

August 31, 2023

Mr. David Miller
Chair of the Investment Committee
California Public Employees' Retirement System
400 P Street
Sacramento, CA 95814

Re: Consultant Trust Level Review

Wilshire's 2023 Trust Level opinion letter covers the "firm" review that is consistent across the individual program reviews provided under separate cover. This opinion letter is focused on a qualitative assessment of INVO's activities this fiscal year to supplement the quantitative performance information provided by both Staff and Wilshire in the Trust Level Review agenda item. In evaluating the quality of an asset management organization, Wilshire assesses factors contributing to the stability of the organization and the alignment of incentives between the team and the organization's long-term objectives. Past Wilshire reviews have highlighted our concerns over Staff stability, as a successful investment program requires a true long term investment horizon that comes from a consistent and enduring investment philosophy. The organization recognizes this importance given Investment Belief #2 – A long time investment horizon is a responsibility and an advantage. Driving strong portfolio returns requires consistency, deep resources, a thorough understanding of the opportunity set, and accountability.

This year's overall Organization evaluation is unchanged from last year's review when the hiring of the Chief Investment Officer led to an increase in our evaluation. Stability in leadership is critical to successfully implement the strategic portfolio approved by the Board and the interim ALM review that is currently ongoing. Wilshire expects the broader organization score to increase over time, should greater stability be realized within INVO's leadership team.

The Chief Investment Officer has laid out a series of initiatives designed to move INVO in a productive direction. Over the past year, the Board has received regular updates on the progress of these initiatives, which include items such as active risk innovation, investment data & technology, culture, and people, all of which are vital for building a resilient investment program. In support of the CIO's vision for INVO in these important areas, the organization has implemented adjustments to the reporting structure.. For example, the Deputy CIO – Private Markets was brought in earlier this year to oversee all private asset investment activities. This hiring is a positive addition given the Board-approved increase in private asset exposure. Enhancing the resources available to scour the private opportunity set will be a significant determinant of INVO's success in this area. Wilshire will discuss any additional changes with the team and highlight them for the Board as necessary.

The CIO is actively shaping INVO culturally and strategically to improve Total Fund performance by improving accountability, in line with Investment Beliefs #4 – long-term value creation requires effective management of three forms of capital: financial, physical, and human; and #10 - strong

processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives. Active risk management is a strategic priority, and the CIO continues to explore additional active strategies through a risk budgeting lens. Value-add opportunities will be measured relative to expectations established as part of the risk budget, further increasing Staff accountability for results. Active return targets (alpha) should be set based on the strategies pursued within the portfolio and, importantly, the desired active risk tolerance of the Board. Set too low, the portfolio is likely to hew closely to the policy benchmark and potentially miss out on active return opportunities. Outsized active return objectives could encourage excessive risk taking or a belief that the objective is unrealistic. This balance is critical in driving consistent performance through time and across different market environments.

Ensuring that CalPERS continues to have the tools necessary to recruit and retain qualified, diverse candidates remains a strong focus for the CIO, in line with the strategic initiative around “People.” There remain both new and existing positions across the individual programs that will require hiring through recruitment or promotion, and it is critical to ensure that sufficient resources are in place to execute on the Board’s strategic investment decisions. As a governmental entity, CalPERS faces some unique organizational risks that for-profit enterprises have greater flexibility in managing, such as the inability to provide employees direct and indirect ownership opportunities. These long-term forms of incentives are common within private sector investment organizations and can serve as significant retention tools. The absence of such compensation structures can expose the organization to the increased risk of losing intellectual capital at the INVO Senior Staff level to asset managers and other financial institutions. We do note that the organization has made strides to adjust pay scales to be more competitive in the marketplace, as well as aligning incentive compensation with Total Fund performance objectives. CalPERS continues to compete for talent in a tight labor market environment and any changes to the compensation structure should be undertaken with a clear understanding of the risks they might introduce.

These risks could be personnel related, such as increased turnover or recruiting challenges, or portfolio related, impacting how much active risk is incorporated across investment programs. Personnel turnover is not uncommon (nor always undesirable) and ensuring investment continuity and improvement is of paramount importance through recruitment of a strong bench.

Investment governance within INVO runs through the three committees stood up last year, which are made up of the most senior investment professionals, across multiple market segments, providing diversity of experience and insight.

- Operations & Administration focuses on organizational priorities, policy, technology, talent, Board preparation, and communications. The interim Chief Operating Investment Officer is a key contributor on this committee.
- Total Fund Management directs strategic portfolio design, leverage and liquidity monitoring, and absolute and active risk management.
- Investment Underwriting is responsible for evaluating the investment pipeline, approval of larger investment commitments, overseeing proxy voting, and managing ‘investment

and innovation' working groups. This ensures an additional level of oversight for more impactful investments, with multiple eyes evaluating the opportunities.

Wilshire is comfortable that the governance aligns with the critical functions necessary to design and build a strong investment program. As the Board consultant, we will continue to monitor their functions and modifications as the committees evolve, staying attuned to flux in reporting lines and responsibilities which could impact Staff stability.

Sustainable Investments Highlights

In recent years, the CalPERS' sustainability team has seen several evolutions, with each change viewed as a positive development for the organization and the broader sustainability efforts. First, last fiscal year, the Board Governance & Sustainability Team (BGST) was formed. The BGST combined two previously distinct functions under the interim leadership of the MID who reported to the CEO and had a dotted line to the former interim CIO. This most recent fiscal year, the team evolved and expanded through the creation of the Sustainable Investments (SI) team which is part of INVO and reports to the CIO.

In March 2023, coinciding with the establishment of the SI team, a MID for Sustainable Investments was hired. The Sustainable Investments MID is tasked with setting the vision, strategy, and governance for CalPERS' sustainability work as well as leading all aspects of the fund's efforts to develop and implement ESG research and processes to support ESG integration into the investment decision-making process. We view this hire as paramount for the success of the SI program and to maintain CalPERS' position as a sustainability leader amongst U.S. peers.

Broadly, SI is responsible for a wide range of priorities including those that were previously overseen by the BGST: the board self-evaluation process; financial markets advocacy; human capital management, including the responsible contractor policy; stakeholder engagement; and diversity, equity and inclusion work, including the emerging manager program. Additionally, the SI team, through its expanded mandate, is also responsible for: the SI portfolio, which is in the process of being established and will invest solely in sustainable assets; ESG integration, which involves incorporating ESG into investment making decisions; and sustainability data and reporting, all of which are trust wide efforts that are across multiple asset classes.

Specifically, the SI team is broken into five sub teams: 1) Sustainable Investment & Strategy, 2) ESG Integration, 3) Data & Analytics, 4) Emerging & Diverse Managers Program, and 5) Capital Markets Advocacy, Policy, & Regulation. The breadth of the SI team is impressive amongst peers and the depth is anticipated to grow in the coming years, as elaborated upon in the next section.

We believe that the Sustainable Investments team is appropriately positioned, reporting directly to the CIO and operating as an integrated part of INVO. With the new MID and the additional resources in queue, the team is well poised to execute on the initiatives outlined later in this section. As of the end of the fiscal year, the team consisted of nine contributors, with three open positions and one pending internal transfer. Several additional openings within the Sustainable

Investment & Strategy team are also expected to follow this fiscal year, as the team looks to build out the SI portfolio.

Given the recent changes and planned additions, CalPERS is positioning itself to be best-in-class when it comes to sustainable investing. However, it will take time before the team is fully staffed, and it is important that expectations be managed accordingly. Recruiting top talent with the appropriate skill set is a challenge, especially within sustainable investing, which is still an emerging space despite it being a high-profile area in recent years. Despite CalPERS' unique hiring constraints, this is a challenge seen broadly within the industry and is not exclusive to CalPERS.

In past years, significant resources were invested in CalPERS' regulatory advocacy program and external initiatives, including multiple presentations to Congressional hearings on sustainability topics, several reports such as the one focused on Task Force for Climate-Related Disclosures, and formal consultation responses to the SEC to improve sustainability disclosures standards across the market. This work has continued in a meaningful way with the addition of an Investment Director serving as the Head of Corporate Governance, who joined in March 2023; the implementation of proxy enhancements, including three related to director voting linked to climate change; and through continued collaboration in initiatives such as the Climate Action 100+, which moved into Phase 2 in June 2023.

During the last fiscal year, the SI team experienced a fundamental shift to go beyond the focus on external efforts to putting more emphasis on internal efforts, particularly around improving ESG integration across the Total Fund. This work has involved significant, proactive collaboration across INVO and is an ongoing effort. The SI team's goal is to expand upon the principles and guidelines that have historically been in place at CalPERS, to ensure that ESG is bedded into investment making decisions across asset classes.

Another notable accomplishment this past year was the refresh of the emerging and diverse manager program, called the Mosaic program. The program made an initial \$1 billion commitment working with external emerging and diverse manager specialists, TPG and GCM Grosvenor. The effort is focused on private market investments.

Finally, as CalPERS seeks to have a sustainable program – which SI defines as the ability to maintain and support a process over the long-term and promote the economy, environment and equity – navigating, reporting on, responding to, and capitalizing on the transition to a low carbon economy remain key areas of focus for the organization and the SI team specifically.

Looking ahead, under the leadership of the new SI MID and his Investment Directors, CalPERS' SI team developed a robust SI 2030 Strategy with five primary objectives including: generating portfolio alpha; improving portfolio resilience; implementing an ambitious Net Zero plan; promoting greater inclusion and representation; and building and promoting efficient and equitable financial markets. These are ambitious efforts that require Board and executive buy-in, frequent and effective collaboration across multiple teams, and additional staffing to support the

efforts. We believe that CalPERS is taking the necessary steps to make significant progress towards these goals.

We will incorporate further comments on Sustainable Investments into the other INVO programs where relevant.

Conclusion

In summary, we continue to monitor the stability of the investment organization and believe there remains room for improvement in the overall evaluation score. The strategic initiatives provide a roadmap to successfully move the portfolio forward in key areas:

- Team stability and resources – People Strategy and Investment Data & Technology
- Improving absolute returns – Portfolio Optimization, Sustainable Investment Strategy, Private Assets
- Improving relative returns – Active Risk Innovation
- Consistent investment in private assets – Innovation Platform and Private Debt Implementation

As for any investment management organization, we would like to see evidence of continued senior member stability and will continue to monitor the progress of strategic initiatives. We are optimistic that the CIO and the strategic initiatives will help drive the Total Fund in a positive direction.