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PENSION
CONSULTING
ALLIANCE

The year '2016' is displayed in a large, blue, serif font. To the right of the year is a vertical yellow line.

CalPERS Investment Committee

Annual Private Equity Program Review
November 2016

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Historical Context

CalPERS Private Equity Portfolio	6/30/08	6/30/12	6/30/16
Private Equity Portfolio (\$B)	\$24.8	\$34.2	\$26.4
Total CalPERS Portfolio (\$B)	\$239.6	\$233.3	\$295.2
Private Equity as a % of the Total Portfolio	10.3%	14.7%	8.9%
Private Equity Target Allocation	10%	12%	12%*
Non-U.S. Exposure**	35%	37%	39%
Manager Relationships	153	134	99

*Policy target as of 6/30/16 was 12% with an interim target of 10%

** Based on portfolio company location

Private Equity's presence in the overall portfolio is diminishing over time due to a combination of factors:

- Distributions have exceeded contributions by approximately \$24 billion since 2011
- Few commitments were made in the 2009-2011 time period relative to 2006-2008
- Recent sales of partnership interests on the secondary market
- Ongoing efforts to curtail the establishment of new manager relationships
- CalPERS' specific transparency requirements have compressed universe of acceptable managers
- High purchase price environment has lessened the urgency to put more capital to work
- Increased competition for allocations with top managers

Portfolio Observations

As of June 30, 2016:

- Portfolio has outperformed Policy Benchmark over 1- and 20-year periods; underperformed over 3-, 5- and 10-year periods
- PE has been CalPERS' best performing asset class over the latest 10-year period, averaging a 10.2% annual time weighted return
- Largest strategy exposures: Buyouts (60%), Expansion Capital (15%)
- Bifurcation of portfolio between Strategic and Legacy holdings is ongoing
- Program committed approximately \$4 billion during FY 2015-2016 and has a budget of \$4 billion for FY 2016-2017

Meaningful Program Updates

- PEARS is operational with continuing enhancements expected
- Investment Director (Underwriting) departed in September; replaced by former head of Co-Investments, which was consolidated with Underwriting
- More investment officer departures than in prior years; some replacements arrived from other CalPERS groups (without private equity experience) or from outside of organization
- Average capital weighted contractual management fee and carried interest rates:

Fiscal Year	Management Fee	Carried Interest
2012-13	1.22%	16.92%
2013-14	1.17%	15.51%
2014-15	1.13%	14.80%
2015-16	1.08%	14.55%

Challenges

- Attract and retain talent at Investment Officer level
- Obtain necessary transparency from managers
- Continue negotiating more favorable terms and conditions
- Develop succession plan for Managing Investment Director
- Escalate CalPERS' role with ILPA, particularly by senior personnel
- Consider expanding due diligence procedures to augment those of SEC
- Rich buyout market/lower return environment
- PEARS enhancements/troubleshooting
- Maintain consistent investment pacing
- Examine alternatives to the existing business model

SWOT Analysis – Private Equity Program

STRENGTHS

- Size/market presence
- Long-term positive track record
- Deep and experienced senior team
- Strong resources and processes
- Leadership role promoting transparency
- Reduced contractual fee/carry rates
- Relationships with leading managers

WEAKNESSES

- Shortage of junior Investment Officers
- Benchmarking challenges
- Staff compensation limitations
- Cost of participation in asset class
- Capital deployment requirements
- Move to 30 managers remains challenging

OPPORTUNITIES

- PEARS and enhanced data capture
- ILPA/other industry groups
- Regulatory/legislative oversight of PE
- Contractual compliance reports by third parties to supplement SEC actions

THREATS

- Lower return environment
- Industry-wide lack of complete transparency
- Structural imbalance between GPs and LPs
- Employee recruitment and retention
- Managing Investment Director succession
- Uncertain level of SEC oversight
- Other large LPs with competing ideologies
- Non-investment related time commitments

Investment Beliefs

1. **Liabilities must influence the asset structure**

Private Equity has been the portfolio's best performing asset class over the long term, though the assets tend to be illiquid and non-income producing

2. **A long term investment horizon is a responsibility and an advantage**

Private equity is a long term asset class; program has generated a 20-year return of 11.4%

3. **CalPERS investment decisions may reflect wider stakeholder views**

Staff includes ESG language in investment contracts though room for improvement exists; private equity IRC includes senior investment professionals from outside of PE group

4. **Long term value creation requires effective management of three forms of capital: financial, physical and human**

Move toward 30 Strategic managers provides CalPERS the opportunity to deepen relationships with leading firms and promote key CalPERS values and beliefs

5. **CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution**

Program underperformed Policy Benchmark over the latest 3-, 5- and 10-year time periods, while outperforming over the latest 1- and 20-year periods; Policy Benchmark is under review for realignment

Investment Beliefs

6. Strategic asset class allocation is the dominant determinant of portfolio risk and return

Emphasis on 30 Strategic managers may limit ability to achieve/maintain target allocation; PE program is diversified across strategy, geography, industry and investment structure

7. CalPERS will take risk only where we have a strong belief we will be rewarded

CalPERS has a nearly 30-year successful track record in this high risk/high return asset class

8. Costs matter and need to be effectively managed

Staff has negotiated reduced contractual fees and carried interest; PE remains expensive relative to other asset classes

9. Risk is multi-faceted and not fully captured through measures such as volatility or tracking error

Additional PE risks include leverage, illiquidity, transparency, and currency fluctuations

10. Strong processes and teamwork and deep resources are needed to achieve CalPERS' goals and objectives

PE has a large team, strong leadership and well conceived divisions of labor; PEARS is operational with enhancements ongoing and Release 3 scheduled for completion in 2017

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