

Investment Office Cost Effectiveness

Wylie Tollette, COIO
Investment Committee

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Agenda

- Introduction to Cost Effectiveness Initiative
- INVO Cost Drivers
- INVO Cost Trends
- INVO Cost Structure
- CEM Peer Benchmarking
- On-Going Cost Effectiveness Strategies & Results

Investment Belief 8

Costs Matter and need to be effectively managed.

Sub-beliefs:

- CalPERS will balance risk, return and cost when choosing and evaluating investment managers and investment strategies
- Transparency of the total costs to manage the CalPERS portfolio is required of CalPERS business partners and itself
- Performance fee arrangements and incentive compensation plans should align the interests of the fund, staff and external managers
- CalPERS will seek to capture a larger share of economic returns by using our size to maximize our negotiating leverage. We will also seek to reduce cost, risk and complexity related to manager selection and oversight
- When deciding how to implement an investment strategy, CalPERS will implement in the most cost effective manner

INVO Cost Effectiveness Objective

Enhance cost effectiveness of the Investment Program to improve net returns on assets.

FROM	TO
Management Reporting: Inadequate reporting systems and data for effective cost management	Automated financial reporting system; development of timely and meaningful financial reports
Cost Awareness: Limited understanding of total cost to manage the CalPERS portfolio	Comprehensive knowledge of total costs being incurred to manage portfolio
Fee Reduction: Insufficient focus on management and consulting fees paid	Focus on fee reduction and value for cost: development of monitoring processes that track and communicate cost saving efforts
Cost Management: Budget process that incited use of external managers and consultants	Greater flexibility to manage use of external vs. internal resources in the best interest of the fund
Benchmarking: Difficult to compare cost Performance fees against relevant peers	Development of meaningful benchmarking statistics and outperform relevant peers per unit of value

As of April 2015:

- Majority of reporting objectives accomplished
- Cost management reporting is now automated and timely
- Cost Effectiveness continues to be a primary strategic initiative for INVO

INVO Cost Drivers

1. Private vs. Public Assets



Private is Higher
Cost than Public

2. External vs. Internal Management



External is generally
Higher Cost than
Internal

3. Breadth and Type of Investment Strategies/Activities



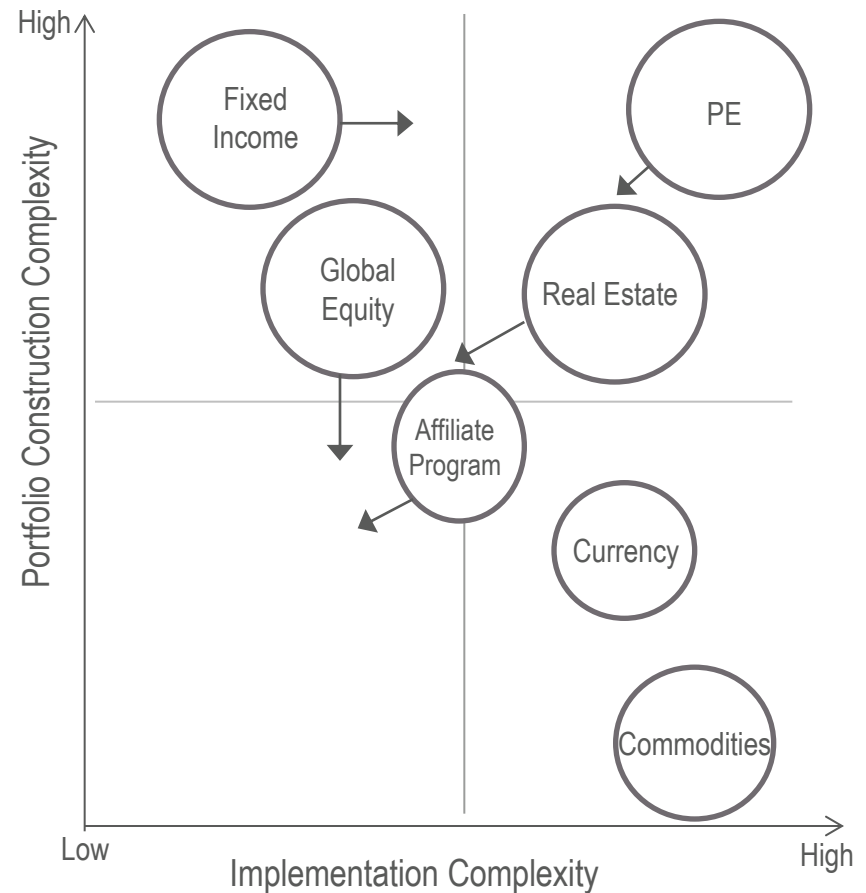
More Complex, High
Volume is Higher
Cost than Simpler,
Low Volume

Absolute size is not necessarily a cost driver.

However, size tends to correlate with complexity, which is a cost driver.

INVO Cost Drivers: Reducing Investment Program Complexity

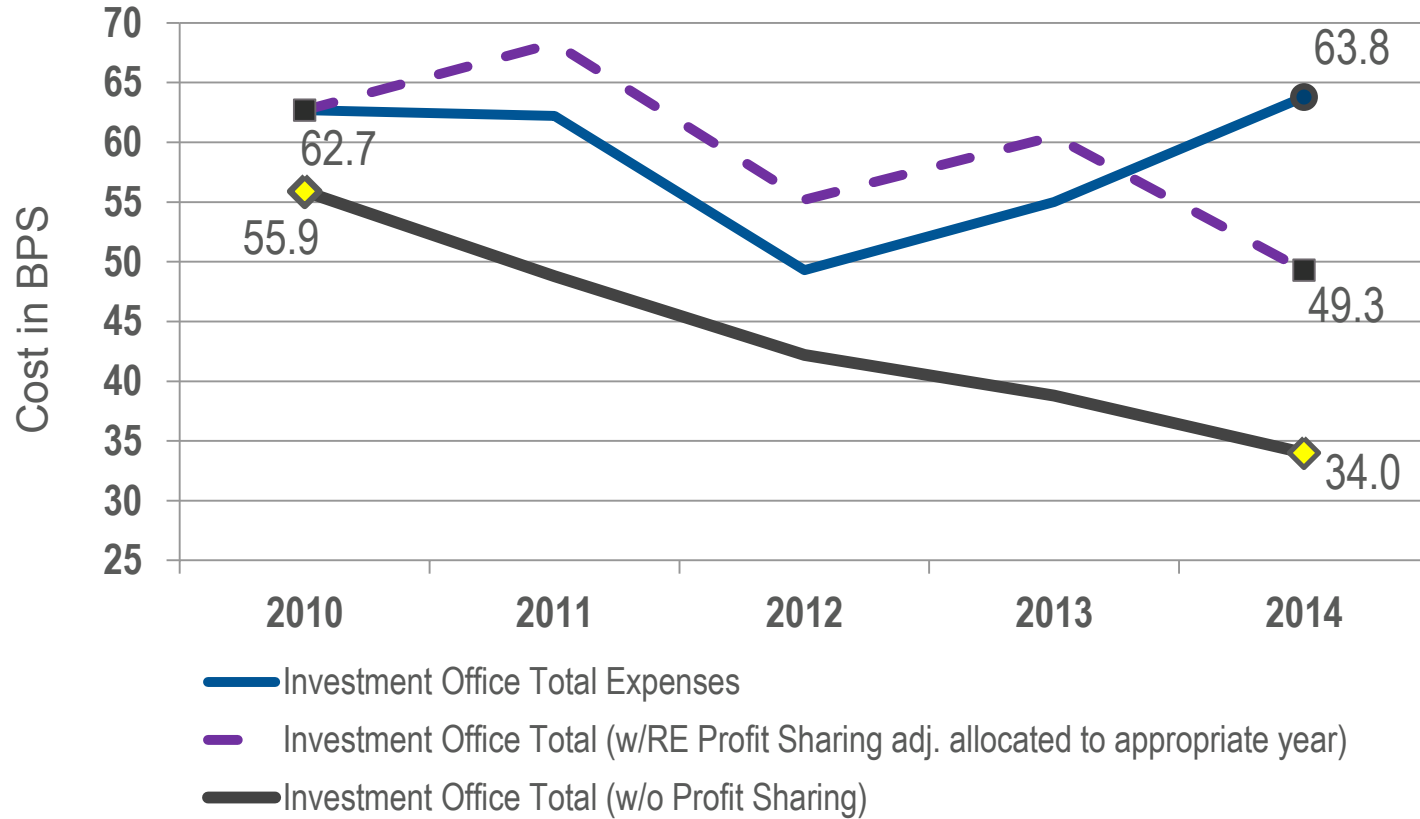
- Investment programs are focused on restructuring portfolios; in general, moving down the scale of implementation and portfolio construction complexity
- Focused on reducing number of relationships and eliminating non-value add programs
- Selectively adding complexity where significant value can be created (e.g. Private Equity (PE) co-invest; internalizing Fixed Income)
- Goal is not to completely eliminate complexity, but to “raise the bar”; make more explicit trade-off decisions among cost, risk and return
- Profit sharing arrangements (performance-based fees) raise complexity and total costs, but can align interests around expected return outcomes



INVO Cost Trends: 5- Year Actuals

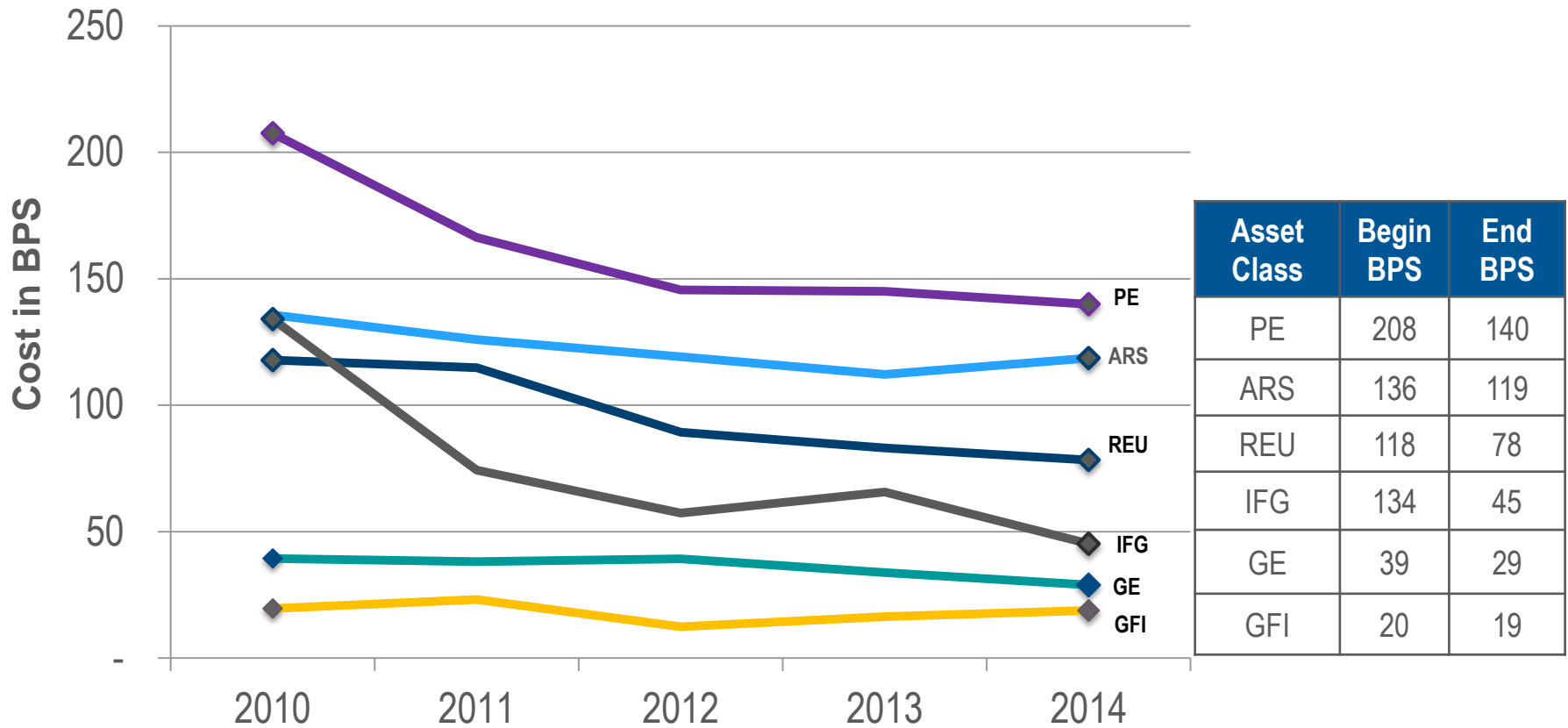
Expense Category	Actual FY \$ 2013 14 ¹ (\$ in millions)	Actual FY \$ 2012 13 ¹ (\$ in millions)	Actual FY \$ 2011 12 ¹ (\$ in millions)	Actual FY \$ 2010 11 ¹ (\$ in millions)	Actual FY \$ 2009 10 ¹ (\$ in millions)	5 Year \$ (Decrease)/ Increase
External Mgmt. Fees – Base	798	821	846	904	911	(113)
External Mgmt. Fees – Profit Sharing	420	396	165	284	125	295
One-Time Real Estate Profit Sharing Accrual ²	399					399
Total External Mgmt Fees	1,617	1,217	1,011	1,188	1,036	581
Consultants	21	27	38	51	35	(14)
Personnel Services	57	42	39	35	29	28
Portfolio Mgmt Services	28	22	21	18	19	9
Operating Services	24	35	24	30	26	(2)
Administrative	4	2	5	2	2	2
INVO Total Port Mgmt. Expense	<u>1,751</u>	<u>1,345</u>	<u>1,138</u>	<u>1,324</u>	<u>1,147</u>	<u>604</u>
INVO Total Port Mgmt. w/o Profit Sharing	<u>932</u>	<u>949</u>	<u>973</u>	<u>1,040</u>	<u>1,022</u>	<u>(90)</u>

INVO Cost Trends: FY 2010-2014 BPS¹



¹Per FY 2013-14 Investment Management Expense Report; figures do not include underlying fund of fund fees for PE and Absolute Return Strategies (ARS) or profit sharing for PE

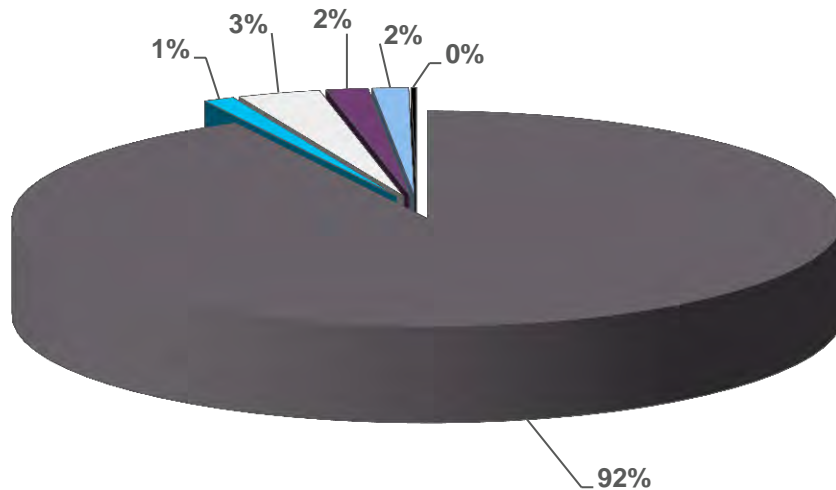
INVO Cost Trends: Ext. Base Mgmt. Fees (FY 2010-14)¹



• Since 2010 the base fee BPS cost for each program has decreased consistently

INVO Cost Structure: FY 2013-14 Total Costs

Fiscal Year 2013-14: \$1.7 Billion



- External Management Fees
- Personnel Services
- Operating
- Consultants
- Portfolio Mgmt Services
- Administrative

Expense Category	\$ (in millions)	% of Total Expenses
External Management Fees	1,617	92%
Personnel Services	57	3%
Portfolio Mgmt Services ¹	28	2%
Operating ²	24	2%
Consultants	21	1%
Administrative	4	0%
Total Cost	\$1,751³	100%
Total Cost	63.8 bps	
Total Cost w/o Profit Sharing	34.0 bps	

- Annual cost in FY 2013-14 was \$1.7 billion
- 92% of INVO's total cost is external management fees

¹Costs include technology, data, analytics and fund accounting expenses

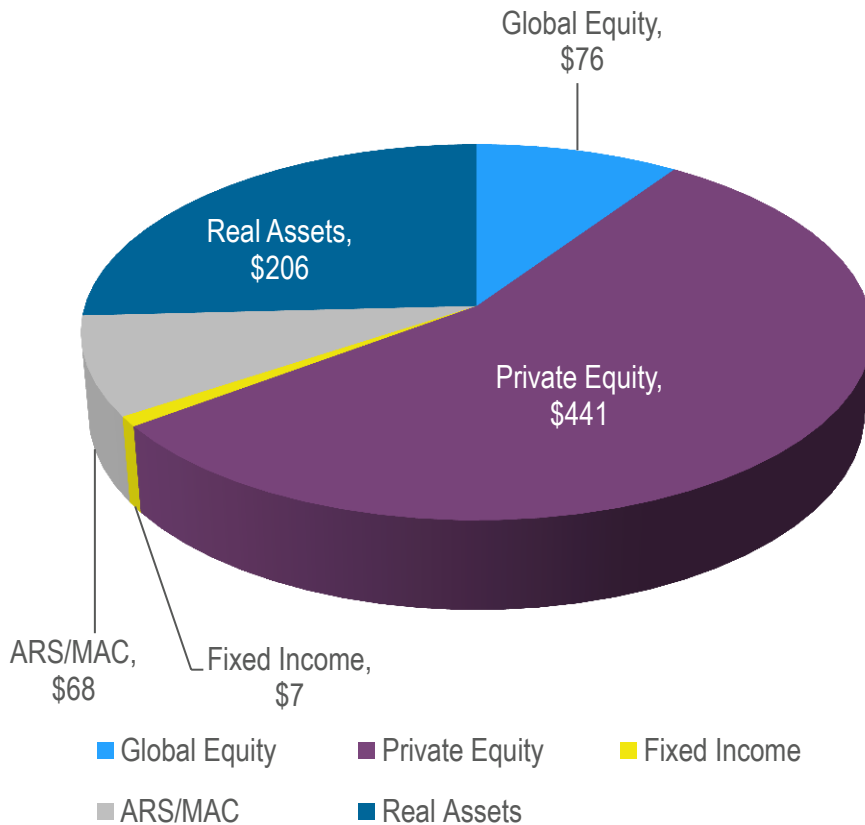
²Costs include legal, appraisal, audit, custody, and tax advisory services

³Per FY 2013-14 Investment Management Expense Report; figures do not include underlying fund of fund fees for PE and Absolute Return Strategies (ARS) or profit sharing for PE

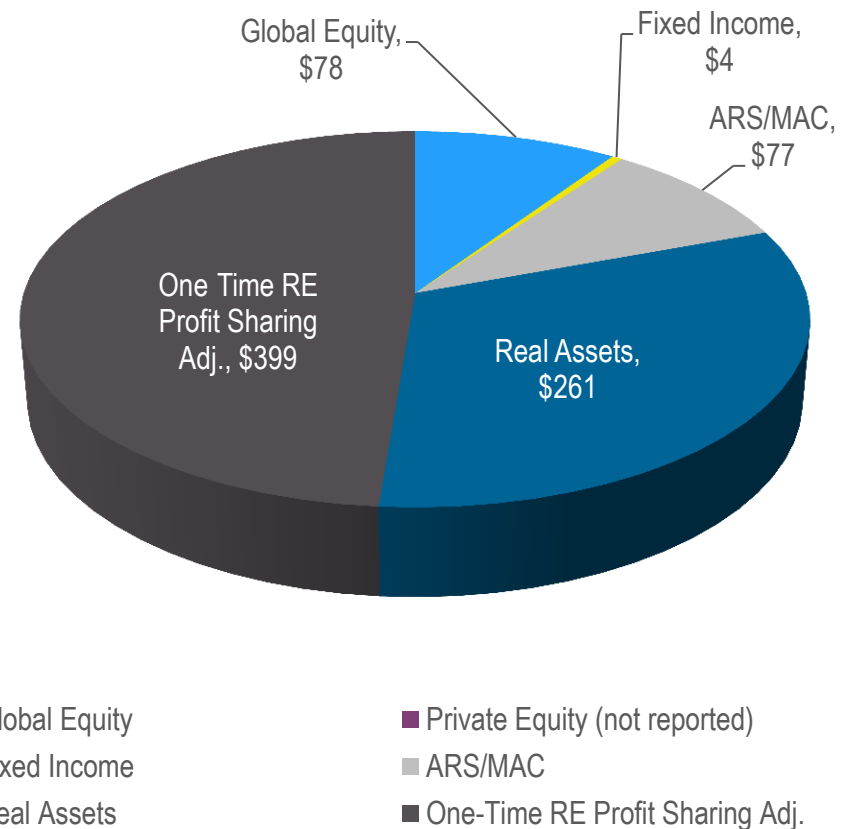
INVO Cost Structure: FY 2013-14 Ext. Mgmt. Fees

Private assets are primarily externally managed and therefore represent 90% of external management fees

Base Mgmt Fees (\$798 million) by program¹



Profit Sharing Fees (\$819 million) by program¹



¹ Per FY 2013-14 Investment Management Report; figures do not include underlying fund of fund fees for PE and ARS or profit sharing for PE

CEM Peer Benchmarking: CalPERS is Cost Advantaged

2013 CEM Benchmark cost analysis reports that CalPERS is lower cost by 7.7 bps, or \$206 million vs CEM Peers

Calendar Year 2013	BPS ¹
CalPERS Actual Cost	40.6 bps
CalPERS CEM Benchmark Cost	48.3 bps
CalPERS Cost Advantage	(7.7) bps

- CEM Benchmark cost is the cost peers would incur if they had CalPERS actual asset mix
- CalPERS actual base cost of 40.6 bps is less than benchmark cost of 48.3 bps due to:
 - Internal management of public assets
 - Index-oriented management of equities
 - Lesser use of fund-of-funds than peers
- Results improved vs. 2012 CEM Actual costs of 53.5 bps and CEM Benchmark costs of 59.2 bps.
- Results are positive. However, CalPERS should be relatively low cost given scale. It is important to focus not only on cost, but also on cost effectiveness (value created net of cost).

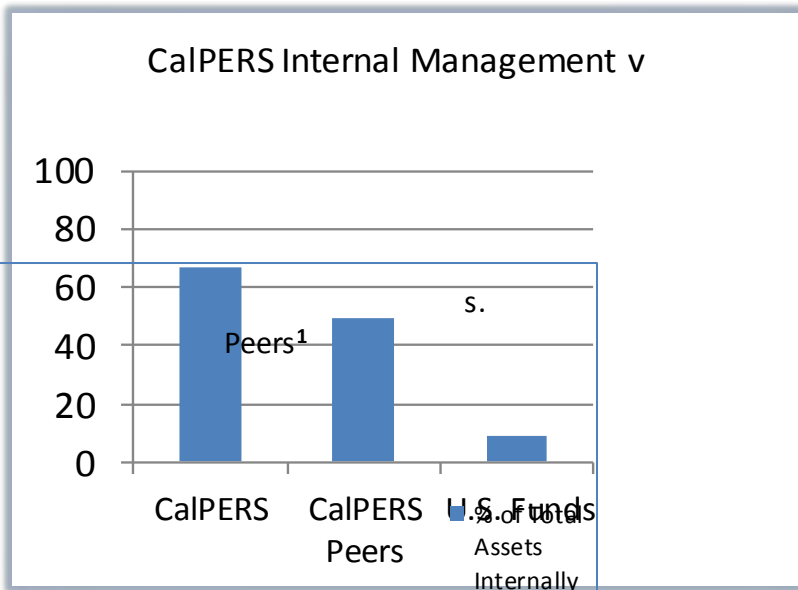
CEM Peer Benchmarking: Internal Management of Public Assets

Internal management of public assets and index-oriented management of equities drive cost advantage

- Cost benefit is driven by internal and index-oriented management. CalPERS internally manages \$204 billion or 88% of CalPERS public market assets (69% of total assets) as of 12/31/2014
- Internal management drives lower total costs, but per CEM Global Leaders Organization Design Review, “Internal assets is the best predictor of total investment full-time employees”

CalPERS Public Market Assets Managed Internally ²

	Global Equity	Fixed Income	Liquidity	Inflation	Total Public Assets
Total Public Assets (\$ billions)	157	54	7	15	233
% Managed Internally	85	90	100	100	88
BPS³	2.1	6.0	1.8	2.3	2.9



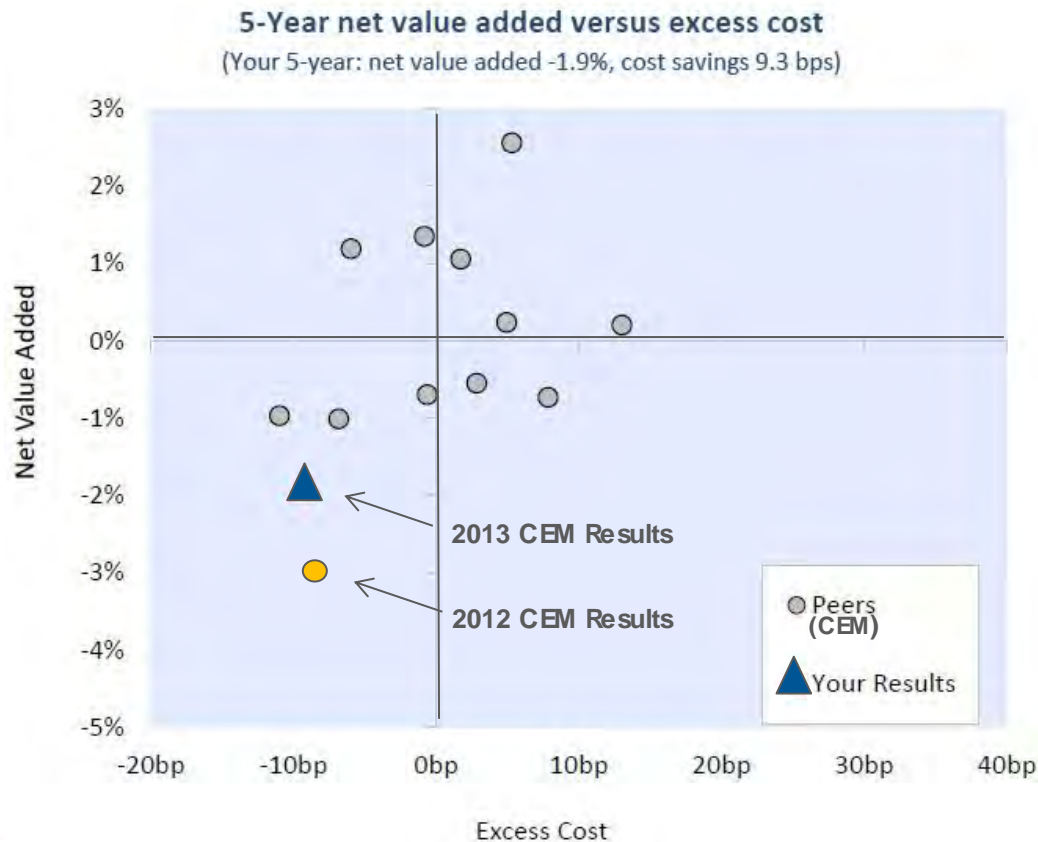
¹ Data per CalPERS CEM CY 2013 Report

² Per 12/31/2014 CIO Quarterly Performance Report presented at February 2015 Investment Committee

³ Estimate of total FY 2013-14 INVO expenses including an allocation of all direct program and shared service expenses

CEM Peer Benchmarking: INVO Net Value Add

5-year (2009-2013) investment returns have offset INVO's cost advantage



CalPERS 5-Year ¹

Total Fund Return	11.0%
- Policy Return	12.5%
- Cost	0.4%
= Net Value Added	-1.9%

INVO Roadmap Actions

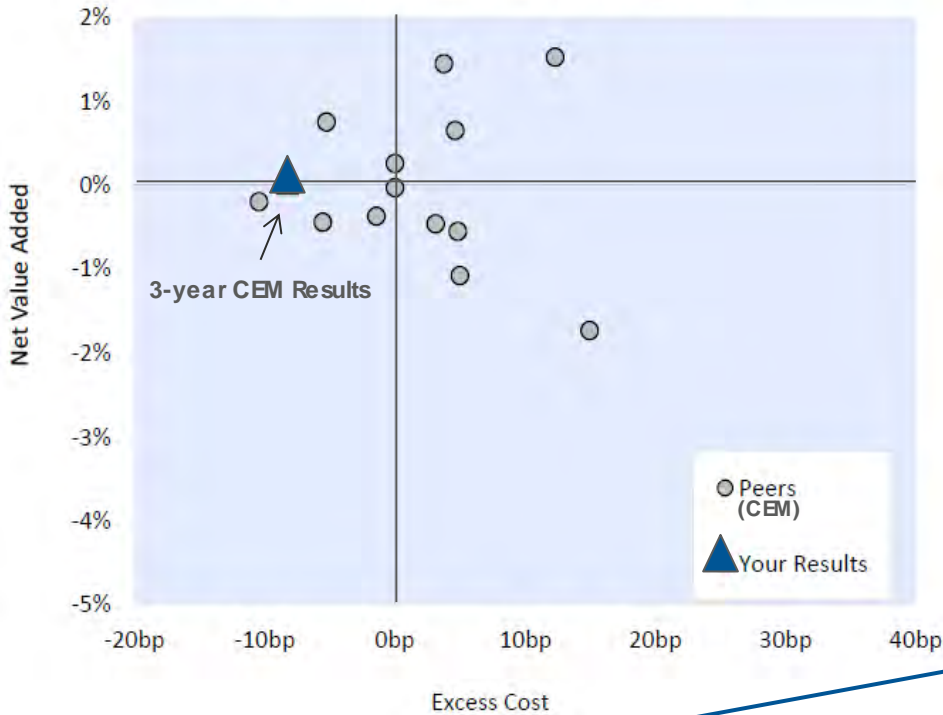
- Restructuring portfolios to improve returns
- Focus on delivering more value for cost
- Invest in risk management and control capabilities

¹ Data per CalPERS CEM CY 2013 Report

CEM Peer Benchmarking: 1 and 3-Year Net Value Add

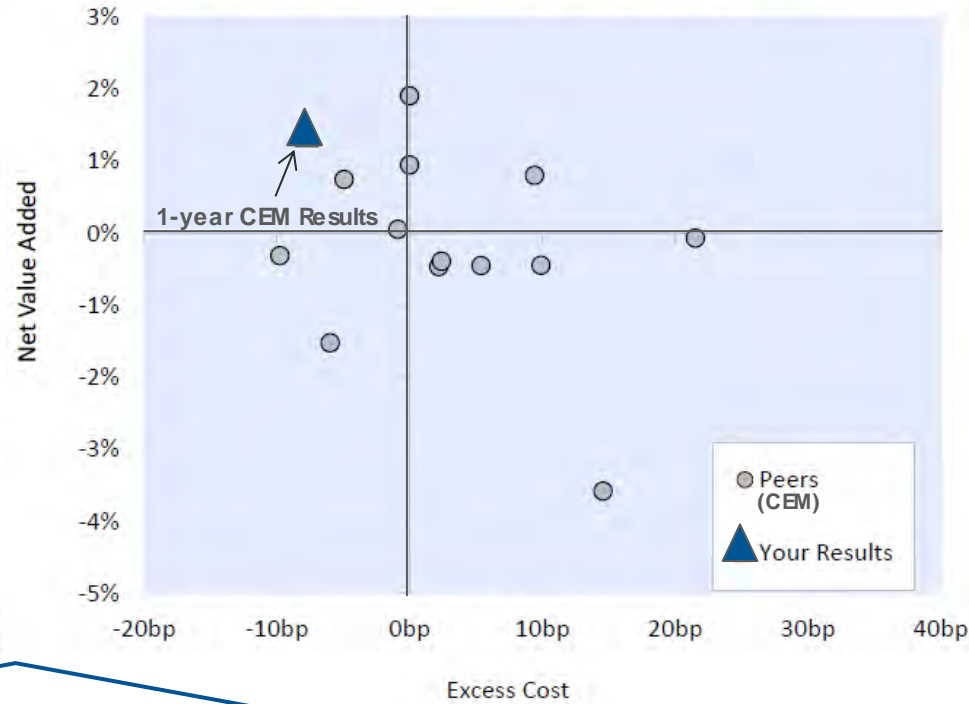
3-Year net value added versus excess cost

(Your 3-year: net value added 0.0%, cost savings 8.2 bps)



2013 net value added versus excess cost

(Your 1-year: net value added 1.4%, cost savings 7.7 bps)



While our 5-year number is still impacted by 2009 returns, our shorter term results show good progress

¹ Data per CalPERS CEM CY 2013 Report

On-Going Cost Effectiveness Investment Strategies

INVO is focused on strategies that deliver more value for cost

- Reduce the total number of managers to achieve economies of scale with external advisors
- Reduce external management fees paid on private assets by negotiating better economics and shifting assets to lower cost strategies
- Transition assets from external managers to internal management where it is possible for INVO to build capabilities
- Continue to reduce reliance on external consultants and advisors, especially for key control or portfolio monitoring functions

Cost Effectiveness: Results To Date

Program efforts have translated into \$293 million of on-going annual cost savings. In addition, incremental efforts and the Special Review (2011) have resulted in \$429 million of one-time cost savings.

Program	FY 2011-12 (\$ in millions)	FY 2012 13 (\$ in millions)	FY 2013 14 (\$ in millions)	FY 2014 15 (\$ in millions)	Total (\$ in millions)
Private Asset Classes	32	34	38	140	244
Public Asset Classes	15	14	20	-	49
Total On-going Savings¹	47	47	58	140	293

Expense	FY 2011-12 (\$ in millions)	FY 2012 13 (\$ in millions)	FY 2013 14 (\$ in millions)	FY 2014 15 (\$ in millions)	Total (\$ in millions)
Management Fees	41	41	53	140	275
Consulting & Other Expenses	6	7	5	-	18
Total On-going Savings¹	47	47	58	140	293

- Previous cost savings used to fund increases in other expenses to internalize Investment functions and staff
- On-going savings amounts are recurring annual estimates expected to realized in the future.

Cost Effectiveness: Accomplishments & Upcoming Priorities

INVO continues to partner with the Financial Office (FINO) on Cost Effectiveness

- **Accomplishments:**

- ✓ Interim reporting to date show FY 2014-15 cost savings of \$140.2 million arising from improved fee structures negotiated on new commitments made by the private asset classes and cost savings from the wind-down of the ARS portfolio
- ✓ Refined controllable expense reporting by asset class and business group and initiated net value add component of management expense reporting
- ✓ Partnered with FINO for GASB 67 and 68 compliance, including new policy accruing real estate profit sharing fees each quarter

- **Upcoming priorities:**

- ✓ Continue to work towards cost savings in controllable cost areas of INVO
- ✓ Continue to work with FINO to further automate manually aggregated expense data
- ✓ Continue to partner with CEM to obtain a meaningful net value added number, relative to an appropriate peer universe median return, adjusted for composition of asset allocation and after expenses
- ✓ Leverage PEARS system to initiate the capture of Private Equity profit sharing (carried interest)

INVO Cost Effectiveness: Summary

- Cost Effectiveness continues to be a primary strategic initiative in the INVO Roadmap and has been integrated into the Investment Beliefs
- INVO Cost Trends support the fact that our base fee costs as a percentage of assets are trending downward over the past 5 years
- Benchmark reporting confirms that CalPERS has advantages that enable it to manage the portfolio at a lower total cost than many of our global peers
- Net Value Add: 1-year and 3 year results placed CalPERS in the positive value added, low cost quadrant
- INVO's continued focus on managing the portfolio more cost effectively has resulted in on-going annual savings of \$293 million and a one-time \$429 million of cost savings to the organization
- CalPERS continues to improve financial system capabilities to better control costs required to manage the portfolio