CalPERS

Investment Committee
Agenda Item 5a

May 15, 2017

Item Name: Private Asset Class Roles and Benchmarks

Program: Asset Allocation & Risk Management

Item Type: Information

Executive Summary
This agenda item continues the dialogue between staff, Board Consultants, and the Investment Committee (Committee), regarding the proposed changes to CalPERS' private asset class roles, segments, and benchmarks presented to the Committee at the April 2017 meeting. CalPERS' benchmarks will have a significant impact on CalPERS' forward-looking investment strategy.

Key recommendations proposed at the April Committee include:
- Consolidation of all three previous Real Assets segments into one Real Asset Class and adoption of an MSCI Investment Property Databank U.S. Core – Fund Level (MSCI IPD) benchmark.
- Consolidation of Private Equity and capitalization weighted Global Equity to form a combined growth related segment.
- Adoption of the FTSE All-World, All Capitalization index plus a return hurdle for the combined growth related segment.

Staff seeks feedback and guidance from the Board Consultants and the Committee on the recommended benchmarks and proposed next steps. Opinion letters from Wilshire Associates, Pension Consulting Alliance, Meketa Investment Group, and StepStone Group are provided as Attachments 1, 2, 3, and 4, respectively.

Strategic Plan
This agenda item supports the strategic plan goal of Fund Sustainability: Strengthen the long-term sustainability of the pension fund. In order to deliver targeted, risk-adjusted investment returns, Investment Office staff strives to build an efficient portfolio by defining the strategic roles of Private Asset Classes, evaluating their characteristics (including opportunity cost), and managing their risk exposures in a transparent manner and from a top-down total fund perspective.

Investment Beliefs
The Asset-Liability Management (ALM) process and associated Strategic Asset Allocation are primary activities underlying the exercise of fiduciary responsibility by the CalPERS Board and staff. Most of CalPERS' Investment Beliefs are associated with this activity and agenda item.

Background
CalPERS conducts an ALM workshop every four years. During this process, staff examines and re-affirms the strategic role for each asset class, estimates the Capital-Market Assumptions, and constructs an efficient frontier based on this information. As part of this year's ALM Workshop, staff has been asked to provide an alternative asset allocation approach in addition to the existing approach. The alternative asset allocation approach has led to the potential use of asset "segments" or partitions of the asset classes and benchmarks. At the January Offsite, staff presented the Committee with a list of criteria used to create the asset segments. This assessment has led staff to recommend the changes described above to the private asset classes.

Analysis
Staff's recommendation to consolidate three segments (Real Estate, Infrastructure and Forestland) into one Real Asset Class is based on:

1. Similar underlying investment characteristics of each segment.
2. Historic inability to acquire material representation within Infrastructure and Forestland.
3. Fostering greater teamwork between the segment investment teams.

This consolidation is consistent with the Asset Class Criteria specified in the CalPERS Total Fund Investment Policy. A second recommendation related to Real Assets, is to shift the benchmark provider from the National Council of Real Estate Investment Fiduciaries (NCREIF) to MSCI IPD. This change would provide:

1. Virtually identical investment characteristics.
2. Simplified vendor relationships.
3. Potential extension to global real estate and Infrastructure should those segments become significant enough to warrant specific inclusion or re-inclusion.

The third recommendation is a simplification of the role statement for Private Equity. The next and most substantial recommendation is to consolidate Private Equity with capitalization weighted Global Equity to form a growth related asset segment. The primary objectives underlying this recommendation are to:

1. Improve CalPERS ability to control the exposure to economic growth.
2. Enable the search for additional sources of excess return across the entire growth segment.
3. Enable the potential to explicitly manage the risks resulting from the idiosyncratic company exposures inherent in Private Equity.
4. Foster greater teamwork between the asset class teams.

The final recommendation is to adopt the FTSE All World All Capitalization based benchmark (used for Global Equity) plus a return hurdle for the combined segment. The rationale is to link Private Equity to its funding source which is the other component within the growth segment.

<u>Proposed Next Steps</u>
Pending feedback from the Committee, staff currently anticipates returning to the Committee in June to present two sets of Capital Market Assumptions to support the two choices that will be presented at the November ALM Workshop: an alternative asset allocation approach and the existing asset allocation approach.

Budget and Fiscal Impacts
Not Applicable.

Benefits and Risks
The benefits associated with the recommendations are to increase the materiality of the Strategic Asset Allocation choices, to enable greater control of the resulting exposures, to enable the potential better management of the risks derived from idiosyncratic Private Equity investment activity, and to foster greater teamwork.

The predominant risk associated with the recommendations is the potential to offset intentional market risks undertaken by the Private Equity general partners.

Attachments
Attachment 1 – Wilshire Associates Opinion Letter
Attachment 2 – Pension Consulting Alliance Opinion Letter
Attachment 3 – Meketa Investment Group Opinion Letter
Attachment 4 – StepStone Group Opinion Letter

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