



## Agenda Item 7c

August 19, 2013

**ITEM NAME:** Emerging Manager Programs Update

**PROGRAM:** Targeted Investment Programs and Private Equity Program

**ITEM TYPE:** Program Review

### **EXECUTIVE SUMMARY**

This agenda item provides an update on CalPERS Emerging Manager Five-Year Plan and Private Equity's Emerging Manager Program.

### **STRATEGIC PLAN**

This agenda item supports the CalPERS Strategic Plan goal to improve long-term pension and health benefit sustainability. 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 talent that may otherwise be overlooked, and cultivating the next generation of external portfolio manager talent.

### **ANALYSIS**

#### *Emerging Manager Five-Year Plan Update*

Consistent with Senate Bill 204 (Price) enacted in 2011, CalPERS has adopted the Emerging Manager Five-Year Plan, Pathway to the Future (Plan). Implementation of the Plan objectives is through ten work streams centered on two major areas: Portfolio Management and External Outreach. Staff has made significant progress on almost all of the work streams outlined in the Plan including the following reports and milestones:

#### Portfolio Management

- CalPERS Emerging and Diverse Manager Data Report was submitted to the Investment Committee in March 2013. The Report provides information on the current number, market value, and performance of emerging and diverse managers in CalPERS investment portfolio.
- Global Equity staff are nearing completion of the restructuring of the Manager Development and Emerging Manager Fund of Funds Programs. This effort is intended to integrate the work of emerging managers with the overarching investment strategy of the asset class.
- Three new investments have been made in Private Equity's Emerging Manager Program, all have been to women or minority owned firms.
- Real Estate's Emerging Manager Program has identified its first two investments, both commitments are to women or minority owned firms.

- Staff is in the process of selecting a consultant to assist with the Research work stream in the Five-Year Plan to benchmark and compare CalPERS emerging and diverse manager exposures and programs with our U.S. public pension peers.

#### External Outreach

- A significant effort is underway to enhance and improve CalPERS Investment Proposal Tracking System. This work will include additional information and guidance for emerging and diverse managers, improved Board reporting, as well as improvements in communicating with managers about the status of their investment proposals.
- Work is underway to create a new Targeted Investment Programs site on CalPERS webpage. The site will provide a centralized location for interested parties to find out about our investment programs and events focused on emerging and diverse managers.
- CalPERS hosted the Emerging and Diverse Manager Forum at the Sacramento Convention Center on December 3, 2012. This well attended event was part of our networking efforts to host and participate in emerging manager-focused events. Staff is currently planning additional workshops and webinars to take place in the coming months.
- Finally, staff has made a concerted effort to reach out to both professional associations and emerging managers to establish positive relationships and assure open lines of communication.

#### *Update on Issues Raised by Managers and Associations*

Recently, concerns have been raised by a few dissatisfied managers and two associations regarding their view that CalPERS has failed to commit enough capital to emerging managers, particularly minority-owned firms. At least one of the associations wrote a letter of support for a proposed audit by the Joint Legislative Audit Committee. CalPERS staff is very confident that the results of such an audit would validate our process and decisions that have been made. However, because of the negative tone of our conversations with the few dissatisfied managers and associations, we have met with 17 legislators or their staff in recent weeks to explain our continued commitment to emerging manager programs.

CalPERS has a long history of supporting emerging and diverse managers and remains committed to ensuring fair access to managing CalPERS assets across a broad and diverse universe of money managers and investment partners. However, the investment environment significantly changed after the economic crisis. In response, CalPERS has restructured its investment portfolio by placing greater emphasis on risk management and improved controls on the investment process.

After reforms in the wake of the placement agent investigation, CalPERS instituted the web-based Investment Proposal Tracking System which ensures equality of access to proposers, and provides CalPERS with insight and opportunity into investment proposals submitted globally.

Investment managers' ability to raise capital from institutional investors was severely curtailed by the economic crisis that started in 2009. The reduced amount of capital available for commitment resulted in greater competition and fewer investments placed with external managers. It is likely that reduced investor capital and increased competition had a disproportionate impact on emerging managers. Emerging managers by definition are smaller firms raising first or second time institutional funds, which would make it more difficult to weather the storm of the global financial crisis. As a result, a few managers and two associations called on CalPERS to increase the commitment of capital to emerging manager programs.

*Private Equity Emerging Manager Program Update*

The calls for CalPERS to increase investment with emerging and diverse managers is primarily focused on the private equity asset class. Capital allocation to private equity has decreased drastically industry-wide. CalPERS Private Equity also had significant reductions in commitment and investment activity as follows:

Private Equity Commitments

2006 – 2008	\$36.7 billion
2009 – 2012	\$ 5.2 billion

Private Equity Proposals Received and Proposals Approved

2006 – 2008	1097 proposals	131 approved	12% approval rate
2009 – 2012	708 proposals	23 approved	3% approval rate

Importantly, in both time periods CalPERS commitment to emerging managers remained constant. In the market run-up from 2006 to 2009, Private Equity committed 18% of all capital to emerging managers; and in the market decline from 2009 to 2012, 18% of all capital committed was to emerging managers.

Also, few other pension systems have commitments as significant as CalPERS does to emerging and diverse managers. As of June 2012, Private Equity had a total of \$14.8 billion committed to emerging managers and \$5.9 billion committed to diverse managers.

The same dissatisfied managers and associations have asserted that CalPERS investment decision process may be unfair to emerging and diverse managers. This claim has also focused on CalPERS Private Equity group. Private Equity's investment decision-making process is solid and has been strongly defined from lessons learned. Private Equity's Manager Assessment Tool (Attachment 1) screens

investments using a consistent, rigorous process focused on detailed scoring criteria in the following categories:

- Historical performance
- Strategy and value creation
- Team
- Portfolio fit
- Alignment of interest.

Cambridge Associates, a well-respected investment industry consultant, reviewed CalPERS Private Equity criteria and factors in assessing managers and found the process to be “a consistent and objective ranking system for screening and analyzing each investment criterion” and “thoughtfully constructed and reflects a best practice.” The Cambridge report states that CalPERS Manager Assessment Tool “...provides CalPERS a competitive advantage over other institutional investors that do not utilize such a robust and effective screening tool.”

*Upcoming Emerging Manager Task Force in Private Equity*

Another respected consultant, Crosswater Realty Advisors (Crosswater) was engaged in February 2013 to review both private equity emerging managers in general, as well as the CalPERS Private Equity Emerging Manager Program in particular. Crosswater was selected for this assignment given its previous role in evaluating the CalPERS Real Estate Emerging Manager Program in 2011. Crosswater’s recommendations are included in the Private Equity Emerging Managers Report (Attachment 2).

Over the last few months, Crosswater interviewed staff at other large domestic pension plans, consultants to large public pension plans, and CalPERS staff. Crosswater states that emerging managers in Private Equity who have great promise have a place in an institutional private equity portfolio. The question is how best to identify these managers.

Based upon their evaluation, Crosswater concluded that Private Equity Emerging Manager performance is quite varied. The mixed performance of emerging managers is consistent with CalPERS own experience investing in emerging managers. The Crosswater Report states that there is a lack of evidence to support whether private equity emerging managers consistently outperform or underperform established private equity managers over the 23+ year history of the CalPERS Private Equity Program. Given the varied performance results, staff agrees that further analysis is appropriate.

Staff concurs with Crosswater’s recommendation to convene a specialized private equity task force to carefully study and evaluate the value creation abilities and resultant performance generated by emerging managers. Staff is currently assembling the members of the task force which will include CalPERS Private Equity

senior staff, the Board's Private Equity investment consultant, and two other highly regarded Private Equity consultants. The task force will conduct in-depth analysis of a subset of CalPERS Private Equity Emerging Managers, including a balanced sample of those who succeeded and those who did not succeed. Upon the conclusion of this detailed review, staff will be able to provide the Investment Committee with a recommendation as to how to structure the CalPERS Private Equity Emerging Manager Program in the future. Staff anticipates returning to the Investment Committee with a progress update in the first quarter 2014.

## **ATTACHMENTS**

Attachment 1 – CalPERS Private Equity's Manager Assessment Tool

Attachment 2 – CalPERS Private Equity Emerging Managers Report by Crosswater Realty Advisors

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CHRISTINE GOGAN  
Senior Portfolio Manager  
Private Equity

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LAURIE WEIR  
Senior Portfolio Manager  
Targeted Investment Programs

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JOSEPH A. DEAR  
Chief Investment Officer