CalPERS

Investment Committee

Agenda Item 8a

March 18, 2019

Item Name: Private Equity Business Model

Program: Total Fund

Item Type: Action

Recommendation

Approve the concept of including Pillars III (Late Stage Venture/Growth) and IV (Long Hold) as parts of the Private Equity Strategic Business Model.

Executive Summary

Over the past 18 months Staff has had ongoing dialogue with the Investment Committee about the private equity market and its inclusion within the CalPERS asset allocation. The organization's exposure to this asset class has been slowly declining as the pace of capital commitments and calls have not kept up with the level of capital distributions back to CalPERS. Staff believe that maintaining or increasing exposure to this asset class is required to support the assumed rate of return targeted for the public Employees' Retirement Fund (PERF).

The market examination has led to the conceptual framework of four pillars. Pillar I (Emerging Managers) and Pillar II (Traditional Partnerships) represent the avenues by which CalPERS has participated in the market to date. Pillars III and IV have been delineated to increase the market access paths for CalPERS, while seeking to also improve the alignment between the general partners and CalPERS.

Staff is requesting Investment Committee support for the concept of including Pillars III and IV as parts of the Private Equity Strategic Business Model.

Strategic Plan

This item supports California Public Employees' Retirement System (CalPERS) Strategic Plan goal of improving long-term pension and health benefit sustainability. The inclusion of Pillars III and IV, to operate alongside Pillars I and II (existing emerging manager and traditional partnership models) is intended to assist in maintaining and increasing investment exposure to the private equity asset class over time. Additional objectives of this effort are improving transparency, control, and focus, while decreasing costs and asset turnover.

Investment Beliefs

This item supports the following CalPERS' Investment Beliefs:

- Investment Belief 1: Liabilities must influence asset structure
- Investment Belief 2: A long time investment horizon is a responsibility and an advantage
- Investment Belief 4: Long-term value creation requires effective management of the three forms of capital: financial, physical and human
- Investment Belief 6: Strategic asset allocation is the dominant determinant of portfolio risk and return

Background

Staff has provided the Investment Committee with information on Pillars III and IV at multiple meetings for the past year. As covered during the February 2019 Board Investment Committee presentation, CalPERS would eventually invest in separate vehicles aligned to Pillars III and IV.

If approved by the Investment Committee, staff shall continue to the next phase of implementation, the identification and negotiation with potential partners. Investment Committee approval of the concept's inclusion within the Private Equity Strategic Plan, is believed important as a signal to the market that CalPERS is serious about implementing Pillars III and IV. Such a demonstration of intent should aid in the identification of a pipeline of potential partners.

Analysis

Attachment 1 consolidates some of the information presented to the Investment Committee at various time points in the assessment of the private equity business model. Key observations are:

- Private equity has provided significantly higher returns than other asset classes, especially since the financial crisis.
- The number of publicly traded companies has been declining.
- CalPERS current pace of capital commitments and calls is insufficient to have the prospect of increasing the level of exposure to the asset class.
- Simply increasing capital commitments via the existing private equity activities, risks an over diversification of managers (simply adding more of them) which could lead to creating an "index" of private equity with likely lower return prospects.

The observations above underlie the motivation to seek alternatives to CalPERS existing private equity activities. The focus of Pillar III will be late stage investments in technology, life sciences and healthcare. Pillar IV would be targeted at long-term investments in established companies. In addition to Pillars III and IV, staff intend to expand some of the activity in Pillars I and II such as co-investments.

The timeline required for full implementation of Pillars III and IV is unknown and dependent on the identification and successful negotiation with capable partners. Staff shall report the ongoing status of the effort to the Investment Committee, as well as bringing any needed policy changes to the Committee for approval. Prior to any funding of a Pillar III or IV vehicle, a Prudent Person Opinion (PPO) shall be available to the Investment Committee.

Budget and Fiscal Impacts

Staff time and travel expense to assess the business model, identify potential partners, conduct due diligence and negotiate contracts. Implementation of Pillars III and IV will require funding an operating budget for the vehicles in lieu of typical partnership management fees.

Benefits and Risks

The primary benefits assumed from Pillars III and IV are increasing the scale of the Private Equity asset class and fostering an improved alignment of interest with the partners. Risks relate to the ability to identify partners that will ultimately be successful executing the strategies, the ability of partners to build adequate teams, reaching adequate scale to reduce the operating budgets below the typical management fee costs associated with typical partnerships and the potential capital concentration in the eventual investments.

Attachments

Attachment 1 – Private Equity Business Model Presentation

____

John Cole
Investment Director

____

Ben Meng
Chief Investment Officer