Memo

To:	Members of the Investment Committee California Public Employees' Retirement System
From:	StepStone Group
Date:	April 18, 2016
Subject:	Strategic Plan Five-Year Update – Infrastructure

StepStone has reviewed the updated Real Assets Strategic Plan to be presented to the Investment Committee in April. With respect to the Infrastructure Program, the changes proposed in the updated Strategic Plan are primarily focused on creating (1) an integrated organizational structure across the Real Assets component programs; and (2) a single portfolio hierarchy for Real Assets, under which risk classifications, parameters and the business model for the component programs will conform to those currently used in Real Estate. StepStone believes that the increased integration of the component asset classes should help to reduce complexity across the Real Assets Unit and Investment Office. As we discuss below, some of these changes have already been implemented while others are forthcoming, including revisions to the Investment Policy (the "Policy").

In July 2011, Infrastructure was transferred, along with Real Estate and Forestland, to the newly-formed Real Assets asset class. Shortly thereafter, the Investment Committee approved the Infrastructure Strategic Plan. In 2015, the Real Assets Unit ("RAU") initiated the process of integrating investment staff, procedures, reporting, and policies across the three component programs. These changes were undertaken as part of the INVO Vision 2020 effort to reduce risks, costs, and complexity across CalPERS' Investment Office. The 2016 strategic planning process began in July 2015 and included a series of roundtables with market participants, and an evaluation of market conditions by geography and strategy, and other topics. The updated Strategic Plan sets forth an integrated Real Assets Unit for the first time, with a single organizational structure and portfolio hierarchy, including risk classifications, parameters and a business model for Real Estate, Infrastructure, and Forestland.

The updated Strategic Plan introduces several changes to the Infrastructure Program, which are outlined below:

- **Organization:** The RAU has created a new, integrated organizational structure comprising five divisions: Strategic Planning, New Investments, PARRGO, Portfolio Management Group, and Investment Research.
    - The RAU initiated these changes in 2015. The reorganization of staff is complete, yet certain policies and procedures are still in the process of being integrated. StepStone believes that the new organizational structure should lead to greater consistency in the investment process, decision making, asset management, and reporting across the RAU and Investment Office.
- **Risk Classification**: The updated Strategic Plan proposes to change the Infrastructure risk classifications to conform to those used in Real Estate.
    - The 2011 Infrastructure Strategic Plan introduced risk classifications to highlight specific return drivers, risks, and other criteria that are specific to Infrastructure investments (Defensive, Defensive Plus, and Extended). In the updated Strategic Plan, the existing Infrastructure risk classifications will be replaced with those currently used in CalPERS' Real Estate Program and by other institutions for Real Assets (Core, Value-Added, and Opportunistic). The use of a single risk classification scheme should help to clarify the role that Real Assets investments are expected to play in CalPERS' portfolio, particularly for purposes of Asset Liability Management. StepStone notes that new risk classifications for Infrastructure will require a revision to the definitions currently used in the Policy. Staff will begin the process of updating the Policy following Investment Committee approval of the Strategic Plan. Further, existing Infrastructure investments must also be reclassified in CalPERS' reporting systems.

- **Segments:** The updated Strategic Plan proposes the classification of infrastructure sectors into "segments" used in Real Estate (Essential, Commercial, Consumer, Residential, Specialized, and International).
    - Several infrastructure sectors have been mapped onto Essential, Commercial, Retail, and International segments. However, further detail on the use of these segments across CalPERS' existing Infrastructure portfolio and future investments is required, particularly since infrastructure investments have not historically been classified by segment. Further, existing infrastructure investments must be reclassified by segment in CalPERS' reporting systems.
- **Geography**: Geographic regions used in Infrastructure have been changed to conform to those currently used in Real Estate and with the classifications used by FTSE. In addition, the upper limit of the allocation range for US investments has increased from 80% to 100%, while the lower limit on investments in developed markets outside the US was reduced from 20% to 0%.
    - StepStone considers international investments to be an important component of a diversified infrastructure allocation, particularly due to the size, depth and maturity of the infrastructure market outside the US. The proposed changes to geographic segments are not expected to impact CalPERS' ability to invest outside the US.
- **Business Model**: The updated Strategic Plan incorporates a limit on Infrastructure and Forestland manager relationships to 10. Currently, the Infrastructure Program has 8 manager relationships.
    - The emphasis on maintaining fewer, larger relationships with external managers is positive and should contribute to a reduction in the complexity and costs associated with CalPERS' investments. Given the specialized nature of certain infrastructure sectors and regions, StepStone notes that a cap on the number of manager relationships may limit CalPERS' ability to gain access to top-tier specialists, and to maintain a diversified portfolio of Infrastructure investments.
- **Other changes**: The updated Strategic Plan incorporates a Debt Service Coverage Ratio (DSCR) of 1.25% for Infrastructure investments, a new limit on exposure to Development (up to 10%) for all Real Asset component programs, and an integrated Environmental, Social, and Governance ("ESG") goals and sustainable investment practices across Real Assets. These changes are prudent and should help to strengthen the Program's focus on risk.

StepStone welcomes the opportunity to answer any questions of the Investment Committee.