CalPERS

Investment Committee

Agenda Item 7a

March 18, 2019

Item Name: Assembly Bill 181 (Rodriguez) Emerging and Transition Investment Managers

Program: Investment Manager Engagement

Item Type: Action

Recommendation

Adopt a **Support, If Amended** position on Assembly Bill (AB) 181 to remove the requirement that each system identify in its annual report the emerging managers terminated by the system.

Executive Summary

This bill requires the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) to submit a report to the Legislature beginning on or before March 1, 2020, and annually thereafter until January 1, 2024, on the status of achieving appropriate objectives and initiatives regarding the participation of "emerging managers" (and additionally for CalPERS, "transition managers") responsible for asset management within their respective investment portfolios, including those engaged within a "fund of funds" structure. Each system's board is required to define what the terms "emerging manager" (and additionally for CalPERS, "transition manager") mean for purposes of this reporting requirement. The bill explicitly requires each system to include in its report (1) the name of each manager, (2) the amount managed by each manager per asset class, and (3) the names of managers terminated by the system.

Strategic Plan

This agenda item supports the Strategic Plan goal to strengthen the long-term sustainability of the pension fund.

Investment Beliefs

This agenda item supports Investment Belief 3 and the Sub-Belief of Investment Belief 10: that CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries; and diversity of talent at all levels is important.

Background

<u>CalPERS Investment Manager Engagement Program</u>
For more than 25 years, CalPERS has played a leadership role in developing and implementing emerging and transition manager strategies, investing with emerging managers, directly or through fund of funds arrangements, and more recently with transition managers. For purposes of these investment strategies, emerging investment managers are generally described within the industry as newly formed or relatively small firms. Each CalPERS asset class participating in this program has separate emerging manager and transition manager definitions based on assets under management and/or length of track record.

Consistent with its fiduciary duty to work in the best interests of its 1.8 million members, CalPERS' objective for investing in emerging manager programs is to generate appropriate risk-adjusted investment returns by: identifying early stage funds with strong potential for success; accessing unique investment opportunities that may otherwise be overlooked; and cultivating the next generation of external investment management talent. CalPERS has made significant efforts to communicate our investment strategies and criteria for making investment decisions to the external manager community, including emerging managers, to help ensure that investment proposals are aligned with CalPERS' objectives.

Analysis

<u>Specifically, as the bill relates to CalPERS, AB 181:</u>

- Requires the CalPERS Board of Administration (Board) to submit a report to the Legislature commencing March 1, 2020, and annually thereafter until January 1, 2024, on the status of achieving appropriate objectives and initiatives regarding participation of emerging managers and transition managers responsible for asset management within its portfolio of investments.
- Specifies the report must also identify and include all of the following:
    - The name of each emerging manager and transition manager contracted with to provide investment portfolio or asset management services, including, but not limited to, fund of fund contracts, for all asset classes, as applicable.
    - The amount managed by each emerging manager and each transition manager by asset class.
    - The name of each emerging manager and transition manager that has been terminated by the board.
- Requires the Board to define the terms "emerging manager" and "transition manager" for reporting purposes.
- Specifies that nothing in this section shall require the Board to take action that is not consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution.

<u>According to the Author:</u>
"AB 181 places back into law required annual reports to the Legislature from the California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS) relating to the use of emerging and transition managers for purposes of investment and asset management. For numerous years, each system has utilized emerging

managers to assist not only in the diversity of investment firms for purposes of asset management, but also in the diversity of their respective investment portfolios. The emerging manager programs also serve as incubators for these firms towards gaining valuable experience in the investment arena."

CalPERS Reporting of Ongoing Emerging and Transition Manager Program Activities
Chapter 701, Statutes of 2011 (SB 294, Price), required that CalPERS and CalSTRS each define the term "emerging investment manager" and produce a 5-year strategic plan for emerging investment managers' participation across all asset classes. That bill also required each retirement system to submit an annual report to the Legislature, until January 1, 2018. More than ten years prior, CalPERS launched its Management Development Program to allocate capital and invest directly in small and emerging public equity investment management firms in exchange for an equity stake. In 2007, CalPERS also established a series of emerging manager initiatives focused on hedge fund and private equity strategies.

Following the enactment of SB 294, the Investment Office created an Emerging Manager Program to integrate its emerging manager strategies across all asset classes, improve communication and engagement with the emerging manager community, and address the specific reporting requirements of the bill. The first report, the 2012 Emerging Manager Five-Year Plan established a strategic framework of ten work streams to address these portfolio management and external outreach activities. In 2015, the Investment Office created a Transition Manager Program to address the continuous maturity and development of its original Emerging Manager Program by providing a pathway for an emerging manager to be seriously considered as a traditional, established manager engaged by an Investment Office asset class.

As part of its final report mandated under SB 294, CalPERS adopted a new Emerging and Transition Manager 2020 Plan to continue the strategic framework established under the 2012 Emerging Manager Five-Year Plan. The 2020 Plan identifies appropriate objectives and initiatives to be undertaken over a three-year period ending June 30, 2020, including how transition managers will be identified, evaluated, and selected, as well as the administration of two global solicitation processes seeking qualified candidates for the Transition Manager Program. The Investment Office team members report annually to the Board on activities undertaken to meet the six plan objectives, and continue to engage and communicate with the emerging and transition manager community. As of June 30, 2018, the net asset value of these emerging and transition manager strategies was $8.6 billion, with approximately $2 billion in new assets allocated since 2017. As of the same date, CalPERS had $3.85 billion invested with women and minority-owned managers.

AB 181 Impacts on CalPERS Emerging and Transition Manager Programs
As written, the bill may create concerns with stakeholders in that it would require CalPERS and CalSTRS to publicly report the names of emerging and/or transition managers who have been terminated by each system. This could be misleading and have negative connotations for an emerging or transition manager that is listed as being terminated. CalPERS team members recommend the Board consider requesting amendments to delete this requirement from the bill.

The bill would also require CalPERS to report investment information for each individual emerging or transition manager, which could potentially require contractual changes and notification to affected emerging and/or transition managers. Currently, CalPERS reports this information in the aggregate and not by each individual fund manager. CalPERS suggests the author considering amending the bill to apply to new contracts to eliminate the need to amend existing contracts.

Budget and Fiscal Impacts

Program Costs/Savings:

Unknown

Administrative Costs/Savings:

Unknown, but likely nominal. The Investment Office and Legislative Affairs Division already has dedicated team members who manage CalPERS' emerging and transition manager program and mandated legislative reporting, respectively. However, existing resources would be diverted from normal activities to fulfill the bill's reporting requirement.

Benefits and Risks

Benefits:

- Provides reassurance that the Legislature and CalPERS are committed to an investment strategy that include emerging managers.

Risks:

- Could have a negative impact on those of the emerging and transitional managers who are listed as terminated on the CalPERS or CalSTRS annual report.
- Diminishes the maturing of CalPERS emerging manager program by giving the impression it is a result of a legislative mandate.

Attachments

Attachment 1 – Legislative History

____
Danny Brown, Chief
Legislative Affairs Division

____
Ben Meng
Chief Investment Officer