

Emerging Manager Program Review

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Board Governance and Sustainability

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1. Overview: Scope & Definitions

- Emerging Managers are generally defined as newly formed investment firms or those raising their first, second, or third fund
- Fund of Funds – or multimanager investments – are pooled investment funds that invest in other vehicles

1. Overview: Scope & Definitions (Continued)

CalPERS' framework for Diversity, Equity, and Inclusion

Culture

- Integrating diversity, equity, and inclusion best practices into CalPERS' culture to increase awareness, build mutually rewarding relationships and foster teamwork

Talent Management

- Support and retain a high-performing, equitable and diverse workforce by ensuring human resource processes strengthen diversity in recruitment, retention, and succession

Health Equity

- Fostering equitable health outcomes for members and their families by ensuring all health members can attain the highest possible level of wellbeing

Supplier Diversity

- Building relationships with a diverse group of businesses, recognizing the unique value of partners with a shared commitment to equity and inclusion

Investments

- Achieving stronger investment returns, with the belief that diverse boards and companies that value diversity perform better

1. Overview: Scope & Definitions (Continued)

California State Legislation

Proposition 209, 1996

- Amended the California State Constitution to prohibit state governmental institutions from considering race, sex, or ethnicity, specifically in the areas of public employment, public contracting, and public education. A ballot proposal to remove Proposition 209 was defeated in 2020

Senate Bill 294, 2011

- Required CalPERS to submit an annual progress report to the California State Legislature, the final report was submitted in January 2018

Assembly Bill 890, effective March 2023

- Supported by CalPERS' Board, this requires an annual status report to the California State Legislature on achieving appropriate objectives and initiatives regarding participation of emerging or diverse asset managers in the system's investment portfolios

1. Overview: Scope & Definitions (Continued)

Purpose

- To achieve favorable risk-adjusted returns by harnessing the talent of new investment managers

Objectives

- Identifying early-stage funds with strong potential for success
- Accessing unique investment opportunities that may otherwise be overlooked
- Cultivating the next generation of external portfolio management talent

1. Overview: Scope & Definitions (Continued)

Asset Class	Global Equity	Private Equity	Real Assets
Business Model	Advisor Legato	Fund of Funds Grosvenor Capital Management Customized Fund Investment Group (GCM CFGI or GCM Grosvenor)	Mentoring Manager/ Separate Account Canyon Partners Real Assets (Canyon)
Firm AUM or Fund Size	<\$5B (Firm AUM)	Up to \$2B (Fund Size)	<\$1B (Firm AUM)
Institutional Fund/ Separate Account Series Age	No Requirement	First, Second, or Third Time Institutional Fund	First, Second, or Third Time Separate Account/ Fund
Geographic Focus	No Requirement	United States of America	Urban areas in California, Seattle, Portland, Phoenix, & Denver
Investment Strategy	Long Only Publicly Traded Securities	Buyout, Growth, & Distressed for Control (Special Situations), Secondaries and Co-Investments	Value-add & Opportunistic

1. Overview: Scope & Definitions (Continued)

Asset Class	Global Equity	Private Equity	Real Assets
Program Name	Emerging Manager Advisor Program	GCM Grosvenor Domestic Emerging Manager (DEM) Funds I, II, & III	Real Assets Emerging Manager Program
Inception Year	2000	2007	2012
Commitment	N/A	\$1.8B (including two legacy Capital Link Funds) ¹	\$1.4B
Operating Model / Operator	Fund of Funds Legato	Fund of Funds GCM Credit Sussie Customized Fund Group (CFIG)	Separate Account Canyon
Market Value	\$606M	\$692M	\$358M
Number of Managers	4	33 General Partners (Managers) and 40 Funds	5

As of June 30, 2021

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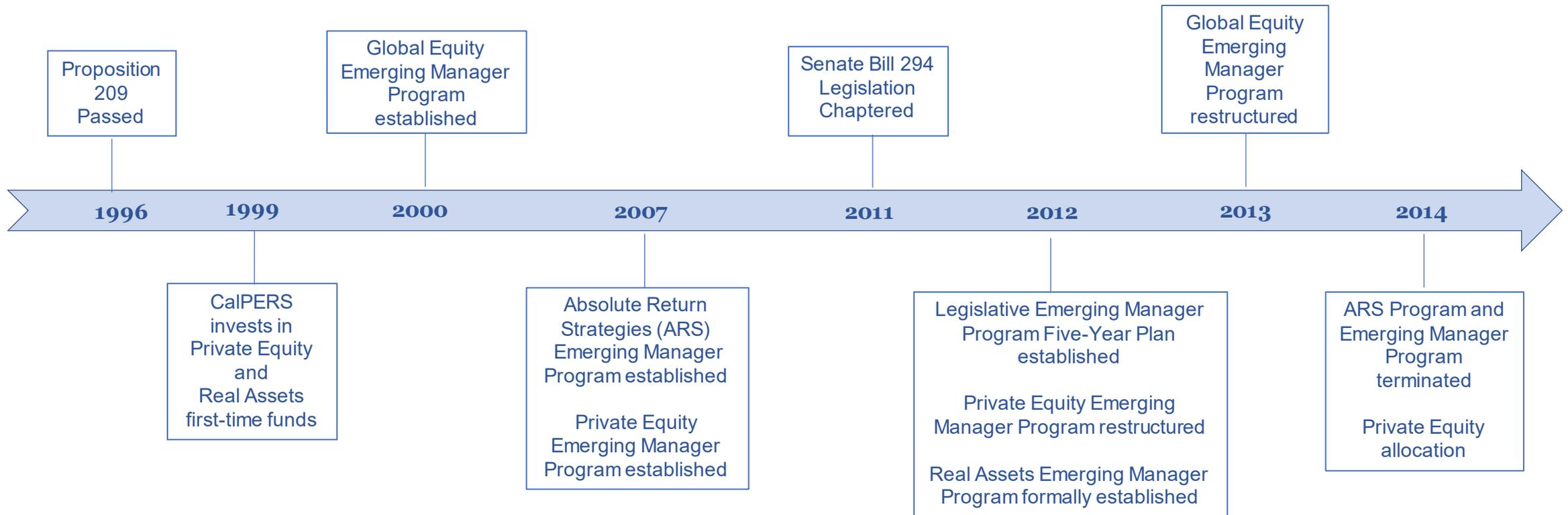
5. Asset Class Overview

- Global Equity
- Private Equity
- Real Assets
- Global Fixed Income
- Opportunistic Strategies

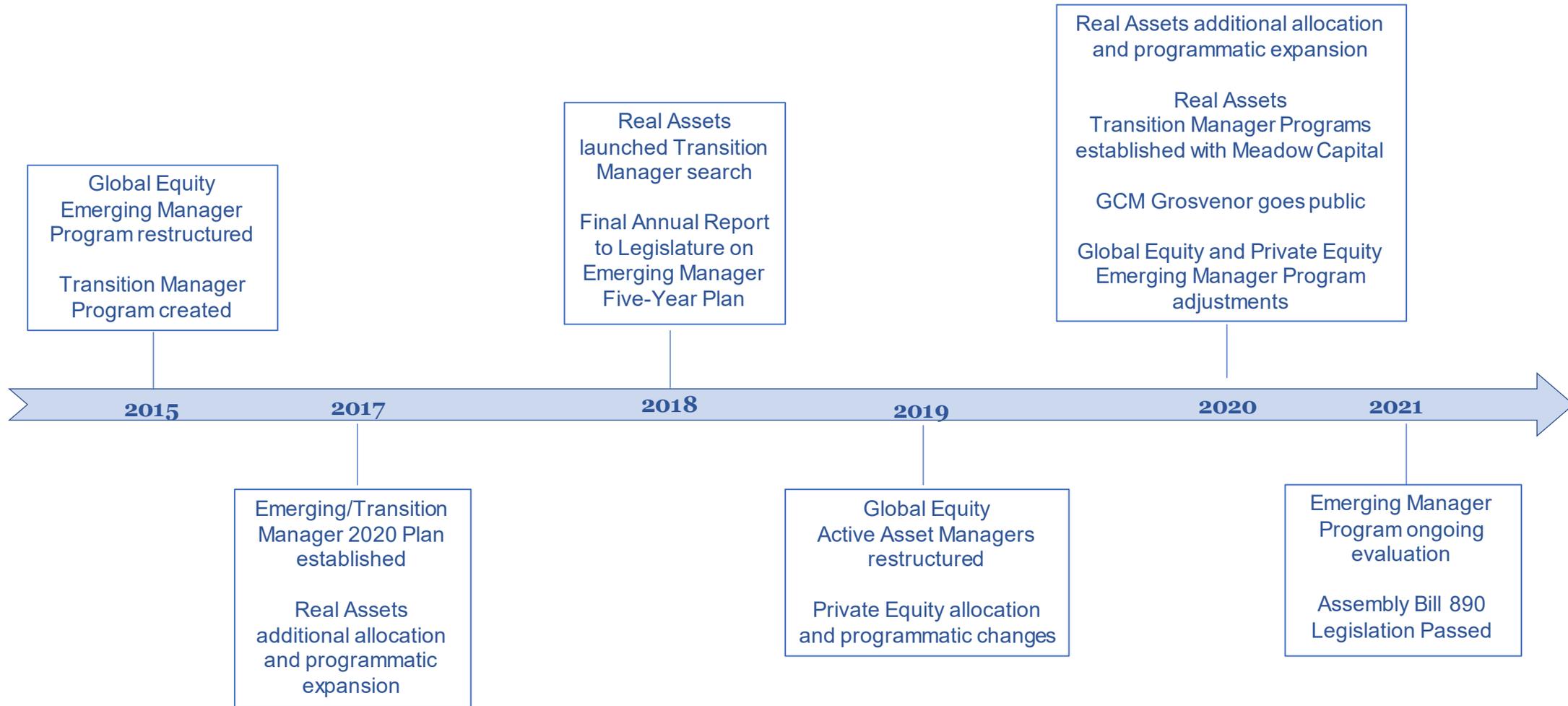
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2. Program History



2. Program History (Continued)



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3. Review Process

1. CalPERS Asset Class and Program Insights
2. Peers
 - CalSTRS
 - New York City Employment Retirement Fund
 - New York City State Common Retirement Fund
 - Texas Teachers Retirement System
3. Advisors
 - GCM Grosvenor Capital Management
 - Canyon Partners Real Estate
 - Legato
4. Stakeholders and Strategic Partners
5. Research: evidence from market studies (see appendix)

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4. Investment Case: Performance

Emerging Managers are Active Managers Seeking Alpha

Alpha Generation requires:

Market/Structural inefficiencies (“Alpha Fishing Pond”)

- Private markets remain structurally more inefficient than public markets (network effects, information scarcity, market fragmentation)
- Within public equities, international, and emerging markets remain relatively less efficient

Timely identification of inefficiencies (“Skilled Fishers”)

- Niche funds with highly specialized skills can have an informational advantage

Operational capacity to execute

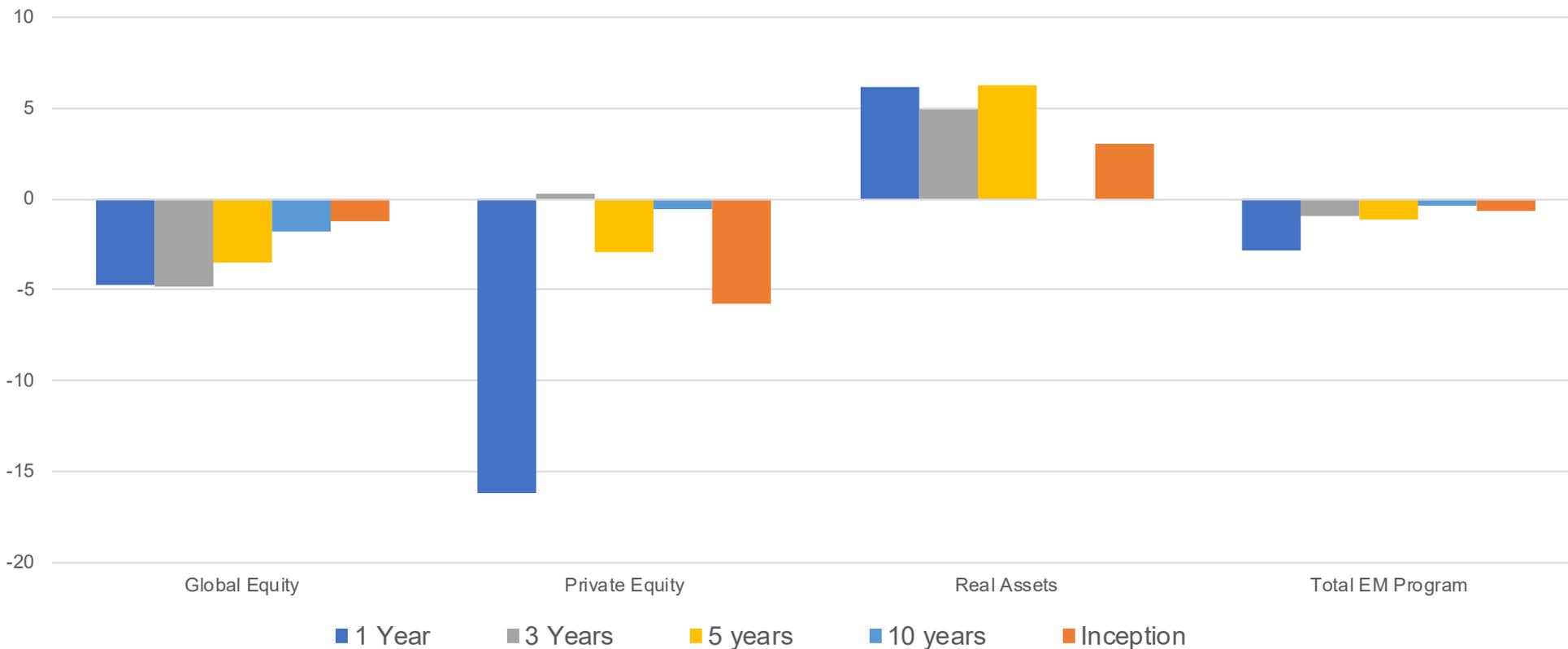
- A critical aspect to assess for newly established firms

Sustainable alpha generation requires repeatable processes

- On-going performance attribution is critical

4. Investment Case: Performance (Continued)

Emerging Managers Net Performance in Relation to Benchmarks



Time-Weighted Net Returns as of June 30, 2021



Benchmarks are as follows:

- Global Equity: Asset weighted benchmark of the managers/strategies
- Real Assets: Real Asset program benchmark
- Private Equity: Private Equity program return

Dates of Inception are as follows:

- Global Equity: June 2000
- Real Assets: September 2012
- Private Equity: August 2007

4. Investment Case: Performance (Continued)

Emerging Manager Program cost considerations

- CalPERS uses specialist, external advisors to source, mentor and develop Emerging Managers which brings an additional layer of fees
- Costs for Emerging Manager investments vary, and base fees can be relatively higher on a net asset value basis compared to total asset class costs
- Emerging Manager investments are small in relation to CalPERS' total portfolio and do not offer fee efficiencies through economies of scale

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5. Asset Class Overview

Global Equity

- To reduce active risk, assets were brought in house by retiring 30 external managers in 2019
- Global Equity's Emerging Manager Program restructure resulted in \$19.4M of savings in fees + operating expenses, close to 20% of the overall cost reduction achieved in the active risk review
- Retained Legato Capital Management LLC as one of four external managers for Global Equity, alongside Arrowstreet, which transitioned from the Emerging Manager program

5. Asset Class Overview (Continued)

Global Equity: The Role of Legato

Manage the portfolio and partnerships

- Due diligence on a broad universe of Emerging Managers globally
- Select Emerging Managers with best fit for CalPERS' programs
- Incorporate environmental, social, and governance factors alongside diversity, equity, and inclusion factors as part of research process
- Monitor risks and recommends portfolio changes warranted by market changes or manager issues/opportunities

5. Asset Class Overview (Continued)

Global Equity: The Role of Legato

Strategic partner to underlying managers

- Provide resources to managers to help grow their business: outsource providers on compliance, technology, legal matters, business development, and product creation
- Connect managers with other equity investors and potential partners
- Host Emerging Manager forums to broaden industry knowledge and capacity

CalPERS

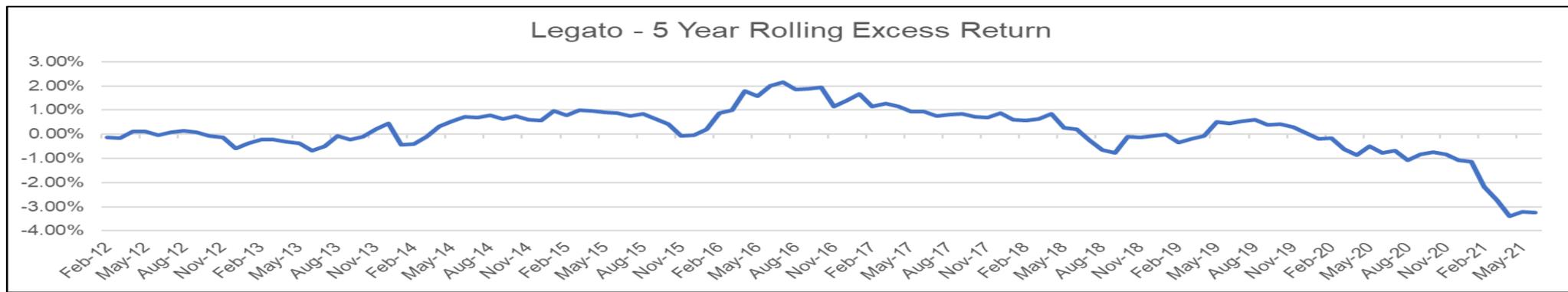
- Provide insights as to industry trends in Emerging Manager space
- Thought leadership in various areas – “Introspection, Manager Analytics”

5. Asset Class Overview (Continued)

Global Equity: Achievements and Challenges

In recent years investment managers have had to contend with:

- US Large Companies have disproportionately outperformed US Small Companies, Developed Markets and Emerging Markets, each areas where Emerging Manager Programs tend to invest
- Increased competition for assets from the growth of indexed investments, ETFs, and private market alternatives
- Fee compression has caused shrinking profit margins
- Need to continually invest in technology to support operations, product innovation, communication, and distribution



5. Asset Class Overview (Continued)

Global Equity: Achievements and Challenges

- Global Equity's longest and most successful external manager relationship came from the Emerging Manager Program with Arrowstreet delivering more than 200 bps of annualized excess return for 20 years
- Legato has reduced Average Annual Manager Fee from 60 to 46 bps over the last two years and reduced operating expenses by 29% in the last year
- Global Equity is predominantly internally managed and benchmarked to a highly efficient market index. The double layer of fees in the Emerging Manager Program (combined fees are 72 bps) makes it challenging to add value

5. Asset Class Overview (Continued)

Private Equity

- Private Equity decided to invest in the Emerging Manager space in 2006
- Original mandate was to commit capital using Fund of Funds to deploy to first- and second-time funds with a variety of strategies (buyout, mezzanine, credit etc.) up to \$1B in size and domiciled in the US
- Since then, Private Equity has committed capital as follows:
 - First two were awarded to Centinela Management Partners
 - Third was to Credit Suisse Customized Fund Group (acquired by Grosvenor Capital Management in 2013)
 - Fourth and fifth capital allocations were also awarded to Grosvenor Capital Management
- The mandate for the latter was expanded to include third time funds up to \$2B and allow for co-investments and secondaries
- Grosvenor took over the management responsibilities for the first two Fund of Funds (Capital Link Funds I & II) in 2013

5. Asset Class Overview (Continued)

Private Equity

Capital Commitments made to the Emerging Manager Fund of Funds

Vintage Year	Fund Name	Commitment	Manager
2007	Capital Link Fund I, LLC	\$502M	Centinela Management Partners
2008	Capital Link Fund II, LLC	\$435M	Centinela Management Partners
2012	GCM Grosvenor DEM I, L.P.	\$100M	Grosvenor Capital Management
2014	GCM Grosvenor DEM II, L.P.	\$250M	Grosvenor Capital Management
2019	GCM Grosvenor DEM III, L.P.	\$550M	Grosvenor Capital Management

5. Asset Class Overview (Continued)

Real Assets

- Started investing in the Emerging Manager Program in the 1990s with varying degrees of success
- In 2011, reevaluated the approach and made changes reflected in the current approach
- Recalibrated program and developed a formal program under clearly defined guidelines and investment philosophy

5. Asset Class Overview (Continued)

Real Assets

Qualifications

- Originated and managed real estate investments in the aggregate having a gross market value < \$1B
- Has not originated and managed more than 3 commingled real estate funds or single institutional investor separate account real estate funds
- Established a verifiable record of successful investing in real estate in target geographical markets that created value for the organization's investors

5. Asset Class Overview (Continued)

Real Assets: The Role of Canyon

- Serve as an oversight and mentoring manager to the underlying Emerging Managers
- Perform outreach to identify and underwrite Emerging Manager prospects
- Assist Emerging Managers in managing the institutional investment and reporting processes utilizing industry best practices
- Each Emerging Manager specializes in a product type based on their core competency
- Expansion into Student Housing and Self Storage sectors is under review

5. Asset Class Overview (Continued)

Real Assets: The Role of Canyon

Sustainability Practices

- Emerging Managers are proactive in implementing energy efficient best practices
- Canyon and the Emerging Managers adhere to the Responsible Contractor Program Policy

5. Asset Class Overview (Continued)

Real Assets

Canyon supports the thesis of mentoring Emerging Managers while also making a positive impact across a variety of social and environmental engagements

Guidance & Infrastructure

- Canyon maintains discretion over all major decisions
- Canyon's in-house team of diverse real estate professionals can replace EMs in the event of a default or removal

Mentorship

- EMs benefit from stability and continuity of a dedicated team
- Mentorship mitigates risk by providing guidance at the corporate and investment levels

ESG

- Implementation of Anti-discriminatory policies
- Quarterly seminars with its EMs on a variety of topics, including those which address standard ESG practices

Performance-based incentives

- Both Canyon Advisors and EMs only earn promotes after portfolios are realized
- Programmatic joint venture structure facilitates exclusivity and mandate clarity

Diversification

- Joint ventures with multiple EMs allow for asset class diversification
- Canyon Advisors investment discretion allows for capital allocating/re-allocating

5. Asset Class Overview (Continued)

Global Fixed Income

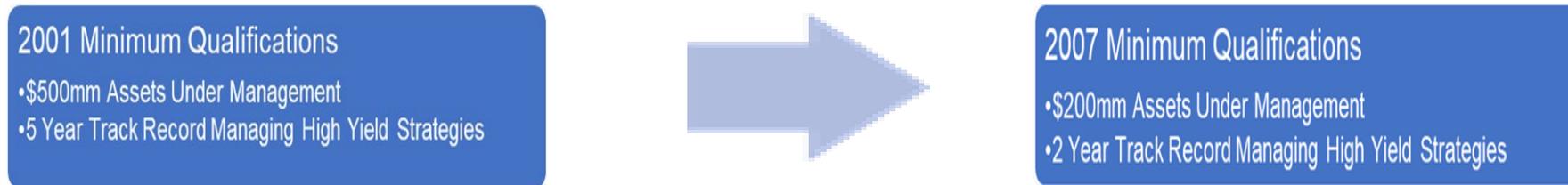
Asset Class Structure

- 96% of Global Fixed Income is internally managed as of 6/30/2021
- Currently only four external high yield managers with assets under management
 - Two active managers with targeted alpha generation
 - Two with targeted index like returns/risks
- Only two Request for Proposals have been issued over the past 25 years (2001 and 2007)

5. Asset Class Overview (Continued)

Global Fixed Income

CalPERS worked with Wilshire Associates in 2007 to develop minimum qualifications that would be more inclusive to increase the likelihood of securing diverse owned firms while remaining consistent with California's Proposition 209



A manager universe database was used to locate eligible firms and six met the minimum qualifications and were sent the Request For Proposals

- Four of the six firms responded to the opportunity and two were visited as part of the due diligence process
- One of the firms was hired but later resigned due to personal issues

5. Asset Class Overview (Continued)

Global Fixed Income

Future Possibilities

- Global Fixed Income's low internal cost structure and strong alpha generation present a high bar for external management opportunities
- The results of the Asset Liability Modelling process may add additional opportunities for external managers including Emerging Managers

5. Asset Class Overview (Continued)

Opportunistic Strategies

Program Structure and Objectives

- Opportunistic Strategies is a newly formed group that enables the Total Fund to access investment opportunities outside of the existing benchmarked asset classes
- The program is mandated to invest in private debt for CalPERS
- Total dollars deployed approximately \$2.5B as of September 2021

5. Asset Class Overview (Continued)

Opportunistic Strategies

Future Possibilities

- Opportunistic Strategies welcomes new and innovative strategies which can add value to the program
- Depending on the ALM process, the program will use its experience learned through the build up phase to set up minimum qualifications for Emerging Manager opportunities as portfolio moves towards the targeted allocation

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Data Challenges

- Lack of consistent data to allow insight into the drivers of performance across the Emerging Manager programs and the industry more broadly

Benchmarks

- These vary across asset classes from the underlying managers' benchmark to total fund program benchmarks which makes a total fund view complex

6. Lessons Learned (Continued)

Program Criteria and Process Impact Performance

- Notwithstanding the data challenge, we find positive impact from criteria such as geographic focus and negative impacts from time needed for approvals or readjustments
- The asset classes have each reviewed and responded in order to adjust program parameters

Active Management Costs

- Costs matter to performance and these can be relatively high in the emerging manager fund of funds structure
- The shift to internal management has diminished the role of external managers overall

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Research and Industry Outreach

- CalPERS has identified this as a topic for the Sustainable Investment Research Initiative next round of research (SIRI III)
- CalPERS to complete a Diversity, Equity, and Inclusion Survey by Lennox Park of all our external managers to provide us with greater insight into investment industry workforce, leadership, decision-making practices, as well as our own portfolio
- CalPERS to explore the viability of additional asset classes with Emerging Manager Programs
- Research and survey results will inform future Emerging Manager Program model and investment strategy

Questions & Discussion

Appendix

CalPERS' Strategic Partners

- Asian American Investment Manager Association <https://aaaim.org/>
- Executive Leadership Council <https://www.elcinfo.com/>
- Hispanic Heritage Foundation <https://hispanicheritage.org/>
- National Association of Investment Companies <https://naicpe.com/>
- National Association of Securities Professionals <https://nasphq.org/>
- New America Alliance <https://www.naaonline.org/>
- The Investment Diversity Exchange <https://tidexchange.com>

Research on Emerging and Diverse Manager Strategies

- [How Diversity & Inclusion Matter | McKinsey](#)
- [From Impact Investing to Investing for Impact 022420.pdf \(carlyle.com\)](#)
- [Diversifying Investments: A Study of Ownership Diversity and Performance in the Asset Management Industry – Knight Foundation](#)
- [KNIGHT DIVERSITY OF ASSET MANAGERS RESEARCH SERIES: PHILANTHROPY – Knight Foundation](#)
- [Wilshire Shares Latest Results, Key Lessons from Its Diverse Owned Manager Initiative](#)
- [Race influences professional investors' financial judgments | PNAS](#)
- [Georgetown Endowment Diversity Report 2021 - FINAL.pdf | Powered by Box](#)