to incorporate some
8 of that into this risk report, you know, what is our risk
9 of actually hitting our target over the long term? And so
10 I'll just leave you with that question, but I would like
11 us to start thinking -- you know, these are great reports.
12 They do tend to be a little bit on the shorter term view.
13 And so to the extent that we can start incorporating more
14 of our long-term view, given that that is a drive in
15 Investment Beliefs, I think we should incorporate that.
16 Thank you.
17 CHAIRPERSON JONES: Okay. You're welcome.
18 Mr. Jelincic.
19 COMMITTEE MEMBER JELINCIC: You mentioned, you
20 know, our equity exposure getting real low and the crisis.
21 My recollection is that that really was a function of
22 liquidity rather than a affirmative choice to reduce
23 exposure. We reduced exposure because we sold stocks
24 because those were the only thing we could sell and we had
25 bills to pay. Is my recollection accurate?

1 MANAGING INVESTMENT DIRECTOR BAGGESEN: That's
2 exactly right. That's right. And the one comment I'd
3 make in relation to that though, Mr. Jelincic, is that the
4 issues that were causing the liquidity stress are not
5 existent within the program today. There's been a
6 complete restructuring of things like the collateral
7 portfolios and whatnot. So we don't anticipate, unless
8 there's -- there's always the opportunity for something
9 else to come up and create that kind of stress, but
10 nonetheless we don't expect the next crisis will mirror
11 the last.
12 COMMITTEE MEMBER JELINCIC: So we expect that it
13 really is different this time.
14 (Laughter.)
15 MANAGING INVESTMENT DIRECTOR BAGGESEN: It's
16 always a dangerous statement.
17 COMMITTEE MEMBER JELINCIC: Yeah. On six of
18 nine, your crises, one of the things I thought was
19 interesting is the oil crisis, both top and bottom, had
20 very similar performances in terms of portfolio return,
21 and yet very different excess returns. And I don't know
22 what you make of that, but I just thought it was kind of
23 an interesting thing.
24 And then the other observation is on two of nine,
25 your active versus total risk. When I look at the 08/09

1 period, the realized risk went down, the forecast risk was
2 going up, and I'm -- intuitively that doesn't make a lot
3 of sense to me. But if it's -- so if you could explain
4 why the realized risk went down, it would be helpful. And
5 if -- and the other thing I will say is we see this chart
6 every six months or so. And if it's really a complicated
7 answer, maybe I will leave the question out there and you
8 can address six months from now when you show us this
9 chart again.
10 MANAGING INVESTMENT DIRECTOR BAGGESEN: Sure. We
11 can try to bring more clarity to that. But in reality the
12 realized risk levels during the period when the market was
13 falling in the fall of 2008, and prior to March of 2009,
14 that is an environment where one correlations had
15 dramatically spiked, and the prices of securities were
16 declining rapidly.
17 Over that entire time period, the equity
18 valuation fell more than 50 percent, so there was a
19 tremendous negative effect that was happening. Following
20 that, when the markets started to recover, basically the
21 volatilities realized within the pricing of the assets
22 dropped away pretty dramatically, but you can see that it
23 was still building in the risk system, as that information
24 was being assimilated, if you will, into the Barra system.
25 So the Barra risk didn't peak until at least a year later

1 basically, in contrast to what was actually being
2 experienced within the portfolio.
3 So there's just -- there's that -- it's just the
4 actual outcomes versus the -- basically, the system that
5 is used to estimate these values and the paradigms that go
6 into the calculation of that system.
7 But I think the realized experiences can change
8 very rapidly, Mr. Jelincic, in particular once a crisis or
9 once a whatever has gone by, the situation actually tends
10 to change fairly rapidly at that point as to what is
11 realized.
12 COMMITTEE MEMBER JELINCIC: But during the
13 crisis, I would expect volatility to be going up, and this
14 is telling me it went down.
15 MANAGING INVESTMENT DIRECTOR BAGGESEN: Yeah. If
16 you noticed, I think the peak on this -- and again, I'd
17 have to get the actual data, but I suspect the peak number
18 in what was realized would probably have equated to
19 something around August or September of 2009. And the
20 market bottomed in March of 2009, at least the equity
21 market.
22 COMMITTEE MEMBER JELINCIC: Okay.
23 MANAGING INVESTMENT DIRECTOR BAGGESEN: So I
24 think it was literally it just took that amount of time
25 basically for it to roll through into the sort of actual

1 pricing that the fund was experiencing.
2 COMMITTEE MEMBER JELINCIC: Okay. That would
3 explain it. Thank you.
4 CHAIRPERSON JONES: Yeah, thank you.
5 Eric, you had mentioned that our risk
6 expectations during the crisis was not realized, because
7 of the correlations were increasing. And as they
8 increased, we lost the diversity that we had hoped to
9 acquire from our asset allocation. And so I know this is
10 all based on current and past information, but just a
11 question for going forward, and we talked about
12 instituting a factor based allocation approach to help
13 deal with some of that -- that correlation -- those
14 correlation issues when we had the financial crisis. So
15 just from a viewpoint, how much -- how different would
16 some of this look, if we were dealing with the
17 factor-based allocation?
18 MANAGING INVESTMENT DIRECTOR BAGGESEN: With the
19 factors, just moving to a factor construct, if our actual
20 asset exposures are similar to what they are now, the
21 factor construct isn't going to change the outcomes. In
22 other words, you would still be basically seeing the same
23 kind of losses, same kind of volatilities. And it's not
24 clear that going from construct A to construct B
25 automatically results in a radically different allocation

1 of the assets.

2 As I think Ted pointed out and Wylie pointed out,
3 we very much have a growth oriented portfolio, because
4 that's the part of the marketplace that has the potential
5 of return that can be generated.

6 The only way that we would have a significantly
7 different outcome is if we basically started down the path
8 of, I'm going to use the term risk parity, which in
9 essence tries to more balance the actual risks attached to
10 the portfolio.

11 And if you think about it in probably its most
12 fundamental construct, you have risk attached to economic
13 growth, and then you have interest rate risk. And
14 interest rate risk tends to be negatively correlated,
15 particularly in a stressed environment, relative to the
16 growth risk. And that is largely due to the actions of
17 central banks trying to reignite economic growth. So they
18 tend to drive interest rates down, which tend to result in
19 a increase in fixed income prices.

20 So those are the most fundamental diversification
21 elements that we're aware of. And a risk parity kind of a
22 strategy tries to increase that interest rate sensitivity.
23 Albeit to do that at the current low levels of interest
24 rate basically brings down the expected return on the
25 fund.

1 So the only way to build in a lot of risk
2 diversification currently is if you're using a significant
3 amount of leverage. And then that brings in yet another
4 form of risk onto the fund at that point. But that is one
5 of the challenges, just going to a risk-factor construct
6 is not going to radically change it as long as our assets
7 are still highly concentrated in economic growth
8 sensitivity. Regardless of how we label that, we're going
9 to experience a similar outcome.
10 CHAIRPERSON JONES: Okay. And you mentioned
11 leverage -- the leverage that you list here, is that all
12 the leverage? In other words, there are no off-balance
13 sheet leverage?
14 MANAGING INVESTMENT DIRECTOR BAGGESEN: The
15 leverage that you see listed is the -- let me think about
16 how to describe this. This is the leverage that is
17 identifiable given the definitions that we're using. I
18 would suggest to you that there's a significantly higher
19 degree of leverage attached to many of the assets of the
20 fund that we do not account for directly and is not
21 directly recoursed to CalPERS.
22 But, for example, when you invest in publicly
23 traded companies, the global equity portfolio, those
24 companies, in large measure, use debt as part of their
25 financial structure. So CalPERS, let's say, is an equity

1 holder. We own a share of Apple stock. And Apple is
2 probably a bad example, because, well, they've been
3 increasing their debt a little bit. But nonetheless, it's
4 not a highly levered company. But typically, those
5 companies have exposure to more assets than just the
6 equity value of the financial structure.
7 So that is a form of leverage attached to those
8 company exposures as well. So if you really start to dig
9 through and actually measure all of this, you'll find that
10 there's a significant exposure to assets beyond just the
11 value of the fund. In some cases, we have accountability
12 and we buy those assets directly, or our managers buy
13 those assets on our behalf. In other cases, that is
14 endemic to the financial structure that these enterprises
15 use in basically building their businesses.
16 So I would suggest that there's -- economically,
17 there's a significantly higher degree of leverage than is
18 attached to the table that you see on page five.
19 CHAIRPERSON JONES: And so leverage doesn't come
20 into play when we have a commitment of as -- resources
21 versus allocated resources?
22 MANAGING INVESTMENT DIRECTOR BAGGESEN: A
23 commitment of resources versus allocated?
24 CHAIRPERSON JONES: Yeah. You know, we have
25 private equity and we have a commitment, but we don't

1 have -- we haven't allocated to that total commitment. So
2 what about -- how does that play in this leverage
3 question?
4 MANAGING INVESTMENT DIRECTOR BAGGESEN: Yeah.
5 Those capital commitments do not create leverage in and of
6 themselves, because basically we have -- the capital that
7 we believe we're going to satisfy a capital call with is
8 invested currently either in equities or fixed income. So
9 we would basically be reducing those asset exposures and
10 redeploying it into, let's say, a private equity or real
11 estate portfolio.
12 CHAIRPERSON JONES: Okay. Thank you.
13 Ms. Hollinger.
14 COMMITTEE MEMBER HOLLINGER: Yeah. Thank you,
15 Eric. Great report. I just wanted to clarify something,
16 because you were talking about a negative return and, you
17 know, our ability to catch up regarding that our payouts
18 are increasing and the maturing of our population.
19 Wouldn't it really be any gap between the
20 realized return and the benchmark doesn't have to be
21 negative.
22 MANAGING INVESTMENT DIRECTOR BAGGESEN:
23 Certainly -- so our actuarial --
24 COMMITTEE MEMBER HOLLINGER: Like, if we add two
25 percent and our benchmark is 7½, that still requires us,

1 you know, the same thing to catch up, based --
2 MANAGING INVESTMENT DIRECTOR BAGGESEN: That's
3 exactly right. When we look at the actuarial value, when
4 this was shown on the -- in the other attachment, it was
5 Attachment 1, and --
6 COMMITTEE MEMBER HOLLINGER: I just wanted people
7 to understand that it's not limited to a negative return.
8 MANAGING INVESTMENT DIRECTOR BAGGESEN: No,
9 that's right. If you -- it was on page 29 of 36 in
10 Attachment 1. And I don't think I can flip back to that
11 on the screen.
12 COMMITTEE MEMBER HOLLINGER: That's okay.
13 MANAGING INVESTMENT DIRECTOR BAGGESEN: But
14 anyway, you see the very, very -- it's not quite exactly
15 straight, but you see the line that almost looks straight,
16 that's the actuarial assumed rate of return. And you see
17 that that number happens to lie almost exactly on the
18 benchmark. So our conversion of a 7½ percent return
19 expectation into the benchmarks that underlie the total
20 fund policy benchmark, the asset allocation, over the
21 period of this chart you've basically had an asset
22 allocation that gave you something that approximated that
23 7½, which I think gets back to Ms. Mathur's point that she
24 made before as to how -- what's our risk around that 7½.
25 COMMITTEE MEMBER HOLLINGER: Right.

1 MANAGING INVESTMENT DIRECTOR BAGGESEN: What you
2 see though is the actual realized line has fallen below
3 that. That falling below happened in the sort of -- it
4 says fiscal year 2009 is when it really dropped below it,
5 which is when a lot of the problems were happening in the
6 real assets area, and other parts of the portfolio. And
7 that gap started opening up.
8 Now, we've gone -- since then, we've had a number
9 of years where we've actually had positive returns, but
10 you see that the gap is still sitting there.
11 COMMITTEE MEMBER HOLLINGER: Right.
12 MANAGING INVESTMENT DIRECTOR BAGGESEN: So it's
13 very, very difficult to make that back up again once it
14 opens. But you're right, we have a gap from that almost
15 straight line, that gap opens up when we earn less than 7½
16 percent.
17 COMMITTEE MEMBER HOLLINGER: Correct.
18 MANAGING INVESTMENT DIRECTOR BAGGESEN: And
19 relative to the more volatile benchmark line, that's when
20 the relative return. So, for example, in this current
21 year, our relative return was nine basis points below, so
22 that gap opened up a little tiny bit even more on the
23 relative line, and opened up significantly more in
24 relation to the 7½ percent line. But you're absolutely
25 right. There's many different ways to have shortfall.

1 COMMITTEE MEMBER HOLLINGER: Okay.
2 CHAIRPERSON JONES: Okay. I think -- we are
3 going to take a break, 10 minute break. Not I think, we
4 are. And let's reconvene at 11:55.
5 Thank you.
6 (Off record: 11:45 AM)
7 (Thereupon a recess was taken.)
8 (On record: 11:55 AM)
9 CHAIRPERSON JONES: We're reconvening the
10 Committee meeting. And Mr. Eliopoulos.
11 CHIEF INVESTMENT OFFICER ELIOPOULOS: Sure.
12 Well, I think we had a terrific discussion on the Item 6A.
13 So I think with no further ado, I think it would be a good
14 time for you to hear from your consultants.
15 CHAIRPERSON JONES: Okay. Let's move to the next
16 item then.
17 MR. JUNKIN: Great. I think I'm going to lead
18 off.
19 (Thereupon an overhead presentation was
20 presented as follows.)
21 MR. JUNKIN: Andrew Junkin with Wilshire
22 Consulting. And thank you, I will try to not repeat
23 staff, since that was a thorough discussion. But I did
24 want to provide just Wilshire's perspective on a few
25 things as your consultant. And we've kind of got four

1 broad topics on a few of the pages I'm going to hit.
2 We've got, you know, 120 pages. I'm going to touch eight
3 of them.
4 So the four broad topics that -- you know, a
5 couple of the pages are going to talk -- talk to sort of
6 intermediate-term, long-term themes that we see. A couple
7 of pages on risk, one on just decomposing the return,
8 which I think has already been done pretty well, just a
9 different look at it. And then one kind of a challenging
10 environment, which I think investors are facing.
11 --o0o--
12 MR. JUNKIN: Page two. So without further ado,
13 page two. So John Rothfield really I thought did a great
14 job covering the economic overview. Our view is really
15 not that different, that this is a pretty moderate growth
16 environment, and that future returns are going to be
17 impacted by the current elevated valuations of lots of
18 assets right now. And that's what you're seeing in our
19 asset class assumptions here.
20 You can see the change from December of '14 to
21 the second quarter. And there's been an uptick in
22 expected returns. Really, if you look at sort of the
23 bottom third here, returns minus inflation. Our real
24 expected returns are really about the same. So the push
25 forward in expected returns has really been driven by a

1 slightly revised upward view on inflation.
2 In terms of risk, we've had a number of
3 conversations about risks. There doesn't seem to be
4 anything structural to us. I think John made a similar
5 comment. There's not a 2008 kind of lurking in any of the
6 data that we have seen. So, you know, a lot of times the
7 risks that are the surprise risks are the important risks,
8 the unforecastable risks.
9 But if you look at what the global economy has
10 gone through in terms of macro surprises already, you
11 know, oil falling from 105 to 45, a massively strong
12 dollar, China, Greece. You know, we survived a lot of the
13 macro risks that could have been disruptive. At this
14 point, I think the next one that we're going to face is
15 obviously how does the market react to the federal reserve
16 beginning to raise rates?
17 --o0o--
18 MR. JUNKIN: And so from there, let's go to page
19 five. So we can -- we don't know how they're going to
20 react. We can see how the market reacted to
21 easening(sic) -- easening? I think I just made up a word
22 easing. So, you know, here this is fed policy versus
23 equity values in the U.S., and you can see when the fed
24 really kind of hit the gas in terms of adding liquidity to
25 the system. That's -- the equity market really responded

1 to that.
2 You know, the question I think that's outstanding
3 at this point is what happens as the fed tightens? If you
4 go to page six -- or I'll take you to page six -- this is
5 the same chart, but now we're looking at the ECB, and
6 we've added the forecast for what's likely to happen to
7 the European Central Bank balance sheets as they truly
8 embark on quantitative easing at this point.
9 Is it going to be an echo of what we saw in the
10 U.S.? I think really the same question that I ended the
11 lasts page on applies here, which is what happens when the
12 fed tightens? Is the fed going to sort of override the
13 impact of the ECB, because a lot of the juice has already
14 been squeezed out of that? So that's something that bears
15 watching.
16 --o0o--
17 MR. JUNKIN: Page eight, this is a new page for
18 our report. And it really is kind of aligned with some of
19 the discussions that we've had on risk mitigation. I
20 would change the title of this page to expected return and
21 volatility estimates based on some of the conversation
22 that we've had right now. Our forecast using our expected
23 return assumptions, which I showed you earlier, for
24 volatility over a 10-year time period is about 12½. So
25 that's baked into the top part of this chart.

1 So you can see the expected return. If you kind
2 of start on the left, 6.61. That's based on our current
3 assumptions. What does that turn into? That's about a
4 $20 billion annual increase, you know, both from
5 depreciation, interest, dividends, things like that.
6 So if you move one column to the right, what
7 happens if we come in one standard deviation below, one
8 standard deviation above, the return goes from 661 to
9 19.2. And the gain goes from 20 billion to 58 billion.
10 That's great news, right? You can carry that out one more
11 standard deviation up, a 32 percent return and a $96
12 billion gain. That's great news, right? Well, risk
13 mitigation conversations take on a whole different tone if
14 we've gotten a $86 billion gain.
15 The flip side of that though is really I think at
16 the heart of the risk mitigation workshops that we've
17 done. One standard deviation below the expected return
18 and you lose $18 billion, two below, and you lose $56
19 billion. And we're back to the path of returns having a
20 pretty significant impact, particularly when you're cash
21 flow negative. So that's the current state.
22 So the bottom states that well just what would
23 happen if we had reduced risk, if we kept the same Sharpe
24 ratio, but we moved to a 10 percent risk level. So
25 expected return naturally comes down. I would submit

1 maybe it doesn't come down quite this much, but I wasn't
2 going to play that game.
3 So the expected return goes to 5.6. Your $20
4 billion expected gain goes to about $17 billion. So in
5 the expected state of the world, your $3 billion less well
6 off. But really, the significant difference is on the
7 bottom part of this page. You know, the $18 billion
8 potential loss goes to 13, the $56 billion potential loss
9 goes to 43. Those are holes that you don't have to climb
10 out of on the way back. So just a different way of
11 presenting risk and volatility that we talk about.
12 --o0o--
13 MR. JUNKIN: Page 11. So this now I think hits
14 on something that a couple of Investment Committee members
15 discussed. In the long term, if we do have volatility, if
16 we do have financial risks inherent in the system, what
17 can we do? One of the themes that Ted talked about is
18 broad diversification. And that helps in most normal
19 environments. In truly stressed environments, sometimes
20 that's not enough.
21 So I'm going to start on the upper right on this
22 page. These are months where the global equity market was
23 down one percent or more. And when that happens, it's
24 about a third of the time. You can see 31 percent over
25 the last 24½ half years, because the index didn't go back

1 that extra six months.
2 The average return is actually much worse than
3 just down one. It's down 4 in those months. And really
4 there are three asset classes that you might think of as
5 diversifying that help a portfolio. And the most
6 significant one is long treasuries with a positive return.
7 That goes to what Eric said is the fed tries to reignite
8 stability and growth. And, you know, that's generally the
9 mechanism that works there.
10 REITs just kind of is a broad proxy real estate.
11 The diversification doesn't work when the equity markets
12 tend to be falling. Commodities, not all that reliable in
13 falling equity markets. Moving to the lower left, this is
14 the same chart, but now it's months where the market is
15 down three percent or more, then you can see their average
16 return goes down to minus 6½.
17 Again, long treasuries tend to be a pretty good
18 tail-risk hedge. You know, tail-risk hedging in general
19 for CalPERS at $300 billion is absurdly expensive and
20 probably, in most cases, ineffective. Long treasuries,
21 those are pretty widely available. Something just as a
22 consideration.
23 The last part is if things are down five percent
24 or more, and that's pretty depressing, so we're not going
25 to cover that.

1 (Laughter.)

2 --o0o--

3 MR. JUNKIN: Mike is already elbowing me telling
4 me my time is up.

5 (Laughter.)

6 MR. JUNKIN: Page 15 is just the full year,
7 fiscal year attribution, so you can see what drove the
8 relative returns. And if we kind of focus in the box on
9 the right, really the sum total of the actual allocation
10 versus the target allocation detracted about 10 basis
11 points. That's kind of a non-event. That's kind of what
12 you would expect.

13 Within that, you can see the underweight to real
14 assets was kind of a big penalty, and was offset in some
15 ways by the underweight to inflation assets, because they
16 underperform. So being underweight in underperforming
17 asset is a good thing.

18 And then active management again, in sum total,
19 didn't amount to much, but in public equity and private
20 equity acted as a bit of a drag. The same with income.

21 --o0o--

22 MR. JUNKIN: And now I'm going to jump way ahead.
23 And, in fact, I'm going to sort of be Ed McMahon for Mike
24 here and help set him up for his conversation. I think
25 one of the risks that we see -- and I'm using risk here

1 intentionally instead of volatility -- is the current
2 private equity environment. And I know that Mike is going
3 to get to this, but I just wanted to call out the fact
4 that private equity pricing at this point is at the
5 highest levels that we've seen in the last 10 years.
6 --o0o--
7 MR. JUNKIN: Typically, that tends to be
8 challenging for future returns. And if you look at the
9 private equity overhang, it really hasn't changed much in
10 the last eight years or so. It's still about half a
11 trillion dollars, which is both an opportunity and a
12 challenge. I think that this kind of overhang is likely
13 to provide a little bit of technical support, if there's
14 just a little bit of weakness in the private equity
15 market. If there's a lot of weakness, it's probably not
16 going to do much by way of support. But if we see prices
17 dip down to, you know, nine times, I think some of this
18 capital will get deployed.
19 So I'm going to stop there. Those are all the
20 comments that I had prepared on the 120 pages that we
21 presented, and see if there are any questions. And if
22 not, I'll hand it over to Mike.
23 CHAIRPERSON JONES: Yeah, there is.
24 Mr. Jelincic.
25 COMMITTEE MEMBER JELINCIC: And I'm not going to

1 ask my question, because I forget to note what page it was
2 on, but I will tell you what the issue was. You showed
3 expected returns one standard deviation up, down. The
4 numbers were clearly asymmetrical. They were much higher
5 on the upside than the downside. And I just didn't
6 understand the math. But since I don't remember the page,
7 I'll let it go.
8 MR. JUNKIN: We vetted that about three different
9 ways, so I'm pretty confident in it, but I'm not -- I
10 won't say I'm ever 100 percent confident in anything. You
11 know, when you've got a $20 billion gain as your starting
12 point, two up from that is a really big number, two down
13 has that $20 billion cushion. That's the expected return.
14 COMMITTEE MEMBER JELINCIC: Okay.
15 MR. JUNKIN: The gain and the loss shouldn't be
16 equal.
17 COMMITTEE MEMBER JELINCIC: Okay. That will
18 explain it. Thank you.
19 MR. JUNKIN: Thank you.
20 CHAIRPERSON JONES: You're welcome.
21 Mike.
22 MR. MOY: Mike Moy from PCA. To correct the
23 record, I did not elbow him.
24 (Laughter.)
25 MR. MOY: But he did use more than eight pages, I

1 think.

2 (Laughter.)

3 MR. MOY: I lost count.

4 So I'm just going to add a couple of
5 observations, because I thought that Ted's synopsis of
6 what's gone on in the private equity space was excellent.
7 We see, as you can see, on page four of 17 in the
8 exhibits, it's not on the slides, that the absolute
9 performance of private equity has been higher than the
10 actuarial rate, and higher than your peer groups have been
11 doing. It hasn't been higher than your benchmarks, but
12 Andrew is going to talk a little bit about that.

13 The expectation that those rates of return will
14 continue is very high. The fear that Andrew referred to
15 with respect to the pricing right now in the private
16 markets is at the highest it's ever been. We have
17 observed very high level of discipline among the managers.
18 They're not running out making investments, because they
19 realize that buying in at a high multiple is not where it
20 should be.

21 As it relates to what's going on in the industry,
22 there's been a tremendous amount of publicity over the
23 last six months. We authored a paper about a month ago
24 that was quoted in one of the magazines, one of the
25 newspapers that follows the industry and accused us of

1 shilling for the private equity managers.
2 We looked at the paper again to read it for
3 content, and concluded, well, what we were really doing
4 was telling everybody what the industry has been doing,
5 and we encouraged our clients in that paper to collaborate
6 and work together to apply as much pressure as they can to
7 the managers to improve transparency and to lower costs.
8 So we felt that that was a misreading by the
9 author of the article of what the paper was intended to
10 do, but it coincides with what Ted had mentioned during
11 his opening remarks in terms of the direction you're
12 going.
13 The last comment I want to make is we encourage,
14 and you are already doing this, working with the Institute
15 of Limited Partners Association because that is the only
16 way you're going to be able to level the playing field
17 with managers.
18 You have, because of your size, a real advantage
19 in dealing with them one on one, but that only helps you.
20 If you want to get more help, if you drive the industry
21 expectations down, it's going to aid you in your
22 negotiations with the general partners. So we encourage
23 that and we think it's a good move and please keep doing
24 it.
25 With that, I'll turn it over to Andrew.

1 MR. BRATT: Good afternoon. Andrew Bratt, PCA.
2 Very briefly -- I'm cognizant of the time -- I want to
3 talk quickly about the benchmark issue. As you know, your
4 current benchmark is a custom public market index plus a
5 premium, which is common amongst your peers, but it also
6 the problematic, in that the public markets are generally
7 more volatile than the private markets, especially over a
8 short period of time, such as one year.
9 In our report, we also include the State Street
10 Private Equity Index, which is a peer-based index. And as
11 you'll see in our report, CalPERS has consistently
12 outperformed that index.
13 The second point I was trying to make here is
14 that the Private Equity Program is cash flow positive.
15 Has been so since 2011. Distributions from private equity
16 investments have exceeded capital contributions made to
17 fund new investments to the tune of $17.5 billion just
18 over the last three years. We are not confident that this
19 will continue indefinitely into the future.
20 Once the ongoing seller's market subsides, I
21 think that the program -- combined with additional
22 contributions made for new investments, we think that the
23 program will ultimately turn back into cash flow negative
24 status in time.
25 With that, we'd be happy to answer any questions.

1 CHAIRPERSON JONES: Mr. Jelincic.
2 COMMITTEE MEMBER JELINCIC: Yeah. I want to talk
3 a little bit about benchmarks, which probably surprises
4 you. I've never mentioned them before. I understand the
5 problem with comparing it to public markets, but on the
6 other hand it is essentially an equity product. And if we
7 can't get a higher return out of it than we can out of the
8 public market, why should we accept those additional risks
9 in illiquidity and fees. And so that's one question.
10 The other question is peers, I -- you know, yes,
11 we tend to compare ourselves to our peers, but our
12 liabilities are very different, our size is very
13 different, our leverage with the GMs is very different. I
14 see some real weaknesses in a peer comparison as well.
15 So I'd kind of like you to comment on both the
16 peer and the public plus, both strengths and weaknesses.
17 MR. MOY: The benchmark issue, as we understand
18 it for private equity, is going to be addressed more
19 completely as part of the asset allocation study that's
20 sort of in process.
21 But in terms of background as to, you know,
22 what's happened, a public market benchmark plus a premium
23 for illiquidity worked pretty well up until the financial
24 crisis. Since the financial crisis, the volatility of the
25 markets has been much greater than it was before the

1 financial crisis. And it's the volatility that's causing
2 the mismatch. If the volatility were to become more,
3 let's call it, standardized or normalized --
4 COMMITTEE MEMBER JELINCIC: The volatility of the
5 public markets?
6 MR. MOY: Yes. If the volatility of the public
7 markets were to become more normalized, that probably
8 would be a preferable benchmark. The industry struggles
9 with it. I don't have a good answer for you. I think
10 that the answer that I've always turned to is an absolute
11 return exceeds your expected rate of return, which is
12 designed to compensate the system so that it can
13 ultimately pay benefits. And that to me is really where
14 the future is, paying benefits.
15 COMMITTEE MEMBER JELINCIC: Does that suggest
16 that it ought to be the actuarial assumption of the fund
17 plus something as the benchmark, rather than necessarily
18 public markets?
19 MR. MOY: It could suggest that. I don't know
20 whether that's feasible, because I'm not a quant, so that
21 is a possibility.
22 COMMITTEE MEMBER JELINCIC: Okay. Thank you.
23 And the peer, the strength and weaknesses of comparing to
24 peers.
25 MR. MOY: I think if I were in your shoes having

1 a peer benchmark on a continuing basis would give you an
2 idea as to how well your staff was doing versus the other
3 staffs -- other investors. Longer term, I think using a
4 public market benchmark plus a premium is really where it
5 should be looked at, but 10 years is when I would be using
6 that as a frame of reference.
7 In the interim, because you need to compensate
8 your people, comparing them to what other investors are
9 doing to me is a more equitable approach to it.
10 COMMITTEE MEMBER JELINCIC: Thank you.
11 CHAIRPERSON JONES: Ms. Mathur.
12 COMMITTEE MEMBER MATHUR: Yeah, I think J.J.'s
13 questions just sort of got to my questions, so I don't
14 want to belabor the point, but I think there are
15 challenges with the existing benchmarks in terms of
16 survivor bias and sort of the ability to go back and add
17 your data if you perform well or not to -- and to exclude
18 it if you didn't. So I think there are some challenges
19 with existing market benchmarks.
20 So to the extent that there's a way to smooth the
21 public markets volatility, I don't know what that would
22 look like. I think 10 years probably helps, if you look
23 at the very long term. And I'm sure you guys are already
24 thinking -- all of you are already thinking about this.
25 But I think, you know, that's something we should think

1 about.
2 MR. MOY: Thank you.
3 CHAIRPERSON JONES: Okay. Next.
4 MR. GLICKMAN: Good afternoon, David Glickman and
5 Christy Fields from PCA.
6 Christy and I are going to share with you three
7 observations in the next couple of minutes. The first is
8 about the real estate markets, the second is about your
9 portfolio, and the third is about the real estate unit.
10 To echo what's been said and to be as succinct as
11 possible, for the kinds of real estate investments that
12 CalPERS seeks, nothing is cheap. And as a result, the
13 amount available for new investments has not been fully
14 deployed.
15 PCA's observation is that we're very glad to see
16 that both staff and the managers are exerting extremely
17 good discipline, and are not stretching to do deals which
18 are marginal or outside of what would be the acceptable
19 and appropriate kinds of real estate investments for the
20 system in the way that the role of real estate is now
21 defined and constructed in the overall portfolio.
22 The second comment we would make about the
23 existing real estate portfolio is that it continues to
24 approach the target of being a diversifier and an income
25 generator for the overall portfolio, as it becomes more

1 and more invested in existing and income-producing
2 commercial assets.
3 There's currently part of the execution of that
4 strategy is to sell the commingled fund interests in which
5 CalPERS doesn't have control, and in which the investment
6 strategy is different than the current real estate
7 investment strategy.
8 And once that process has been completed, that
9 will display the portfolio that remains even more closely
10 to the goals that have been set for the portfolio.
11 MS. FIELDS: I think the last point we wanted to
12 make was about the leadership of the real assets unit.
13 Paul Mouchakkaa has been around -- or in place for roughly
14 five months at this point, and he has done some
15 significant work in assessing and fine-tuning the business
16 practices of the unit, and the analytics that are used to
17 make the investment decisions. He's also made some
18 adjustments in terms of human resources and the roles and
19 responsibilities of each of the staff members in the unit,
20 that we believe are constructive and that will enhance the
21 investment process and improve portfolio construction and
22 reduce risks over the long term. Morals is much better,
23 by the way, also.
24 CHAIRPERSON JONES: Okay. Thank you. Mr.
25 Jelincic has a question.

1 COMMITTEE MEMBER JELINCIC: I'm glad that our --
2 that we are not throwing money at this market. But my
3 question is, is there a segment of the market that perhaps
4 we should be looking at that's opportunistic. And, I
5 mean, opportunistic in the broadest sense, not necessarily
6 just higher risk? Are there mispriced segments of the
7 market that we ought to be at least considering?
8 MR. GLICKMAN: Hard to answer quickly and
9 narrowly, but we don't see that there are very many
10 opportunities out there that are mispriced in favor of the
11 buyers.
12 COMMITTEE MEMBER JELINCIC: Okay. Thank you.
13 CHAIRPERSON JONES: Okay. Thank you. Then next.
14 MR. KECK: Hi. Tom Keck with StepStone. And
15 since I'm talking about one percent of the portfolio, I'll
16 try to be as brief as I can.
17 (Laughter.)
18 MR. KECK: The good news is the portfolio has
19 actually been performing quite well. So in Attachment 5,
20 we've got a brief letter just kind of laying out the high
21 points are that over one-, three- and five-year periods
22 you've exceed the benchmark by about 1,000 basis points on
23 average. So things are going very well in the existing
24 portfolio.
25 As you've heard from some of the other asset

1 classes the outlook going forward. I'd want to moderate
2 those expectations that outperformance is not going to
3 continue. Pricing is certainly very high, but we think
4 that there are some very interesting opportunities in the
5 market, whether it's the energy dislocation, the need for
6 investment in roads, in other transportation
7 infrastructure, as well as infrastructure in economies
8 that are emerging and becoming developed economies.
9 So we think there are a lot of great
10 opportunities out there. And the other good news is that
11 I think CalPERS has positioned itself to take advantage of
12 those opportunities when they arise. You have a number of
13 advantages as an infrastructure investor. The long-term
14 orientation being a dollar based investor is certainly
15 helpful as to infrastructure here in the U.S. And I think
16 CalPERS is known around the world as a sophisticated and
17 kind of leading investor.
18 So shifting from a strategy that focuses on
19 commingled funds to one that focuses more on partnerships
20 with specific managers where they can leverage the CalPERS
21 name and position in the market I think is going to be a
22 very good strategy to take advantage of the market
23 opportunities going forward. So those -- that's basically
24 my remarks. I'll be happy to entertain any questions.
25 CHAIRPERSON JONES: Yes. I have a question. The

1 public-private partnerships domain, what's the status of
2 that, because there doesn't appear to be much traction in
3 terms of agreements coming forward? And while, at the
4 same time, the backlog, the need is so great, but yet
5 instilled. What is your views about -- number one, what
6 are the impediments, and number two, what steps could be
7 taken to try to bridge some of those gaps?
8 MR. KECK: Public-private partnerships have been
9 extremely helpful overseas, but have been a long time
10 coming here in the states. And I think it's primarily
11 been political barriers to get over. There's certainly a
12 lot of interest on both the public side as well as the
13 private investor side.
14 But I think there's also a lot of concern amongst
15 policymakers about setting up partnerships where investors
16 are seeming to be able to earn high returns at the expense
17 of institutions, so they're concerned about making bad
18 deals in these types of situations. I think there's also
19 concern about privatization of public sector jobs or
20 potentially having those jobs go away.
21 So we've seen a lot of people, a lot of talk, and
22 a lot of energy around public-private partnerships. And
23 as you say, there's a lot of need for that -- those
24 investment dollars. But I think until policymakers and
25 investors are able to find ways to bridge the gaps on some

1 of these issues, it's probably going to continue to be
2 slower than we'd like to see.
3 CHAIRPERSON JONES: Okay. Thank you.
4 Mrs. Mathur.
5 COMMITTEE MEMBER MATHUR: Thank you.
6 You noted the exceptional performance of this
7 program, which is certainly a wonderful thing to see.
8 And, you know, we've been fairly slow in deploying capital
9 in this space. And so I'm wondering -- I mean, I think --
10 I know our staff has been remarkably disciplined about
11 adhering both to the policy, but also to their own
12 internally developed investment parameters. I'm wondering
13 if you think there are anythings that we ought to change?
14 Maybe, now is not the time to talk about them, but maybe
15 we're setting too high a bar. Maybe somewhere -- there's
16 somewhere in between that we should be. And I guess I
17 would just ask you to comment on that, to the extent that
18 that's appropriate for public session.
19 MR. KECK: I think you have made some significant
20 changes in terms of shifting toward this partnering
21 approach. And I think to echo Mr. Jelincic's earlier
22 point, there's no point in being in this asset class if
23 you're going to throw money at assets that are not going
24 to provide some sort of excess return above your
25 benchmark.

1 So I think the discipline that you've shown is
2 part of the reason why you're enjoying the benefits that
3 you are today. And I think the structure that you have in
4 place will allow you to take advantage of what will
5 probably be limited opportunities, even -- there are a lot
6 of capital searching for these infrastructure
7 opportunities. And so I think you do still want to
8 continue to be disciplined as you look for places to
9 invest.
10 COMMITTEE MEMBER MATHUR: Yeah, and I guess I'm
11 not trying to argue for a lack of discipline --
12 (Laughter.)
13 COMMITTEE MEMBER MATHUR: -- but whether the --
14 whether the parameters are at the right place. And I
15 guess my question really is to the -- you know, what is
16 the appropriate risk premium for these types of
17 investments, and -- and is -- you know, there's
18 somewhere -- I mean, 13 percent for one year, 17.8 percent
19 for five years, that is great, and accretive to our
20 overall -- reaching our overall target, but our target is
21 7½ percent. So to -- so where -- is there -- is there
22 somewhere that we could be that would allow us to deploy
23 more capital at perhaps an overall lower rate of return
24 that would be even more accretive to the bottom line?
25 MR. KECK: So your target for infrastructure is

1 CPI plus a margin.
2 COMMITTEE MEMBER MATHUR: Yeah.
3 MR. KECK: So I think that is very appropriate,
4 and I think allows you to pursue the kinds of assets that
5 should allow you to get the money to work. If you were
6 expecting a 13 percent return from infrastructure, then I
7 would say, you don't -- you aren't going to get very much
8 put to work.
9 COMMITTEE MEMBER MATHUR: Okay. Thank you.
10 CHAIRPERSON JONES: Okay. That concludes -- no
11 further question son this. Thank you all for your
12 presentation, and very informative.
13 And we will move to next item on the agenda,
14 which Project Updates Regarding Investment Policy
15 Revisions.
16 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
17 Thank you, Mr. Chairman. Wylie Tollette, CalPERS
18 staff. And I'll introduce Kit Crocker, Investment
19 Director for our ICOR team, who is responsible for
20 maintaining the investment policies for the office.
21 This agenda item intends to provide an update on
22 our ongoing project to simplify and improve our investment
23 policies. There are two key remaining elements to this
24 project to continue the clean-up of the policy documents
25 as we go through the individual asset classes for the

1 remainder of the calendar year, and to move the risk
2 constraints and limits that currently exist within the
3 Investment Office delegations over to the investment
4 policy documents.
5 There are several reasons we're moving this
6 project forward. The first, it's very helpful for staff
7 to have all the risk parameters and limits in one
8 document, so that no detective work is required to
9 identify the appropriate limits around a particular
10 investment, and that detective work is occasionally
11 required today.
12 This also allows the Investment Committee to
13 oversee and improve a holistic policy document that has
14 all of the risk limits within it, and is clearly within
15 the oversight responsibility of the Investment Committee.
16 And then finally, this provides an opportunity
17 for the Board to take up review and approval of simplified
18 delegations at a later date.
19 So with that, we're happy to take questions from
20 the Committee.
21 CHAIRPERSON JONES: Mr. Jelincic.
22 COMMITTEE MEMBER JELINCIC: I just want to
23 reiterate what I said in the briefing. We, as a Board,
24 occasionally lose track of the limits and the delegations
25 that we've done. And so I'm just requesting that as you

1 bring these things forward, you always remind us what
2 delegations and limits we have placed. You remember a few
3 months ago we got a whole table of them, and a number of
4 Board members were kind of surprised at what we had
5 delegated away. So I just want to make sure that we don't
6 lose track of that. And so I just want to reiterate what
7 I had said on the briefing.
8 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
9 Understood.
10 COMMITTEE MEMBER JELINCIC: Thank you.
11 CHAIRPERSON JONES: Okay. No further questions
12 on that.
13 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE:
14 Thank you.
15 CHAIRPERSON JONES: Thank you very much. We're
16 going to take a break for lunch and we will convene at
17 1:30.
18 (Thereupon a lunch break was taken.)
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1 A F T E R N O O N S E S S I O N
2 (On record: 1:31 PM)
3 CHAIRPERSON JONES: Okay. We'd like to reconvene
4 the Investment Committee meeting. And we will start with
5 Item 8, the Federal Investment Policy Representative
6 Update.
7 Mr. Eliopoulos.
8 CHIEF INVESTMENT OFFICER ELIOPOULOS: I believe
9 we have --
10 DEPUTY EXECUTIVE OFFICER BOYNTON: Good
11 afternoon, Ann Boynton, CalPERS staff. We have our
12 federal representative Dan Crowley from K&L Gates on the
13 phone. And I believe Dan is ready to go to give you a
14 very brief update. In addition, you have materials in
15 your packet. I know he's ready to answer any questions
16 you might have about that.
17 CHAIRPERSON JONES: Okay. Thank you very much.
18 MR. CROWLEY: Hi, Mr. Chairman. This is Dan
19 Crowley here in Washington. I'm with my -- two of my
20 colleagues, my partner Bill Kirk and Eric Love who joined
21 us from the Treasury Department last month.
22 I know time is short, so I will just hit the high
23 points, and then, of course, be happy to take any
24 questions you might have. The first thing to point out,
25 of course, we just passed the five-year anniversary of

1 Dodd-Frank. There are -- there continue to be a number of
2 legislative efforts on the Hill. None terribly
3 significant in terms of repealing any of the major
4 provisions in Dodd-Frank, but there are a bunch of
5 proposals, some bipartisan, some not, that I would say
6 mostly fall in the category of technical corrections with
7 some exceptions.
8 There are, for example, efforts to increase the
9 threshold for designation of non-banks systemically
10 important financial institutions from the current 50
11 billion. It would go up to 500 billion, but the F stock
12 would retain its discretion to designate and institution
13 below that threshold.
14 Another provision that is in both the House
15 discussion materials and Senator Shelby's reform package
16 is exempting community banks from the Volcker Rule. And
17 we can -- if anybody has any questions about any of those
18 legislative efforts, I'd be happy to respond to them.
19 Let me talk a little bit about some recent
20 successes at the SEC relating to executive compensation.
21 And then I'll talk just for a minute about derivatives,
22 housing finance reform, and the status of various
23 appointments to the SEC and the CFTC.
24 On executive compensation, the SEC finally
25 finalized the clawback rule. This would require national

1 securities exchanges to establish listing standards that
2 would allow for recovery of compensation of the senior
3 executive in the event of an accounting restatement. And
4 I know -- I'm sorry, this was a proposal, which I know
5 that CalPERS will comment favorably on that proposal.
6 The one that has been finalized is the pay ratio
7 rule. On August 5th, that was finalized. It requires
8 disclosure of the ratio of the CEO pay to the average
9 employee pay. That was something that CalPERS has been
10 out front on for a long time, sent a letter of support in
11 2013. And so we can put that one in the win column.
12 Of course, the policy process being what it is,
13 there's already discussion of legislation to repeal the
14 pay ratio rule. There are bills in both the House and the
15 Senate, HR 414 in the House Financial Services Committee.
16 Chairman Hensarling has said he intends to pursue Senator
17 Mike Rounds has a bill, S-1722 that would also repeal the
18 pay ratio rule.
19 However, at this point, it is unclear whether
20 either of those bills have much prospect. Chairman Shelby
21 has not indicated whether he will be bringing up either
22 bill, but we will be monitoring that and keep you posted.
23 On derivatives, there continues to be most focus
24 on harmonization of cross-border regulatory regimes. The
25 European Commission has been moving forward as has the

1 CFTC and the SEC. But again continued focus on
2 cross-border issues, particularly in the context of
3 reauthorization of the CFTC.
4 On the SEC side, Patrick McHenry has introduced a
5 bill, HR 1834 to allow for private resale of restricted
6 securities. The intent here is to create a robust
7 secondary market for restricted securities. That one may
8 very well move forward. He has indicated that it's a
9 working draft, and he intends to work with ranking member
10 Waters who supports the effort. So we should expect that
11 one to go forward. Obviously, the devil will be in the
12 details and we will keep you posted on that.
13 The SEC on August 5th finally finalized their
14 regulatory regime for security-based swap dealers and
15 major swap participants. That one is also one that we're
16 watching carefully to make sure that there's harmonization
17 between the SEC and CFTC. And as I said, global
18 harmonization remains top of mind on all of the
19 derivatives implementation issues.
20 Turning to housing finance reform, several
21 provisions in the Shelby Bill deal with GSE reform in one
22 form or another. There's an effort to give financial
23 institutions safe harbor protections for liability for all
24 qualified mortgages that they keep on balance sheet.
25 There's a discussion of a similar proposal in the House.

1 And there also is a lot of discussion about requiring the
2 GSEs to transfer risk to the private sector, so-called
3 credit risk transfer proposals.
4 We expect there to be some form of housing
5 finance reform legislation in the fall, primarily in
6 response to the FHFA director's decision to allow the GSE
7 CEO's to increase their compensation from what had been a
8 cap of $600,000, he moved that up to $3 million. And that
9 has provoked a bipartisan reaction, which may very well be
10 the driver for some sort of reform legislation in the
11 fall. If so, we should expect both the QM release and
12 credit risk transfer pieces to be a part of that package.
13 There's also ongoing discussion about using G
14 fees as pay-fors, most recently in the Highway Trust Fund.
15 But again, we can get into specifics on any of these
16 legislative issues, if members of the Committee would like
17 to pursue those.
18 Just let me mention that last week
19 Commissioner -- CFTC Commissioner Mark Wetjen announced
20 his intention to resign. Scott O'Malia, the Republican,
21 had resigned a year ago. There was no activity or no
22 expectation that the President would nominate only a
23 Republican commissioner, but now that there is a
24 Democratic vacancy as well, we expect him to nominate
25 Commissioners to be determined for those two CFTC slots.

1 And, of course, there continue to be two openings at the
2 SEC to replace Commissioners Luis Aguilar and Dan
3 Gallagher, who has announced his resignation.
4 So we are monitoring those developments. There
5 have been some discussion of candidates for the SEC. The
6 CFTC nominees there really hasn't been much discussion,
7 but we will monitor both sets of developments and keep you
8 posed. So in the interests of time, I will stop there and
9 answer any questions.
10 CHAIRPERSON JONES: Okay. Thank you. We do have
11 a question from Mr. Jelincic.
12 COMMITTEE MEMBER JELINCIC: On housing, you
13 talked about the GSE's engaging in more up-front and
14 first-loss transfers. What does that mean and what does
15 it mean to us?
16 MR. CROWLEY: Well, that's a good question. I
17 think what it means remains to be determined. There's a
18 lot of discussion. Generally speaking, there's, you know,
19 the idea of securitizing risks, sort of spreading it
20 through into the capital markets. There's also another
21 form of up-front risk sharing would be private mortgage
22 insurance. I was listening to the discussion earlier
23 about the decline in home purchases, home ownership. And,
24 you know, traditionally, first time and low income home
25 buyers have either relied on the FHA, if they qualify, or

1 on private mortgage insurance, if they have less than 20
2 percent down. So private mortgage insurance has a track
3 record -- to demonstrate a track record of risk transfer,
4 so that's one possibility.
5 The second set of questions is whether there's
6 going to be pool insurance. I'm sorry, risk transfer with
7 respect to pool. So there's two different types, right,
8 there's -- on the front end of a mortgage origination,
9 either having home buyer equity or private mortgage
10 insurance or FHA insurance on the one hand, and then once
11 the pools of mortgages are securitized by the GSEs whether
12 there can then be risk transfer. There have been a number
13 of experiments in this area, if you will. There was
14 STACRs proposal, and a couple of other things where
15 essentially the GSEs sold off risk into the marketplace.
16 They were successful, and so people on the hill
17 are now exploring ways to do that on a more regularized
18 basis. But the answer to your question is the devil will
19 be in the details and those discussions are ongoing. And
20 so we would be happy both to keep you apprised of
21 developments, and if CalPERS chooses to weigh in, we would
22 be happy to help facilitate that as well.
23 COMMITTEE MEMBER JELINCIC: Okay. And then on
24 the Senate Banking, you talked about them incorporating
25 the, what is it, Federal Regulatory Improvement Act,

1 what is -- what's in that other than exempting community
2 banks?
3 MR. CROWLEY: Well, there's a lot of sort of what
4 I would characterize as nuts and bolts changes. Many of
5 them are not controversial and have bipartisan support.
6 Others are more expansive and attempt to revisit
7 provisions in Dodd-Frank. I mentioned the SIFI threshold
8 exemption and the Volcker Rule exemption. But there are
9 things in there likely evaluation of capital adequacy
10 regimes as they relate to insurance companies. There are
11 some -- in addition to the two provisions, I mentioned the
12 QM and risk transfer. There's also a prohibition on the
13 GSE's selling preferred shares -- or the government
14 selling the preferred shares, and the GSEs, unless
15 approved by Congress, it would prohibit any increase in
16 guarantee fees charged by the GSEs. There would be a
17 series of sort of technical issues allowing credit unions
18 to become members of the Federal Home Loan Bank system
19 requiring the CFPB to promulgate rules on rural areas with
20 respect to the federal consumer finance laws.
21 Another provision would create an ombudsman
22 within the Federal Financial Institutions Exam Council.
23 There are amendments to the SAFE Act to allow the
24 Nationwide Mortgage Licensing System to be used across
25 different states without loss of privilege. There are a

1 bunch of those sort of nuts and bolts.
2 But I think the two provisions that sort of go
3 most at Dodd-Frank are the exemption for depository
4 institutions with under $10 billion in assets that would
5 exempt them from the Volcker Rule.
6 Now, I note that Dodd-Frank itself exempts small
7 depository institutions from the jurisdiction of the CFTP
8 and that threshold is $10 billion. So it's consistent
9 with some of the other exemptions for community financial
10 institutions.
11 So nothing terribly controversial. Although,
12 frankly, not a lot of democratic support for the bill for
13 a couple of reasons. One is that some of it goes beyond
14 what the ranking member, Chair Brown, would agree to
15 support, but also Chairman Shelby has now taken the entire
16 package and inserted it into the appropriations bill, the
17 Senate Financial Services and General Government
18 appropriations bill with an eye towards a possible omnibus
19 spending package.
20 And that means that it has made it a lot more
21 difficult to have substantive discussion on each of the
22 individual pieces. And so there's likely to be united
23 Democratic opposition on -- first, on procedural grounds,
24 and then probably on some of the substantive issues as
25 well.

1 Although, I should point out that in addition to
2 the House Financial Services Committee package of bills,
3 there are also Democratic proposals from both the Senate
4 Banking Committee and the House Financial Services
5 Committee. And there's quite a bit of overlap in a number
6 of areas.
7 And so it is not inconceivable that we see reform
8 legislation moving forward with bipartisan support on
9 probably, oh I'd say, about at least a dozen and a half
10 issues. Things like streamlining privacy act notices
11 under Gramm-Leach-Bliley. I mentioned the allowing credit
12 unions into the federal home loan bank system. Even QM
13 safe harbor protection for loans held in portfolio, that
14 is a proposal that is supported by Democrats as well.
15 And so two sets of issues. One, substantive, one
16 procedural, but we are monitoring all that and keeping you
17 apprised of developments.
18 COMMITTEE MEMBER JELINCIC: And then one final
19 area. CFTC and SEC funding, obviously we have been long
20 advocates of fully funding those organizations, especially
21 now that they've got even more regulatory obligations. In
22 your weekly report, you've talked about the funding, but
23 also some of the restrictions that the legislation is
24 proposing to put on it. So my question is what are you
25 doing on our behalf on this funding issue?

1 MR. CROWLEY: Well, up to this point, we've been
2 monitoring and reporting. These funding issues for the
3 agencies are caught up in much larger budgetary
4 discussions. And to a certain extent, it's a bit of
5 Kabuki theater, because everyone understands that these
6 agencies have to be funded. And so much of the discussion
7 about de-funding or under-funding is really political
8 posturing.
9 For example, there's been some comments by the
10 House Ag Committee that the CFTC should not be funded
11 until the Commodity Exchange Act is reauthorized. But, of
12 course, it's going to be funded, and it will almost
13 certainly be funded at last year's levels, if not more.
14 I think that whole set of issues gets caught up
15 in the federal budget process toward the end of the fiscal
16 year. We do have a fiscal cliff coming up at the end of
17 September. So there will have to be either a continuing
18 resolution, in which case all agencies will continue at
19 the current funding levels, or an omnibus funding bill,
20 which kill continue appropriations for the next year at
21 agreed upon levels.
22 But we can certainly look for opportunities to
23 weigh in with the appropriators and with the leadership.
24 But at the end of the day, I think it's safe to expect
25 that these agencies will be fully funded.

1 COMMITTEE MEMBER JELINCIC: Thank you.
2 CHAIRPERSON JONES: Okay. Thank you very much.
3 I see no further questions. So thank you for the
4 report.
5 MR. CROWLEY: Thank you.
6 CHAIRPERSON JONES: Okay. We'll move now to the
7 next item on the agenda, Senate Bill 588 (de León), Wage
8 Theft Recovery. Mr. Blackledge.
9 LEGISLATIVE AFFAIRS ASSISTANT DIVISION CHIEF
10 BLACKLEDGE: Good afternoon, Chairman Jones and members.
11 Scot Blackledge, CalPERS staff.
12 This agenda item is being presented on Senate
13 Bill 588. It's authored by Senator Kevin de León,
14 President Pro Tem of the Senate and is sponsored by SEIU
15 California, the Wage Justice Center and also the Korean
16 Immigrant Workers Alliance.
17 This bill deals with wage theft recovery. It's
18 been an issue that's been before the legislature for
19 several years. Prior to this iteration, the proposals
20 have generally focused on copying mechanic's liens that
21 involve real property. But in this instance, Senator de
22 León is taking a different tack. And what he's doing is
23 he's allowing the State Labor Commissioner -- excuse me --
24 to file a levy, or in limited cases, a lien on an
25 employer's property to enforce court judgments for unpaid

1 wages, and other compensation penalties and interests owed
2 to an employee for work performed in the State.
3 This is a gradually escalating process. And so
4 with the worker's consent, it would allow the Labor
5 Commissioner to file levies on an employer's assets, go on
6 to a bonding process for employers that do not appeal the
7 judgments of the Labor Commissioner, and then eventually
8 to a lien on real property.
9 There is no formal opposition to the Bill.
10 However, the Chamber of Commerce has expressed concerns.
11 And it's our understanding that they're working with
12 Senator de León's office to resolve those issues.
13 I'm happy to answer any questions.
14 CHAIRPERSON JONES: Seeing no questions, thank
15 you for the report.
16 Next item on the agenda is the Private Equity
17 Cash Flow Distribution Examples.
18 Mr. Réal Desrochers.
19 CHIEF INVESTMENT OFFICER ELIOPOULOS: Mr. Chair,
20 Committee
21 (Thereupon an overhead presentation was
22 Presented as follows.)
23 CHIEF INVESTMENT OFFICER ELIOPOULOS: Mr. Chair,
24 Committee members, while Réal and Christine Gogan make
25 their way up --

1 CHAIRPERSON JONES: And while they're coming up,
2 I would just ask Committee members, since there are a
3 number of charts that will be displayed, I would ask that
4 we hold our questions till we get through all of the
5 charts, please. Thank you.
6 CHIEF INVESTMENT OFFICER ELIOPOULOS: We
7 appreciate that, Mr. Chair. I think you heard my comments
8 earlier this morning on this topic. I won't repeat them
9 now. This purpose is to give the Committee, you know, as
10 clear a delineation and description of the mechanics of
11 how cash flows work in a typical commingled fund in
12 private equity. Obviously, it's a generalization. The
13 terms vary by partnership, but we've tried to provide the
14 Committee with a description of what's typical in the
15 private equity commingled fund, focusing again -- and I'll
16 turn it over to Réal in a second -- focusing on first the
17 asset management fee, which is a fee paid for services,
18 and as distinct from, and what you'll see in the slides,
19 the profit sharing of the carried interest, which is, as
20 it sounds, a share of the profit -- a share of the profits
21 based on the performance of the fund.
22 So with that, I will turn it over to Réal.
23 MANAGING INVESTMENT DIRECTOR DESROCHERS: Thank
24 you very much, Ted. Good afternoon, Board members and
25 Investment Committee. My name is Réal Desrochers,

1 Managing Investment Director of Private Equity. With me
2 is Christine Gogan, that is an Investment Director in the
3 group also.
4 So like Ted said was explaining, we discussed a
5 few months ago to bring back to how does a private equity
6 fund is typically structured. And I think to -- also,
7 like I repeat what Ted said was saying, but we want to go
8 over the payment of cash flow, how much get distributed
9 between the general partner, the investment advisor, and
10 the limited partners.
11 And lastly, I want to show an example of what
12 does it mean for a large investor that has a portfolio of
13 fund of private equity.
14 --o0o--
15 MANAGING INVESTMENT DIRECTOR DESROCHERS: So on
16 slide 3, this is a typical structure of a private equity
17 fund, where you have in the center a commingled fund, you
18 have on the left-hand side limited partners, of which
19 CalPERS would be one. There could be many of them.
20 Typically, the limited partners would provide 97 to 99
21 percent of the capital. The limited partner, like on top
22 of being a provider of capital, they have limited rights,
23 because this is the structure of the partnership. We
24 cannot have governance -- the limited cannot have
25 governance right, because they want to have limited

1 responsibilities.
2 So we relinquish a lot of the governance, right,
3 in the commingled fund to the investment advisor. This is
4 why it's so important and so critique to select the
5 manager that you want to be with.
6 The limited partners -- a larger limited partner
7 typically would have a representation on the advisory
8 board. But the advisory board is there -- the most common
9 function is really to opine on conflict of interest that
10 might arise between the limited partners and the
11 investment advisor. And I'll repeat, there is a large
12 number of limited partners, CalPERS being one.
13 If you look on the right-hand side, the red box,
14 the investment advisor, they are the promoter of the fund.
15 They are the manager of the fund. They have the
16 governance of the fund. They typically invest between
17 one -- depending on the size of the fund, depending on
18 their asset base - how you say - it's not uncommon to see
19 one percent. And the maximum we will see is typically
20 two, three percent. It varies.
21 The commingled fund functions -- this is where
22 it's a legal entity with -- from which we receive audited
23 financial. And the commingled fund managed by the advisor
24 is -- this is where the money goes into the portfolio
25 company.

1 --o0o--

2 MANAGING INVESTMENT DIRECTOR DESROCHERS: What I
3 would like to do in the next slide is to take an
4 example -- a typical example and to show how does the
5 money goes in into these portfolio company. And then the
6 next slide, I'm going to -- we're going to go through how
7 does the money come back to the limited partners.

8 So for ease of illustration, we've taken a very,
9 very simple illustration of a commingled fund with the
10 investment manager, because this is -- there is much more
11 attributed to that than what see in here. But for ease of
12 illustration, we have taken an example of $120 million
13 fund that would be subscribed, because it's subscribed by
14 the limit partners.

15 The fund has a -- we assume that the funds has a
16 typical arranged management fee of two percent per year
17 for a 10-year period. This is also -- this is not common.
18 This is on the high side. We wanted to illustrate on the
19 high side what should be a fee.

20 And the sharing of the profit, or called
21 typically carried interest, would be 20 percent to the
22 general partner, the investment advisor, and 80 percent to
23 the limited partners. So if we take this example, we look
24 at the $120 million on the left-hand side, you see that we
25 assume that $120 million would be called to go into the

1 commingled fund. Twenty million dollars would be used to
2 pay the management fees of the advisor, and $100 million
3 will go into the, what we say -- would go into the ground,
4 would be invested in companies.
5 If you look on the right-hand side, we wanted to
6 illustrate also the management fee, which creates so much
7 controversy, as it should probably. Twenty million
8 dollars goes to the investment advisor. So that's
9 important that you keep that in mind, because I'm going to
10 tell you that the $20 million that goes to the investment
11 advisor is no different than any other asset class. This
12 is the fee paid to manage the asset, and it will stay with
13 them. That's what we're going to see in the other slides.
14 Question, is it -- that's the situation. So if
15 everyone is okay with that, we go to the next slide.
16 --o0o--
17 MANAGING INVESTMENT DIRECTOR DESROCHERS: How
18 does -- gets the money gets to be distributed to the
19 limited partners, and to the investment advisor?
20 So we keep the same example, $120 million
21 commitment by the limited partnership to a commingled
22 fund. Two percent management fee 80/20 -- 80, so -- and
23 we assume here that the realization of the fund would be
24 $200 million. So that is when all is said and done at the
25 end of the life of the fund, $200 million of value is

1 sitting on the table.
2 Now, what we want to show you is how does that
3 get distributed?
4 So before the general partner takes any fees, has
5 to reimburse the cost of the investment, has to reimburse
6 the management fee. So that's $120 million. This is what
7 you see. The arrow, that goes back to the limited
8 partners, of which CalPERS is one.
9 So the Delta between the profit realized by the
10 bucket -- by the commingled fund, 200 -- it's not a
11 profit. I'm sorry, it's the asset that is generated, $200
12 million. They have to reimburse the management fee.
13 Again, it's not a reimbursement. They have to net the
14 management fee and the cost that went into the ground, so
15 120, has to be netted of the $200 million.
16 So the profit to be shared is $80 million. And
17 this is when the economics start to trigger. We have
18 assume also no preferred return in here. Typically, never
19 in every, there is a preferred return. So you see that
20 the $80 million get to be shared, $64 million with the
21 limited partner, of which CalPERS is one, 20 percent goes
22 to the investment managers, $16 million.
23 So this is where the 80/20 -- I repeat, the $20
24 million management fee paid to the investment advisor.
25 It's part of the -- this is where we go to the next

1 place -- the next slide.
2 --o0o--
3 MANAGING INVESTMENT DIRECTOR DESROCHERS: In all
4 of these partnerships, we have -- I don't want to confuse
5 the people, clawback, distribution waterfall. What we
6 want to go through is how does the flow -- I'm going to
7 repeat what we just said, how does the cash flow to --
8 between the limited partners and general partners?
9 So we will go to the arithmetics of what I just
10 explained to you.
11 --o0o--
12 MANAGING INVESTMENT DIRECTOR DESROCHERS: I don't
13 want to go through all of these. The blue side, if we go
14 on the left-hand side of the slide, I will take you
15 strictly to the bottom one, the third one, net investment
16 gain. I'll explain that the pool of $200 million has to
17 net the management fees return the costs. So this is the
18 $80 million that is being shared, 80/20. This is what you
19 have, 20 percent of the 80 million, 16 million, 80 percent
20 of the 80, 64.
21 Now, I think it's interesting to see how does
22 that get reallocated at the end of the life of the fund?
23 So we put total capital return to CalPERS, but it's -- I
24 repeat, we should have put there to limited partners,
25 because CalPERS is one of many. CalPERS is extremely

1 rarely -- you will remember we discussed one fund where
2 you were the sole LP here, extremely rarely. CalPERS is
3 rarely more than 10 percent of a fund.
4 So you have the investment cost, 100 million, the
5 management fee recoup, or recapture. So 80 percent of the
6 profit, as we explained, so 64. So the limited partner
7 gets to share $184 million, and the investment advisor
8 gets $36 million. This is the management in terms of cash
9 flow. They get to keep their management fee, and then
10 they take their share of the profit, because this -- the
11 investment was -- turns out to return a profit.
12 --o0o--
13 MANAGING INVESTMENT DIRECTOR DESROCHERS: Now if
14 we go on the next slide, I think we wanted to illustrate
15 the same example, the same fund, $120 million, two percent
16 management fee per year for 10 years, 80/20, no preferred
17 return.
18 But in that case, the fund does not generate good
19 return. So I take you down also to the net investment
20 gain, left-hand side, blue bar, there is no gain to be
21 shared. It's zero. Twenty percent of zero is zero, 80
22 percent of zero is zero.
23 So the fund -- on the right-hand side, the total
24 capital return to the limited partners, in our case here,
25 we assume the 120. So the management fees are being

1 returned. The principal invested in the company are being
2 returned. And the point to make is the general partners,
3 the investment advisor, will get to keep their $20
4 million.
5 I think I would like to illustrate, as an
6 example, to take the example to an extreme. What if they
7 get to lose all of the money? So all of the limited
8 partners they will have paid the $20 million and will get
9 nothing in return, no principal.
10 So again, this is why the importance of really
11 manager selection, understanding who you deal with,
12 understanding their governance. This is why we spend so
13 much time on due diligence, and understanding the people
14 you go with. And you will remember, we mentioned often
15 also manager selection is so critical in terms of getting
16 the performance that you want.
17 --o0o--
18 MANAGING INVESTMENT DIRECTOR DESROCHERS: So the
19 last -- no, you're going too fast -- okay. The last slide
20 that we wanted to show is a portfolio and investors as a
21 portfolio of 100 of these funds. We kept the same
22 example. So imagine the $12 billion is 100 funds of $120
23 million, no preferred return, two percent management fee.
24 So what we wanted to show here is that these
25 large investors will have 100 times $80 million to share,

1 20 percent with the general partners -- 20 percent, yes,
2 with the general partners, 80 percent with the limited
3 partners.
4 You see the numbers are big. So the 100 managers
5 of the 100 fund, assuming they're all different, they have
6 collected $2 billion in management fee, successful
7 investment, $1.6 billion in carried interest or profit
8 sharing. And the limited partners, we got their money
9 netted out, return of their money, and get - this is the
10 important part - the $6.4 billion of gain on the
11 partnership.
12 I want to say it's much -- this is really the
13 core. It's like if we are -- if I am an architect. This
14 is really looking at the architecture of the house. But
15 then when we go and negotiate these things, you have to go
16 in every room. There's -- it's complex, and lots of
17 legalese and business point that we need to be very
18 mindful. That completes, I think, my presentation.
19 We're happy to answer any questions you may have,
20 or at least try to answer.
21 Thank you.
22 CHAIRPERSON JONES: Okay. We have a few
23 questions. Mrs. Mathur.
24 COMMITTEE MEMBER MATHUR: Thank you, Mr. Chair.
25 Thank you, Mr. Desrochers, for that presentation. I

1 recognize that you've just used round numbers for
2 illustrative purposes, but if we could go back to page
3 five, in this example, the management fee is actually
4 greater than the carried interest.
5 MANAGING INVESTMENT DIRECTOR DESROCHERS:
6 Correct.
7 COMMITTEE MEMBER MATHUR: Is that typical? Do we
8 typically see the management fee being -- exceeding the
9 carried interest?
10 MANAGING INVESTMENT DIRECTOR DESROCHERS: You
11 don't want that. No, it's not typical. This is why I say
12 it's very rich. You don't want that, because in a case
13 like that, it means that the people -- I mean, they're
14 going to get rich no matter what. I mean, not rich, but,
15 I mean, they don't have the incentive to really work the
16 asset.
17 COMMITTEE MEMBER MATHUR: Yeah.
18 MANAGING INVESTMENT DIRECTOR DESROCHERS: No,
19 that's not good.
20 COMMITTEE MEMBER MATHUR: I mean, in this
21 example, they're getting 36 percent of the total proceeds
22 of the investment of $100 million in this case.
23 MANAGING INVESTMENT DIRECTOR DESROCHERS: Right.
24 COMMITTEE MEMBER MATHUR: And is that typical
25 that they -- that the --

1 MANAGING INVESTMENT DIRECTOR DESROCHERS: No.
2 COMMITTEE MEMBER MATHUR: -- the GP would end up
3 with third or more?
4 MANAGING INVESTMENT DIRECTOR DESROCHERS: No.
5 The typical, you want the general partner to have, we say,
6 skin in the game. They have to have money at stake.
7 COMMITTEE MEMBER MATHUR: Yeah.
8 MANAGING INVESTMENT DIRECTOR DESROCHERS: We
9 verify -- the short answer is no. They should not get
10 rich on the --
11 COMMITTEE MEMBER MATHUR: On the management fee.
12 MANAGING INVESTMENT DIRECTOR DESROCHERS: -- on
13 the management fee. They have to have the incentive to
14 work and to earn through the profit sharing really. And
15 to do that -- yeah, that's my comment.
16 COMMITTEE MEMBER MATHUR: And have we looked at
17 our own portfolio to see how that actually is -- shakes
18 out in our --
19 MANAGING INVESTMENT DIRECTOR DESROCHERS: We do
20 that all the time. We do that. We do that all the time
21 before we underwrite a new commitment. We do that. We go
22 further. We call the alignment of interests. And every
23 investment recommendation, we look at how much money will
24 be drawn by the advisor. We look also -- we don't want to
25 invest with, what we call, a one-person show. So there

1 is the carried interest or the profit sharing has to be
2 earned over the lifecycle of the fund.
3 They have to be shared -- we look at the sharing
4 within the team. This is why I say we don't want to
5 invest with a one-person show.
6 We want to have team that have proven track
7 record, that have, I would say, entry level people junior
8 people -- not so entry level people, senior people, and
9 have -- we invest in an organization.
10 COMMITTEE MEMBER MATHUR: And, in your view, is
11 one to three percent the right amount of GP investment to
12 really have skin -- meaningful skin in the game?
13 MANAGING INVESTMENT DIRECTOR DESROCHERS: It's a
14 difficult judgment call to be made there, because I think
15 there is no magic number. It depends on the lifecycle of
16 which the firm is in. If you have someone -- we tend not
17 to do first-time fund, but people -- we need to
18 look -- there is no question this is a lot of money.
19 People get a lot of money. There's no question about
20 that.
21 So we look at the -- if it's a firm that -- I
22 think, the most difficult fund to raise for Private Equity
23 Group is the first one and the third one, according to the
24 staff what's happening in the industry. The first one
25 because people will say you need to put -- to have skin in

1 the game, you want to have one percent.
2 People, if they are a spin-out of the group, they
3 say we don't have that much money. They're not poor, but
4 they don't have that much money to put in there, because
5 if they want to be successful, they need to put that
6 amount of money, then they need to put in Fund 2. So they
7 have not had any realization, because the typical
8 lifecycle of a fund is five years.
9 So they will be harvesting in year -- let's say
10 start four to year 10. Then the investor will say, hey,
11 okay, Joe, there is Fund 3. No, we listened to your story
12 for eight, nine years, now show us the money.
13 So this is why people are very -- it's -- this is
14 difficult the first one and the third one, because of the
15 people, if they're good investors, very often they will
16 spin-off from an existing group, because the industry now
17 has 20 years history, so you saw many people. So that's
18 why. There is no magic answer in there.
19 If you take a well-established group, very well
20 established, some are -- it's different. So this is a
21 judgment call that will have to be made.
22 COMMITTEE MEMBER MATHUR: And just one last
23 question. To what extent is the management fee used to
24 seed that GP contribution?
25 MANAGING INVESTMENT DIRECTOR DESROCHERS: This is

1 what we call the management fee offset to the IRS. I
2 don't know, Christine, do we have the number? We track
3 that. But I -- do you have the number?
4 INVESTMENT DIRECTOR GOGAN: Forty-one percent.
5 CHIEF INVESTMENT OFFICER ELIOPOULOS: I think the
6 question, if I could -- I think you're thinking it's a
7 different question. I think Ms. Mathur was asking about
8 whether or not the -- in this example, the $20 million of
9 management fees is effectively being used as the one to
10 three percent --
11 COMMITTEE MEMBER MATHUR: The capital commitment.
12 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- the
13 capital contributed by the --
14 COMMITTEE MEMBER MATHUR: Yeah.
15 CHIEF INVESTMENT OFFICER ELIOPOULOS: -- by the
16 general partner. So it's -- I want to give Réal
17 definitely a chance to answer it. I think there isn't a
18 legal linkage within the agreement. And some agreements
19 in the past, there actually have been provisions that
20 allow the general partner to use the capital collected,
21 you know, for their asset management fees and apply it to
22 their capital contributions. So that's happened in the
23 past.
24 I think now, and going forward, those -- that
25 type of direct legal link between the two is more a

1 disfavored term rather than favored, but it also belies
2 the economic reality that it's a fairly close connection
3 between the amount of capital committed by the general
4 partner and the fees that they take back. So it all goes
5 to this question of alignment of interests that Réal was
6 emphasizing, which is we'd always like to see more capital
7 by the general partner invested in the commingled fund,
8 because it better secures the type of alignment with the
9 limited partners for risk of loss, risk of their capital
10 at loss, just to the same that we have capital at loss.
11 COMMITTEE MEMBER MATHUR: Exactly.
12 CHIEF INVESTMENT OFFICER ELIOPOULOS: Some of the
13 difficulties in achieving, you know, greater alignment in
14 this case by greater amount of capital committed by the
15 general partner, one is just the market environment.
16 We're one of many limited partners negotiating any given
17 agreement. And there's only so much market power that we
18 have in structuring it.
19 The other though is in terms of talking in terms
20 of one percent or two percent. That also belies the very
21 large numbers that are involved here. And even a one or
22 two percent commitment by a general partner depending on
23 well established or new firm can be quite a significant
24 amount to that firm, even though it sounds like a small
25 number in one or two or three percent.

1 But that's exactly -- those are exactly the types
2 of questions that the due diligence teams and the private
3 equity team look at in assessing what is the true
4 alignment. Is it really their capital or not, and how
5 much of it is at risk, and how material is that capital to
6 the firm?
7 COMMITTEE MEMBER MATHUR: I know I said that was
8 going to be my last question, but now that actually
9 spurred a follow-up question, if I might, and that is
10 around how the management fee number is arrived at?
11 Because clearly as these funds have gotten so much bigger,
12 what's actually required to run an office might not -- if
13 you built it from the bottom up, it might not actually end
14 up being 20 -- I mean, two percent.
15 So is that -- I mean, do we require -- is it
16 typical to require some defensive accounting of how that
17 number is calculated or --
18 MANAGING INVESTMENT DIRECTOR DESROCHERS: What
19 you mean is if it's typical to require a budget. How
20 can --
21 COMMITTEE MEMBER MATHUR: Well, a budget or is
22 that really the right number, given how big these funds
23 have become?
24 MANAGING INVESTMENT DIRECTOR DESROCHERS: Right.
25 My -- I don't know. Can I ask people? My own personal

1 opinion this is rich. And this is why the two percent is
2 not the number. I repeat what I said here, the two
3 percent is really on the high side. Typically, what we
4 see, and depending on the size of the fund, today -- in
5 today's environment would be one and a half percent during
6 the investment period.
7 And then after the investment period, what is
8 typically five years, the fee would be half of the fees on
9 this. So the two percent, I just don't want -- like you
10 said I think right on the nail, I mean, the people they
11 will not have an interest to really work for the limited
12 partners if they're guaranteed to have that pay day.
13 COMMITTEE MEMBER MATHUR: Yeah. Thank you.
14 CHAIRPERSON JONES: Mr. Jelincic.
15 COMMITTEE MEMBER JELINCIC: This presentation is
16 good as far as it goes. It's very high level. But one of
17 the things that it did is it assumed a way the things like
18 offsets and fee waivers and clawbacks and fund costs, and
19 preferred returns, which are all the areas that are
20 creating the controversy.
21 Those are the areas where the SEC has said
22 limited partners are getting ripped off, where the IRS has
23 said that it looks like taxpayers are getting ripped off.
24 So I want to dig a little deeper, if I may.
25 Based on public information, one of the funds

1 we're in, it's a 2005 vintage, was a buyout fund. It's
2 $4.25 billion, the management fee is 1.5 percent, and we
3 committed 125 million. And as you said, one and a half is
4 fairly typical at this point.
5 So at that percent if I did my math right, our
6 management fee is 1.875 million per year. Does that sound
7 at least reasonable?
8 MANAGING INVESTMENT DIRECTOR DESROCHERS: It
9 sounds reasonable.
10 COMMITTEE MEMBER JELINCIC: But when I looked at
11 the CAFR on this particular fund, one of the things that I
12 see is fees and costs that we report. And I would assume
13 that the fees are the management fee, and the costs are
14 all those costs that go into the fund, the auditing fees,
15 the advisory firm, all that kind of stuff. Is that a
16 reasonable assumption?
17 MANAGING INVESTMENT DIRECTOR DESROCHERS:
18 There's -- I don't know. There is three types
19 of -- there's in a fund -- in a commingled fund, you have
20 the management fee that are paid, you have sharing of the
21 profit, and you have all sorts of --
22 COMMITTEE MEMBER JELINCIC: Sharing of what?
23 MANAGING INVESTMENT DIRECTOR DESROCHERS: Sharing
24 of the profit, the carried interest.
25 COMMITTEE MEMBER JELINCIC: Oh, okay.

1 MANAGING INVESTMENT DIRECTOR DESROCHERS: Then
2 you have fees that are charged to portfolio companies that
3 are to be shared with the limited partners. And then
4 these are market -- market driven. Some -- if you go to
5 the cycle, you say 2005 vintage year, the -- I don't know
6 what the name of the fund, but a fee of seven --
7 CHAIRPERSON JONES: Excuse me, Mr. Desrochers.
8 Mr. Jelincic, I'm going to ask that that
9 information be provided to them, because you're going to
10 the CAFR, the annual financial report, and citing numbers
11 that they don't have, and they don't even know the company
12 you're referring to, so --
13 COMMITTEE MEMBER JELINCIC: The company is
14 problematic when you --
15 CHAIRPERSON JONES: I'm asking that you provide
16 the information to staff, and staff will be prepared to
17 report back to the whole Committee to answer your
18 question. That's all. With the same information.
19 COMMITTEE MEMBER JELINCIC: You know, quite
20 frankly, none of the numbers I'm raising are things that
21 they can't verify.
22 CHAIRPERSON JONES: No, and I'm not suggesting
23 that, J.J. I'm just saying the process that if you want
24 to get a real answer, rather than an estimate, someone
25 needs to be looking at the numbers that you're talking

1 about and the page number that you're referencing. That's
2 all I'm saying. I support you getting the answer, but I
3 just want them to have the information.
4 COMMITTEE MEMBER JELINCIC: But the -- knowing
5 the fund and knowing those numbers are accurate or not
6 accurate really is not something they need to know to
7 answer the series of questions, because I'm making some
8 assumptions.
9 CHAIRPERSON JONES: As I -- I'm going to rule
10 that if --
11 COMMITTEE MEMBER JELINCIC: Are you going to rule
12 me out of order?
13 CHAIRPERSON JONES: I haven't done that yet.
14 COMMITTEE MEMBER JELINCIC: Okay.
15 CHAIRPERSON JONES: But I'm just saying that if
16 you want to get an accurate answer, I would suggest that
17 we give them the information and let them report the
18 information back to all of the Board members. That's all
19 I'm suggesting.
20 COMMITTEE MEMBER JELINCIC: And -- okay -- but --
21 and I'm telling you the questions I have they can answer
22 without needing to do that.
23 CHAIRPERSON JONES: Well, the response was just
24 made that he doesn't know what company you're referring
25 to. He just made that comment.

1 COMMITTEE MEMBER JELINCIC: Okay. He did, and I
2 gave him the name of the company. But quite frankly, for
3 the questions that I have, he really doesn't need to know
4 the name of the company.
5 CHAIRPERSON JONES: Well, I've indicated the
6 direction, so --
7 COMMITTEE MEMBER JELINCIC: So are you ruling me
8 out of order --
9 CHAIRPERSON JONES: Yes.
10 COMMITTEE MEMBER JELINCIC: -- or are you going
11 to let answer -- ask my questions?
12 CHAIRPERSON JONES: No, I'm ruling you out of
13 order.
14 COMMITTEE MEMBER JELINCIC: I'd like to appeal
15 the decision of the Chair.
16 CHAIRPERSON JONES: And --
17 COMMITTEE MEMBER JELINCIC: And I'd like a roll
18 call vote on that.
19 CHAIRPERSON JONES: Okay. So appealing the
20 decision of the Chair. There's roll call vote requested.
21 So we will ask for a roll call.
22 COMMITTEE MEMBER CHIANG: Just rephrase the
23 question. Just rephrase it.
24 COMMITTEE MEMBER MATHUR: Use the mic. Use the
25 mic. Use the microphone

1 CHAIRPERSON JONES: Wait, wait a minute.
2 Okay. Wait a minute. Now.
3 COMMITTEE MEMBER CHIANG: J.J., just rephrase the
4 question at a more theoretical level, so you can get out
5 of the specifics and get to the point that you want to
6 ask.
7 COMMITTEE MEMBER JELINCIC: Okay. So I'm --
8 you're reversing your ruling, at least for the time being.
9 CHAIRPERSON JONES: Well, if you're going down
10 that track, I'm not. But if you're going to go for just
11 the general question, that's fine.
12 COMMITTEE MEMBER JELINCIC: So if we've made a
13 $125 million commitment, and it's a 1.5 percent management
14 fee, the -- can you explain to me how we could pay costs
15 and fees significantly below that? If I can use a
16 specific example. In '08, we paid 30 million versus 185
17 million. How would that come about that we would pay such
18 a difference between our contractual obligation and the
19 fees?
20 MANAGING INVESTMENT DIRECTOR DESROCHERS: I would
21 be happy to provide you a very precise answer on this, if
22 we know the specific name. I'm sorry I have to go back
23 there, because these agreements are specific to each one
24 of the investment advisors. In that case, they might have
25 had management fee of set. I don't know what the

1 sharing -- I don't remember what the sharing could be.
2 Something it's 50/50, 60/40, 80. So that might be one
3 reason. I don't know.
4 And I know some other -- I know some of the GP
5 will not call the money at the inception of the fund just
6 to save in that, because that is more money that will go
7 into the ground, that will enhance their share of the
8 carry later on. This is why I say it's -- I'll be happy
9 to provide you a very, very, very specific answer if you
10 give me the name. I have the vintage year. We have the
11 management fee. Happy to provide the whole Investment
12 Committee very specific.
13 COMMITTEE MEMBER JELINCIC: Is our management --
14 the management fee we pay likely to be less if there are
15 offsets for charges to the portfolio companies?
16 MANAGING INVESTMENT DIRECTOR DESROCHERS: Yes.
17 COMMITTEE MEMBER JELINCIC: Okay. And so that
18 could be --
19 MANAGING INVESTMENT DIRECTOR DESROCHERS: I'm
20 sorry. In some cases, depending on the partnership, there
21 is no management fee in some given year. Zero management
22 fee, because the offset -- where they are, they will share
23 100 percent there. Again, I cannot -- I can't speak
24 really. I would be really happy if you have more than
25 one, also would be happy to provide you the detail.

1 COMMITTEE MEMBER JELINCIC: Okay. And in this
2 case, the management fee is 1½ percent of the committed
3 during the investment period. So if the investment
4 period -- the management fee paid is significantly less
5 than the contractual rate, where is that reduction likely
6 to come from?
7 MANAGING INVESTMENT DIRECTOR DESROCHERS: The --
8 again, I assume the general partner did not call the
9 money. And I know some people do that. Like I said, not
10 a lot of them, but they want to enhance their return at
11 the end of the -- this is -- the management fee that we
12 see in here doesn't go into the -- doesn't go to the fund.
13 It flows through to the general partners. If you assume
14 the general partner decide not to take the $20 million,
15 instead if it's being invested in the portfolio companies,
16 and if it returns two times the money, it enhanced the
17 limited partner's share of the profit, enhances the
18 general partner's share of the profit. This is why I say
19 I'm happy to provide the detail. I don't know, but happy
20 to provide the detail.
21 COMMITTEE MEMBER JELINCIC: Okay. If a manager
22 charges a -- charges fees to the portfolio company, and
23 shares that with the LPs, would that reduce the LPs'
24 management fees?
25 MANAGING INVESTMENT DIRECTOR DESROCHERS: Again,

1 it depends on the agreement that you have with the general
2 partners. I'm sorry to repeat the same thing, but it
3 depends of the contractual agreement that we have. In
4 some cases -- in some cases, it reduces the management fee
5 to zero, because the sharing arrangement that we have in
6 the contract, like I said, could be 50/50, 60/40. It
7 depends on the cycle. The last three years -- I can tell
8 you the last three years, most of these contracts were
9 down with 100 percent management fee offset in favor of
10 the limited partners.
11 If you go to pre-2007, the sharing was -- I'm
12 looking -- actually looking -- Mike Moy, maybe you can --
13 I would say probably was 60/40, 70 -- it depends on the --
14 MR. MOY: It could have been 50/50, 60/40. It
15 was nowhere near 100 percent.
16 COMMITTEE MEMBER JELINCIC: Let me repeat the
17 question. If the manager charges fees to the portfolio
18 company and shares that with the LPs, would the LP's
19 management fee be reduced?
20 MANAGING INVESTMENT DIRECTOR DESROCHERS: Yes.
21 COMMITTEE MEMBER JELINCIC: Okay. And
22 the -- because the GP got the same amount of fees, but
23 they got part of it from the portfolio company, and part
24 of it from the LPs, correct?
25 MANAGING INVESTMENT DIRECTOR DESROCHERS: I'm

1 sorry. No, repeat that. No, because -- no, it doesn't
2 get the same amount of money.
3 COMMITTEE MEMBER JELINCIC: He doesn't get the
4 same amount.
5 MANAGING INVESTMENT DIRECTOR DESROCHERS: No,
6 because the fee -- the fee collected from the portfolio
7 company in your example would go to reduce the management
8 fee paid by the limited partners.
9 COMMITTEE MEMBER JELINCIC: Okay. So he -- so
10 the general partner would get that money from the
11 portfolio company rather than the LP?
12 MANAGING INVESTMENT DIRECTOR DESROCHERS: That's
13 correct in your example. I assume, yes.
14 COMMITTEE MEMBER JELINCIC: So the money that the
15 GP receives would be the same, but part of it would have
16 come from -- no, why would it be different?
17 MANAGING INVESTMENT DIRECTOR DESROCHERS: Because
18 like I said, in some cases, you get -- there's new
19 management fee to be paid, because it came out from the
20 offset.
21 COMMITTEE MEMBER JELINCIC: Because?
22 MANAGING INVESTMENT DIRECTOR DESROCHERS: It came
23 from the offset.
24 COMMITTEE MEMBER JELINCIC: Okay. So -- but if
25 there was enough of an offset to take it to zero --

1 MANAGING INVESTMENT DIRECTOR DESROCHERS: Right.
2 COMMITTEE MEMBER JELINCIC: -- then would the GP
3 collect less money than they would have in the absence of
4 the offset?
5 MANAGING INVESTMENT DIRECTOR DESROCHERS:
6 Correct.
7 COMMITTEE MEMBER JELINCIC: So they -- they could
8 reduce the management fee by more than they collected from
9 the portfolio company?
10 MANAGING INVESTMENT DIRECTOR DESROCHERS: In
11 theory, you're probably -- I mean, possibly right, but you
12 don't want that. I don't think we want that, because when
13 you take money from the companies, this is reducing the
14 value of the company.
15 COMMITTEE MEMBER JELINCIC: Right.
16 MANAGING INVESTMENT DIRECTOR DESROCHERS: So you
17 want the company -- you expect to have an exit, I don't
18 know, six, seven, eight times EBITDA. And if you take
19 that away from the company, this is hurting. There's a
20 limit there.
21 COMMITTEE MEMBER JELINCIC: Yeah. I mean, from
22 an economic viewpoint, the LP pays it whether it's coming
23 from the right pocket or the left pocket.
24 MANAGING INVESTMENT DIRECTOR DESROCHERS: To an
25 extent, yes. To an extent, yes.

1 COMMITTEE MEMBER JELINCIC: Okay. And -- but to
2 the -- to the extent that the GP collected money from the
3 portfolio company, and shared it with the LP as an offset,
4 then the total that the GP would have collected would have
5 been the same, because other -- he could have collected
6 100 from the LPs, instead he collected 50 from the LPs,
7 gave the -- or from the portfolio companies, gave the GP
8 the LP's credit for that 50, and still wound up with his
9 hundred?
10 INVESTMENT DIRECTOR GOGAN: Just -- if you could,
11 Mr. Jelincic, just boil down the essence of the question
12 again and Réal and I will do our best to try to answer it
13 from a theoretical perspective.
14 COMMITTEE MEMBER JELINCIC: If the GP collects
15 from the portfolio company and uses that money to offset
16 the LP's management fee, so it takes it from one pocket
17 and credits it to the other pocket, the total fees that
18 the GP collects will be the same, assuming it's 100
19 percent offset. When you go back -- you don't agree. I
20 mean, if the assumption is wrong, let me --
21 MANAGING INVESTMENT DIRECTOR DESROCHERS: No, I
22 don't agree.
23 COMMITTEE MEMBER JELINCIC: Okay. If -- okay.
24 Let me give a specific -- the management fee is 100. The
25 fees to the portfolio company is 50. There's 100 percent

1 offset to the LPs. So what then happens is the GP has
2 collected 50 from the portfolio companies, and he will
3 collect the other 50 from the LPs, because that part has
4 not been offset. So he will have collected the 100,
5 correct?
6 MANAGING INVESTMENT DIRECTOR DESROCHERS: No, he
7 would collect 50.
8 COMMITTEE MEMBER JELINCIC: So if he -- so if the
9 management fee is 100, he collects 50 from the portfolio
10 companies, that's --
11 MANAGING INVESTMENT DIRECTOR DESROCHERS: He
12 offset the management fee of 100 by the $50 million that
13 had been collected from the portfolio company.
14 COMMITTEE MEMBER JELINCIC: Okay. So he offsets
15 the 50 --
16 MANAGING INVESTMENT DIRECTOR DESROCHERS: Right.
17 COMMITTEE MEMBER JELINCIC: -- of the management
18 fee. What happens to the other 50 of the management fee?
19 INVESTMENT DIRECTOR GOGAN: It's paid by the
20 limited partners.
21 COMMITTEE MEMBER JELINCIC: Okay. So the GP
22 ultimately gets 100, he gets 50 from the portfolio
23 companies, 50 from the LPs, right?
24 MANAGING INVESTMENT DIRECTOR DESROCHERS: No.
25 COMMITTEE MEMBER JELINCIC: No.

1 CHAIRPERSON JONES: Mr. Jelincic, can I suggest
2 that you sit with them and give them your specific
3 examples, and let them prepare a response and present it
4 back to the Investment Committee at a later date --
5 COMMITTEE MEMBER JELINCIC: The --
6 CHAIRPERSON JONES: -- so that therefore there
7 will be no doubt about what the question is. And also, we
8 have other people that are waiting to speak.
9 COMMITTEE MEMBER JELINCIC: Okay. Let me ask one
10 other question then, and I'll -- if -- you talked about
11 the manage -- the LPs getting credit for all of the
12 management fees. If the manager -- the GP collected part
13 of that management fees from the L -- from the portfolio
14 companies, does it -- do they, in fact, refund that to the
15 LPs ultimately?
16 MANAGING INVESTMENT DIRECTOR DESROCHERS: This is
17 it where it goes for the management fee offset. This is
18 what we call the management fee offset.
19 COMMITTEE MEMBER JELINCIC: I'm sorry. It's --
20 MANAGING INVESTMENT DIRECTOR DESROCHERS: This is
21 what we call the management fee offset.
22 COMMITTEE MEMBER JELINCIC: Okay. So if -- do
23 the LPs ultimately recover that money that they didn't pay
24 that came out of the portfolio companies?
25 MANAGING INVESTMENT DIRECTOR DESROCHERS: Yes, in

1 the waterfall, assuming that the whole bucket would be
2 profitable.
3 COMMITTEE MEMBER JELINCIC: Okay.
4 CHAIRPERSON JONES: Okay. I'm going to call on
5 the next requested speaker.
6 Mr. Costigan.
7 COMMITTEE MEMBER COSTIGAN: All right. So I'm
8 going to actually get a little more basic, just so I can
9 understand this. Réal, first, thank you for trying to
10 make this understandable. It's difficult, I know, even
11 with your presentation. So I just have some real basic
12 questions just so I can understand it.
13 In using your chart, just to understand the fees,
14 when there are four companies and they're taking a
15 realization of $200 million, and you've got the GP costs
16 spinning off, do they spin off other costs? I mean, could
17 the General -- can the GPs receive -- because what we're
18 talking about is compensation between the net profit -- or
19 the profits and the management fees. But do we have any
20 type of agreement, contract that prevents them from
21 sitting or taking any type of cash out of companies 1, 2,
22 3, and 4 before it rolls off or waterfalls down?
23 The other is what prevents them, because I'm
24 aware of couple folks that spin off other little entities
25 to do their marketing and stuff, and they're taking a

1 piece of that. So actually I'll ask my four questions and
2 then I'll listen.
3 Second is who sets what the profit level is?
4 I've read cases before, including one of the private
5 equity companies -- or hedge fund companies we exited from
6 that they had raised the profit level to 11 percent before
7 a fee we would roll-out. And so do we get 20 percent of
8 the first dollar or is there a certain amount that they
9 have to make a determination.
10 Second, where are bonuses accounted for out of
11 the profits, and the management fees. You answered my
12 third one. And then I think back to Priya's question
13 about the 36 percent. I mean, on the front end, the two
14 percent looks interesting, but over the whole term it's
15 considerably more so. Those are my four questions right
16 now. I can repeat them
17 MANAGING INVESTMENT DIRECTOR DESROCHERS: Could
18 you? I have one --
19 COMMITTEE MEMBER COSTIGAN: How are bonuses a
20 accounted for?
21 MANAGING INVESTMENT DIRECTOR DESROCHERS: Like
22 what you have in here, when you have --
23 COMMITTEE MEMBER COSTIGAN: Well, just where
24 would they -- they're not in the management fee.
25 MANAGING INVESTMENT DIRECTOR DESROCHERS: No, the

1 bonus would be at the end of the life when -- assuming the
2 $200 million. It's the $80 million profit, that this is
3 where the bonus would be, and they get their 20 percent
4 part of the bonus.
5 COMMITTEE MEMBER COSTIGAN: Okay. So it's
6 included in that 20 percent?
7 MANAGING INVESTMENT DIRECTOR DESROCHERS:
8 Correct. In a real life example, you would have
9 a preferred return.
10 COMMITTEE MEMBER COSTIGAN: Okay.
11 MANAGING INVESTMENT DIRECTOR DESROCHERS:
12 That's -- that's -- I think that's your question.
13 Number two.
14 COMMITTEE MEMBER COSTIGAN: Well, question number
15 two is who sets what the return is, because I have read --
16 I don't want to name which company, but one of the funds I
17 know we've done business with in a REIT had raised it to
18 before they would distribute any profits, it had to earn
19 11 percent. So who makes that determination?
20 MANAGING INVESTMENT DIRECTOR DESROCHERS: It's a
21 negotiation between the limited partners and the
22 investment advisor. Some fund has zero. Very rare, but
23 have zero preferred return. The market, I would say, is
24 typically six to eight percent in the private equity.
25 COMMITTEE MEMBER COSTIGAN: So where is that --

1 let's assume -- we'll go ratchet down to three percent.
2 So before dollar -- so that first three percent is
3 accounted for where, in the 20 --
4 INVESTMENT DIRECTOR GOGAN: It's in the limited
5 partnership agreement.
6 COMMITTEE MEMBER COSTIGAN: I'm sorry, the GP.
7 So where is it in this 20 or management fees? I get it
8 that it's part of the contract, but if they don't
9 distribute a dollar until they've achieved a three percent
10 return, so that's three percent that they make on 100
11 million, $3 million, where is that accounted for in here?
12 Because it goes to the GP.
13 MANAGING INVESTMENT DIRECTOR DESROCHERS: No, no.
14 It's a contract -- when we go -- if you go to the slide in
15 the waterfall at the end, or there is also -- there is --
16 I don't know if you saw, there is two types of payment
17 there. One is what we call deal by deal, and then we have
18 European waterfall. This is accounting for every year,
19 ever quarter with the a financial statement. We have
20 audited financial statements.
21 And looking at the partnership agreement at the
22 end of the life of the fund, this is where all of the
23 settlement takes place.
24 COMMITTEE MEMBER COSTIGAN: Okay. So -- yes,
25 Ted. Mr. Eliopoulos.

1 CHIEF INVESTMENT OFFICER ELIOPOULOS: I think --
2 Mr. Costigan, I think this example that you have up here
3 has no preferred return. Okay. If you add a preferred
4 return, whether it's the three percent preferred return or
5 eight percent preferred return or an 11 percent preferred
6 return, if you add that into this example, the amount of
7 that preferred return is a priority payment to the LPs.
8 So 100 percent of the preferred return, whether it's three
9 percent or 11 percent, 100 percent, assuming there are
10 profits, and this is a profit example, 100 percent that
11 goes to the LPs, zero goes to the GP, until that -- until
12 that preferred return target is hit, whether it's three
13 percent or 11 percent. And when that preferred return
14 target is hit, then the sharing of profits would occur at
15 80/20.
16 COMMITTEE MEMBER COSTIGAN: Thank you. Thank
17 you, Mr. Jones.
18 CHAIRPERSON JONES: Thank you.
19 Mr. Slaton.
20 VICE CHAIRPERSON SLATON: Thank you, Mr. Chair.
21 Thank you for the discussion that you're bringing to us.
22 What I've gleaned from this, and I'd like to just kind of
23 make some comments at a higher level than where we've down
24 in the weeds. It's very clear to me that the terms and
25 conditions of private equity deals vary by general partner

1 and by vintage. There's no set process. It's a
2 negotiation. It's also clear to me that there's a large
3 number of investors for GPs to choose from, that CalPERS
4 is not the only investor out there, and so therefore, our
5 ability to get the industry to change is something that I
6 appreciate that we're leading on, but we can't control.
7 But I think we're making progress.
8 It's clear this is a largely unregulated industry
9 that we're trying now -- that the United States is trying
10 to do a better job regulating. And I'm glad that CalPERS
11 is a participant in that.
12 I read in the press terms like, you know, hide
13 and cheat and steal. I think those are inappropriate
14 terms. I think we have an industry that probably needs
15 more regulation, but I -- what I want us to focus on is to
16 make sure that we are gleaning as much data as we can, and
17 that we see the progress that's attained, and we start to
18 see the reports.
19 I have faith in this group in front of us that
20 you're negotiating on behalf of CalPERS, as well as it can
21 be done. So I'm not trying to -- and I don't think we
22 should spend a lot more time trying to find where there's
23 an error or a problem. I think you all are on to this,
24 that you're working hard at it, and I think that there's
25 value in us better understanding what the range of

1 possibilities are. So bring scenarios back to us and how
2 it works, like you did here, is instructive for us. But I
3 don't think it's productive for us to spend a lot of time
4 trying to play gotcha.
5 CHAIRPERSON JONES: Thank you, Mr. Slaton.
6 Mrs. Hollinger.
7 COMMITTEE MEMBER HOLLINGER: Thank you. I
8 appreciate the report, and along with Mr. Slaton. Where I
9 would like to go to a place moving forward is to take the
10 information we're getting from all this, and I would like
11 insight from you about what have we learned from this,
12 what do we want to potentially contract for in the future?
13 And while I've heard CalPERS maybe because, you
14 know, we can't control things. But guess what? We can
15 influence things and we can effectuate positive change
16 going forward.
17 So I'd like to know in terms of contracting going
18 forward, where would you suggest we make changes to
19 increase that transparency? You know, I want to use this
20 as a foundation to take us to the next place a better
21 place.
22 CHIEF INVESTMENT OFFICER ELIOPOULOS: I would
23 jump in with just two, and I'll let Réal if mention any
24 others. I think, first, on collecting and this coming
25 fall reporting, the total amount of carried interest paid

1 and accrued, I think that would be beneficial to the
2 marketplace, in general, because there are, you know,
3 plenty of estimates in the marketplace. And you can tell
4 from our examples those estimates rhyme pretty well with
5 the 2 and 20 model.
6 I think having not just CalPERS collecting that
7 information and tying it to the financial statements so
8 that we can report it publicly, and having other LPs of
9 size doing that as well will have a beneficial impact on
10 the marketplace as a whole as it's brought to a greater
11 level of transparency.
12 The other area that can be improvement is this
13 discussion that we just had around portfolio company
14 payments being made to the general partner. There is not
15 enough disclosure in transparency to the LPs of those cash
16 flows moving forward. Our private equity team is now
17 requiring disclosure of that information for new
18 partnerships going forward.
19 COMMITTEE MEMBER HOLLINGER: So we're --
20 CHIEF INVESTMENT OFFICER ELIOPOULOS: But more
21 importantly, we're collaborating with our other LPs
22 through the ILPA association that I mentioned. And again,
23 having a broad base of institutional investors in the
24 private equity industry, collecting and requiring
25 transparency around those fees will be beneficial, one, to

1 know the magnitude and amounts of those fees, but also to
2 bring better transparency to the industry. Those are
3 probably the two areas that I would focus are the best
4 areas to make progress on in the next year.
5 COMMITTEE MEMBER HOLLINGER: In the past have we
6 seen the financials of those underlying companies or no?
7 CHIEF INVESTMENT OFFICER ELIOPOULOS: Well, I'll
8 turn that question over to Christine.
9 INVESTMENT DIRECTOR GOGAN: With respect to
10 what's been occurring in the industry is there's
11 definitely been an evolution that's occurred over time.
12 And I would say we are moving towards an environment where
13 we are receiving the much more detailed information with
14 respect to the underlying. But to make a broad statement
15 that we have always had access to the underlying detailed
16 information in the portfolio companies is a stretch. It's
17 definitely improving.
18 COMMITTEE MEMBER HOLLINGER: And just my last
19 question would be this is I recognize this asset class has
20 given us our outside returns, and has been a necessary
21 component to our portfolio and our reaching our discount
22 rate.
23 But some of the -- in hearing the trust level
24 review report and just looking at returns going forward,
25 you know, it seems to be the general consensus that going

1 forward we may be -- I'm not sure it's realistic or not to
2 expect the returns that we've been getting from this asset
3 class or not. In light of that, is this a good time to
4 renegotiate our fees?
5 CHIEF INVESTMENT OFFICER ELIOPOULOS: Yes.
6 (Laughter.)
7 COMMITTEE MEMBER HOLLINGER: Okay.
8 CHAIRPERSON JONES: Okay. Thanks.
9 Mr. Lind.
10 COMMITTEE MEMBER LIND: Thank you. Just a couple
11 things. I think it's, you know, become clear, Réal, that
12 I guess what sort of happened is we've been hearing how
13 complex this is and how difficult it is to get the reports
14 to have the transparency. And then in a very well
15 intentioned way you came to us today with a presentation
16 that was very, very simplified on how those things work,
17 which I think we all probably sort of knew.
18 It might be more illustrative at some point to
19 come back with some examples of more complicated scenarios
20 that include these bonuses and offsets, and the other
21 things that J.J. was talking about, so we could see what
22 some of those actually look like. That might -- because I
23 sort of understood what J.J. was asking about, but then I
24 got a little bit confused.
25 And so I'm -- when I look at things, it's a lot

1 easier, because there's just a lot of moving parts here,
2 so I might suggest that for, you know, as soon as we can
3 get it, or the next presentation, or whatever.
4 But, you know, the other interesting thing here
5 is that, you know, in the big picture, while, you know,
6 J.J. can sound a little prosecutorial at some time, him
7 asking the simple question sometime ago has really led to
8 ripples in this whole thing throughout the industry,
9 right? There's a lot of noise, a lot of news, a lot of
10 things are happening. I think the transparency is going
11 to become a lot greater. And, of course, we've already
12 been doing some of this work on the PEARS, I think it's
13 called, right?
14 So again, I think it's complex, but the more that
15 we can look at different sort of examples of how these
16 things work. I don't even need to know the names of the
17 companies or the particular contracts that we have with
18 them, but just some better sort of complex examples, so I
19 could sort of follow the charts.
20 CHAIRPERSON JONES: Okay. Mr. Chiang.
21 COMMITTEE MEMBER CHIANG: Could we get a sense of
22 the improvement in terms with companies that we've done --
23 we've invested multiple funds. So years back when I was
24 trying to impress upon Joe and others and asking the
25 question if we are, in fact, paying reduced fees, the

1 response was yes definitely. But I have no sense of how
2 much we're paying less in fees, what the terms of the
3 contracts are. And so if we can get some type of sense.
4 And then my staff had communicated, I think with
5 you Ted or perhaps somebody else, after I came back from
6 RFK Center for Justice and Human Rights, I had been
7 approached by the Rhode Island Treasurer Seth Maganizer,
8 who was the impetus for the letter to the SEC. And I said
9 in many cases some of them are difficult. In some cases,
10 some of the firms did not want to continue or engage in
11 business with the State of California, because they didn't
12 want to be subject to the terms of disclosure, Sequoia and
13 others, way back when.
14 Seth's response was that the funds that deal with
15 Rhode Island are very receptive to. So I don't know if we
16 looked at the funds that deal with Rhode Island and
17 others, but are they funds that we deal with, and the --
18 are they smaller funds that we don't deal with? Are they
19 terms that we're already asking for?
20 So I just wanted to get a broader sense of what
21 the general market is for other institutional investors
22 relative to what we're engaged with at CalPERS.
23 CHIEF INVESTMENT OFFICER ELIOPOULOS: Why don't
24 I -- I'll start off and then I can hand it off to Réal. I
25 think -- I don't know offhand the difference between the

1 portfolio and Rhode Island and ours. So I can't comment
2 on that. And my guess is Réal and Christine won't have a
3 working knowledge of their portfolio, but it's likely to
4 be at a smaller scale than CalPERS for sure.
5 In terms of progress that we've made in terms of
6 the terms and conditions of funds, particularly follow-on
7 funds, one of the difficulties is, you know, we don't want
8 to play poker with our cards open here, is one of our
9 phrases. So we tend not to want to describe in open
10 session our particular fee arrangements.
11 I think the farthest that we've gone and have
12 gone, and I'll turn it back to Réal, is the comments that
13 he made, we use the typical 2 and 20 piece here. I think
14 over the course of the last three, four years that Réal
15 has been here working on the portfolio together
16 with -- together with Joe and Janine in those years as
17 well, a real concerted effort to do better than that in
18 the context of the overall market. And I think Réal
19 mentioned 150 basis points or so is maybe more typical.
20 There are some other things that -- other arrows
21 in our quiver that we can use, which is co-investment and
22 others types of vehicles that we have used, so that's as
23 far as I can go in general. I don't know if, Réal, you
24 want to pick it up from there.
25 MANAGING INVESTMENT DIRECTOR DESROCHERS: I can

1 assure you that I don't their portfolio. But I can assure
2 you that if you remember in 2011 when we came here, when I
3 said I'd present a rebalancing plan, I said we should
4 not -- CalPERS should not be buying retail. We should be
5 wholesale investors.
6 I don't want to -- we have the number. I can
7 assure that we made tremendous progress in there. And we
8 do that. Co-investment is a small part of it. So one
9 part is what we do with Customized investment account.
10 For CalPERS, there's various form that we do there, either
11 side by side with other, or CalPERS being alone in this.
12 I call that a bucket, where we have it alone. We wanted
13 to have more control in the capital.
14 And I can assure you I'd be happy to share it. I
15 don't know if it's in closed session. I want -- I think
16 we make very good progress, created I think -- I would say
17 lots of value. Lots of value.
18 We -- if you remember, we said we should be
19 buying wholesale not retail, and we don't do that many
20 transactions. I don't know if you look, we report every
21 month in closed session what we're working for. I would
22 say compared -- I mean, we don't do that many, but we take
23 a lot of time doing due diligence, a lot of time
24 negotiating.
25 We're working on the core holding. And these

1 things have been going on for over a year. It doesn't
2 happen fast. It takes time. We need to know what we
3 want. So, I'm sorry. I don't -- I should stop here
4 probably.
5 CHAIRPERSON JONES: Mr. Jelincic.
6 COMMITTEE MEMBER JELINCIC: Okay. I won't ask
7 about offsets. Fee waivers. Can you explain to me what
8 fee waivers are, how they're used, and how the GP gets
9 their money back?
10 INVESTMENT DIRECTOR GOGAN: So by management fee
11 waivers, just to make sure that we're on the same page,
12 what you're talking about is the ability for a general
13 partner to use a management fee waiver in place of a
14 deemed contribution for their one to three percent --
15 COMMITTEE MEMBER JELINCIC: Yes.
16 INVESTMENT DIRECTOR GOGAN: -- correct?
17 And so your question is, to start with, you're
18 trying to get a sense of throughout our portfolio how
19 common that arrangement is?
20 COMMITTEE MEMBER JELINCIC: That's a question
21 that I had asked earlier. There's some research
22 apparently being done on it.
23 But this question is just how does it work?
24 What's the process? What's the economics of it? You
25 know, quite frankly, I'm sure that the Wall Street hearts

1 of private equity don't say, you know, I overcharged you.
2 I'm just not going to take the money.
3 INVESTMENT DIRECTOR GOGAN: Well, I think, if I
4 could, one thing that I would like to back up and offer up
5 is that with respect to our entire portfolio, it's
6 important to note that the entire portfolio is audited.
7 Everything is audited. Ninety-seven and a half percent of
8 the portfolio is audited under standards that conform with
9 U.S. GAAP. And so one of the questions without going into
10 a lot of detail on how the management fee waiver mechanics
11 work from partnership to partnership, and it depends to
12 Réal's earlier point on the waterfall computation, one
13 thing that does give us comfort with respect to having
14 assurance that the bottom line numbers that we're relying
15 upon are fairly stated, is that the majority of the
16 portfolio, as I mentioned, the overwhelming majority is
17 prepared in accordance with U.S. GAAP.
18 And there are independent auditors typically, one
19 of the top three, that provide a statement to us that
20 provide information that we, as investors, are reasonable
21 in relying on the fact that the financial presentation of
22 the income statement, the balance sheet, and the capital
23 accounts are materially accurate and fairly represent the
24 financial position of the company.
25 COMMITTEE MEMBER JELINCIC: And so how does the

1 fee waiver function work?
2 INVESTMENT DIRECTOR GOGAN: And so with respect
3 to the fee waivers, to some degree, it's going to depend
4 on whether it is a European waterfall or whether it is a
5 deal-by-deal waterfall. But my point in trying to go back
6 to the audited financial statements is that in accordance
7 with presenting the financial condition of the individual
8 partnership, there are independent auditors that look
9 every year to evaluate and assure that the computation of
10 net income is consistent with the particular limited
11 partnership agreement, and take into account each of the
12 idiosyncratic conditions of the various waterfalls that
13 exist for that particular partnership.
14 COMMITTEE MEMBER JELINCIC: And the SEC would say
15 they didn't do a very good job of it. But let me ask
16 another question that I think is a yes or no. Are they
17 GIPS compliant, Global Investment Performance Standards?
18 CHIEF OPERATING INVESTMENT OFFICER TOLLETTE: In
19 general, no. GIPS -- just for the Committee's benefit,
20 GIPS is a set of -- it stands for the Global Investment
21 Performance reporting Standards. And it's basically a set
22 of standards promulgated by the CFA Institute that help
23 promote consistent reporting of investment performance by
24 managers.
25 The CFA Institute is working on a guidance

1 statement that will be applicable to private equity, that
2 we think may help increase adoption of the GIPS standards
3 within private equity. Essentially, because private
4 equity uses internal rate of return versus time weight of
5 return, not many managers have progressed very far in the
6 private equity space. It's very well adopted in the
7 public asset management space, but not very fully adopted
8 in the private equity space.
9 COMMITTEE MEMBER JELINCIC: Thank you.
10 CHAIRPERSON JONES: Okay. I think it's also
11 important to realize that earlier in the day, Mr.
12 Eliopoulos did indicate an update on the private equity
13 project, the PEARS project, where he indicated that he has
14 collected about 94 percent of the data that's necessary to
15 maybe answer a whole host of questions that we've been
16 asking, and that he plans to come back to the Committee to
17 present that information to us.
18 And so I think it's important that we know. And
19 matter of fact, he also stated in his comments this
20 morning, that they actually went live and parallel on this
21 particular project that they're working. So it's getting
22 there. And I know that we all are interested in
23 understanding some of the complexities of private equity
24 investment. But I think we need to be patient too to make
25 sure that we get all of the information and get the

1 accurate information, because I think there's been too
2 many misquotes, too much misinformation that's been in the
3 public.
4 And as you know, when information is provided to
5 the press, and many times they go with what they were
6 told, and many times it's not accurate information coming
7 from our Investment Office. So I would encourage us all
8 to be a little patient, and certainly answer J.J.'s
9 questions when the data is available, or if he has
10 specific requests that he can provide that request to you
11 and -- so that it can be responded to.
12 So I would just caution us that -- and remind us
13 that that report is coming. And that's going to be the --
14 we champion that report as improving transparency, and
15 also eliciting best practices from this whole industry.
16 So I look forward to getting that report, and
17 then incorporating many of the questions that were raised
18 here into that report when you present it back to the
19 Committee. Okay.
20 So thank you. Now, we will move to public
21 comments. We had a request to speak from Michael Ring.
22 MR. RING: For the record, Michael Ring, Service
23 Employees International Union.
24 Chair Jones, members of the Committee, good to
25 see you all again. Very briefly, I just wanted to give

1 you an update. You may recall that in May at this
2 Committee meeting, Michael Johnson, a security officer
3 with Universal Protection Services in Silicon Valley came
4 and testified along with David Huerta a leader of ours
5 from United Service Workers West. I wanted to give you
6 and update on what's been happening with that.
7 First of all, I want to thank your staff, and, in
8 particular, your real estate staff, and Carrie
9 Douglas-Fong and Laurie Weir for all their work with us on
10 this issue to try to engage all stakeholders in trying to
11 find a good fiduciary solution that brings long-term value
12 to your real estate portfolio.
13 And obviously from our perspective, one of the
14 keys to that is your human capital management work that
15 makes sure that the workers, who in this case are securing
16 investments, are well compensated, and receive the
17 benefits and the work conditions they need to successfully
18 secure your buildings in different locations.
19 So your staff has been, as usual, really a
20 pleasure to work with and have really played a positive
21 role in trying to bring together all stakeholders
22 In spite of the best efforts of so many in this
23 situation, and in spite of an ongoing dialogue with
24 Universal Protection Services, we have not been able to
25 reach a solution that met the needs of Mr. Johnson and

other security workers.

And so on July 15th, SEIU officially downgraded Universal Protection Services from green, in our responsible contracting guide, to yellow. The reasons for that I'll read to you quickly here.

The downgrade stems from the failure of statewide UPS management to implement a plan to mitigate serious issues affecting employees, including allegations of wage theft, discrimination, harassment, retaliation, and unfair labor practices. This downgrade is only for California markets, and it's unfortunate. And we're still in conversations with UPS management to try to find a common ground solution, but I did want to share that update with you and thank your staff and all their managers who've really helped engage the conversation to try to find a solution that can bring healthy markets and lead to the long-term returns that all of you as fiduciaries are working towards.

And I think you've done a really good job of doing that within the context of your human capital management investment belief and your responsible contracting.

So I just wanted to give you an update and thank you and your staff again for all their support in trying to find a solution here.

1 CHAIRPERSON JONES: Okay. Thank you, Mr. Ring.
2 And we appreciate you taking the time today to come and
3 share your views on -- to the -- with the Investment
4 Committee. And please continue to work with staff
5 regarding that particular issue.
6 So that concludes the agenda for the open
7 session. And we will go into closed session in 10
8 minutes.
9 (Thereupon California Public Employees'
10 Retirement System, Investment Committee
11 meeting open session adjourned
12 at 3:01 p.m.)
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1 C E R T I F I C A T E OF R E P O R T E R
2 I, JAMES F. PETERS, a Certified Shorthand
3 Reporter of the State of California, do hereby certify:
4 That I am a disinterested person herein; that the
5 foregoing California Public Employees' Retirement System,
6 Board of Administration, Investment Committee open session
7 meeting was reported in shorthand by me, James F. Peters,
8 a Certified Shorthand Reporter of the State of California,
9 and was thereafter transcribed, under my direction, by
10 computer-assisted transcription;
11 I further certify that I am not of counsel or
12 attorney for any of the parties to said meeting nor in any
13 way interested in the outcome of said meeting.
14 IN WITNESS WHEREOF, I have hereunto set my hand
15 this 24th day of August, 2015.
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