



Investment Committee

Item Number 5 – Open Session

Subject: Collaborative Model 2.0 – Opportunities Portfolio

Presenter(s): Scott Chan

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Attachment(s): None

PowerPoint(s): Collaborative Model 2.0 – Opportunities Portfolio

POLICY

The CalSTRS Collaborative Model is an investment strategy to manage more assets internally - to reduce costs, control risks and increase expected returns - and leverage our external partnerships to achieve similar benefits.

Implementation decisions, such as managing assets internally versus externally, are delegated to staff subject to the CalSTRS Investment Policy and Management Plan, IPMP. Decisions to provide additional resources and support to the CalSTRS Collaborative Model are not covered under any specific policy; however, if the Investment Committee approves any recommendations or changes that require policy changes, they will be integrated into the IPMP and any other policy document, as appropriate.

EXECUTIVE SUMMARY

1. Staff proposes creating a dedicated Opportunities Portfolio designed to be a flexible pool of capital to capture market opportunities which today are challenging to execute in our current structure because an investment:
 - a. Falls in-between two or more asset classes, spans multiple asset classes and/or traverses the spectrum of private markets and public markets ('One Fund' Opportunities),
 - b. Requires a larger position size to facilitate our ability to create value-added structures beyond a specific asset class ('Scale' Opportunities).
2. The leading global organizations in CalSTRS' peers/competition set have designed their total funds as flexible pools of capital that can capture any opportunity but shares similar overall risk-return goals as CalSTRS (subject to different and unique sets of liabilities). Development of a dedicated, but still, modest Opportunities Portfolio has the benefit of progressing in the

direction of greater flexibility while managing any associated risks at a smaller scale. As the investment model proves successful, CalSTRS has the option to increase its allocation to the Opportunities Portfolio. Organizations that can both manage the risks and yet design their total fund to flexibly invest and capture any investment opportunity will continue to have significant competitive advantages versus peers. This is the future direction of investing and allows CalSTRS to evolve towards that future.

3. Executing an Opportunities Portfolio plays to CalSTRS strengths and helps to achieve the three keys in unlocking Collaborative Model 2.0 (which were discussed with the Investment Committee in the January 2022 meeting) including: (1) Leveraging our Partners; (2) Exploiting a One Fund Advantage; and (3) Capitalizing on our Scale Advantages. The Opportunities Portfolio would also enhance CalSTRS current portfolio structure by consolidating existing investments within the Innovative Strategies and Sustainable Investment & Stewardship (SISS) Portfolios.
4. This memo outlines the need and scope of an Opportunities Portfolio for discussion with the Board. Should the Board wish to continue to move forward, Staff recommends the following topics be brought to the Investment Committee for further consideration:
 - a. Portfolio Construction and Management of Risk
 - b. Governance
 - c. Policy Changes and Compliance, Monitoring and Reporting
 - d. Asset Allocation Modeling

DISCUSSION

1. Introduction

Over the past year, a confluence of long-term seismic shifts is accelerating causing greater uncertainties in the investing landscape including: (1) Inflation; (2) A higher interest rate cycle; (3) The reversal of globalization; (4) The global transition to net zero; (5) Higher energy prices; (6) Geopolitical conflict (Russia and China); and (7) The prospect of recession and stagflation. The bottom-line is that future economic outcomes today seem far wider than they have been in the past. In an environment of greater risk, uncertainties and potentially lower expected returns, Staff believes that executing the Collaborative Model will be even more important to increase deal flow save costs, control risks and increase alpha, in order to support the path to full funding.

Staff proposes creating an Opportunities Portfolio to expand CalSTRS opportunity set significantly in areas we can use our competitive advantages such as: (1) Scale whereby larger position sizes facilitate our ability to create value-added structures; and (2) Pursue and invest in opportunities that fall in-between asset classes, across asset classes or traverse private markets to public markets.

2. CalSTRS Need for an Opportunities Portfolio

Expand CalSTRS Opportunity Set:

First and foremost, CalSTRS needs flexible pools of capital to take advantage of upcoming opportunities created by the markets. Markets are and will continue to be volatile and at a very minimum they are cyclical with “boom” and “bust” cycles. In addition, global shifts can create large opportunities and even significant dislocations in asset prices, which can play out in both short-term and long-term opportunities.

Today, most of the investment opportunities CalSTRS evaluates are best executed by individual asset classes. However, there is a growing list of investment opportunities that do not fit neatly into any particular asset class. As the strategic partners that CalSTRS has invested with over the long-term have matured, they have added capabilities across asset classes and in both private and public markets. More and more the investment opportunities presented by our partners are complex and can traverse any conceivable type of asset or involve multiple divisions with crossover from one asset class to another or span both public and private markets. There exists a subset of CalSTRS’ peers/competitors that have the staff and confidence to prosecute such deals in size and they are currently benefitting from less competition.

Leverage CalSTRS Competitive Advantages:

CalSTRS is well positioned to take advantage of these types of opportunities and draws upon our competitive advantages. At the January 2022 Investment Committee meeting, Staff outlined three keys to achieve the vision for Collaborative Model 2.0: (1) Leverage Partners; (2) Exploit a One Fund Advantage; and (3) Capitalize on Scale.

- (1) Relative to other institutional investors, CalSTRS has developed a strong culture that continues to attract and retain top talent. As a result of the continuity and experience of our long-lasting staff, we have created an enviable set of deep and long-lasting relationships with the best money management organizations around the world, which is a competitive advantage that cannot be easily replicated. As our investment partners bring complex transactions that don’t fit neatly into one asset class, CalSTRS is in a great position to leverage them.
- (2) As the largest educator-only pension fund in the world, CalSTRS can take advantage of our scale advantages. Larger position sizes facilitate our ability to create more value-added Collaborative Model structures often with increased controls and lower fees.
- (3) The One Fund Advantage seeks to exploit opportunities that exist in the gaps between asset classes, across multiple asset classes, from private markets to public markets and to leverage insights and knowledge across the entire CalSTRS platform. CalSTRS inherently has two advantages in executing across the entire platform including: (1) A collegial team-oriented culture which enables cross asset collaboration; and (2) Deep asset class expertise, knowledge and staffing that can be combined across our divisions.

It should be noted that CalSTRS has a rich history of cross asset class collaborations. Over the past three years, the list of investments executed to achieve a One Fund Advantage has increased significantly in executing the Collaborative Model.

Current Structure:

Staff can today highlight a number of successful investments that prove and validate the case for an Opportunities Portfolio to progress towards exploiting a One Fund Advantage and better capitalize on investments necessitating Scale Advantages. It is important to recognize that our current structure inhibits rather than empowers these investment strategies.

Asset class benchmarks are one significant challenge for CalSTRS to invest in opportunities that fall in-between asset classes, across asset classes or traverse private markets to public markets. While benchmarks are a necessary form of measurement, they do not accurately reflect the investible universe. This is particularly the case with alternative assets and private markets assets, where benchmarks are in many cases a very poor proxy of the investment opportunities available in the market. Therefore, many attractive investment opportunities do not fall neatly into one of our asset classes. Staff can take risk in investing in assets that are outside the scope of our benchmarks but ultimately this serves as a limiting factor. As the investment universe becomes more complex and evolves, there is no easy answer to how to solve the dilemma. On the one hand, one could increase the complexity of benchmarks by proliferating the scope of benchmarks and thus include the scope of new opportunities. And, on the other hand, one could simplify the benchmarks but delegate and raise the level of risk management to Staff. Both would be complicated and difficult to implement.

There is also an inherent challenge in capitalizing on our Scale advantages at each asset class level. At CalSTRS, each asset class attempts to diversify their asset class portfolios to manage risk to a benchmark. As each asset class is far smaller than the aggregate CalSTRS fund, individual asset class position sizes are smaller than the scale that CalSTRS is capable of taking on to achieve diversification on a total fund level. Diversification at both an asset class level and a total fund level can lead to an unwarranted level of diversification which dilutes the ability to benefit from the scale that creates more value-added Collaborative Model structures that would save costs, increase alpha or control risks. CalSTRS continuously reviews raising delegation limits for position sizes in each asset class, but this won't completely solve the issue. Therefore, the proposed Opportunities Portfolio is designed to capture opportunities which either exceed the size limit of an underlying asset class or exceeds the level of diversification desired at an asset class level.

We believe creating an Opportunities Portfolio provides a next evolutionary step to move towards greater flexibility around the issue of benchmarks and scale. It will also allow Staff greater flexibility to prove the investment strategy case. CalSTRS has some flexibility to invest in its current Innovative Strategies Portfolio, which is managed as part of the Investment, Strategy and Risk team. As we will highlight later, Staff believes that additional enhancements to this model are required.

Peers/Competitors:

CalSTRS' leading global competitors are already executing and successfully capturing opportunities across their asset classes and at scale. They have designed their total fund in a

flexible way to capture any opportunity at scale. The biggest difference in CalSTRS' structure and these leading organizations is how risk is perceived and managed. Without getting into the details, these leading organizations have developed simplified benchmarks that serve as long-term proxies and greater delegation to staff to manage risk.

A great recent analog on CalSTRS progression in delegating to staff a greater ability to capture opportunities and manage risk is CalSTRS decision to move to a risk budget framework in Public Markets. For example, CalSTRS removed components of the Global Equity policy such as the percentage of active management by region. In its place, we added an active risk budget range where Staff could choose to allocate active risk by virtue of the best opportunities across regions subject to a total risk budget.

Development of a dedicated, but still modest Opportunities Portfolio has the benefit of progressing in the direction of greater flexibility while managing any associated risks at a smaller scale. As the investment model proves successful, CalSTRS has the option to increase its allocation to the Opportunities Portfolio. Organizations that can both manage the risks and yet design their total fund to flexibly invest and capture any investment opportunity will continue to have significant competitive advantages versus peers. This is the future direction of investing and allows CalSTRS to evolve towards that future.

3. Scope of Proposed Opportunities Portfolio

Staff proposes defining the proposed Opportunities Portfolio by the following: (1) Opportunities that fall in-between two or more asset classes, span multiple asset classes and/or traverse the spectrum of private and public markets ('One Fund Opportunities'); and (2) Larger position sizes that facilitate our ability to create value-added structures beyond a specific asset class ('Scale Opportunities').

In general, these types of opportunities take one of two forms: (1) Stable return; and (2) Growth/Appreciation.

- (1) Stable Return assets: have return profiles that meet or slightly exceed the 7 percent actuarial rate of return. These investments have a lower risk profile and offer cash flows or operational distributions. As one can imagine, these types of investments could be additive for the CalSTRS Total Fund but not have a fit the portfolio that sources the transaction. For example, a stable return investment of 8 percent would not achieve the Private Equity return objectives. Another example would be a large private debt investment that does not meet diversification goals of the Real Estate or Fixed Income portfolios.
- (2) Growth/Appreciation investments: have a high risk return profile with a return range of 8%-20%. Similarly, these types of opportunities may be great investments for CalSTRS but are beyond the risk return appetite of the asset class. For example, a relatively high-risk return investment is sourced in Inflation Sensitive or Fixed Income may exceed their portfolio risk return objectives.

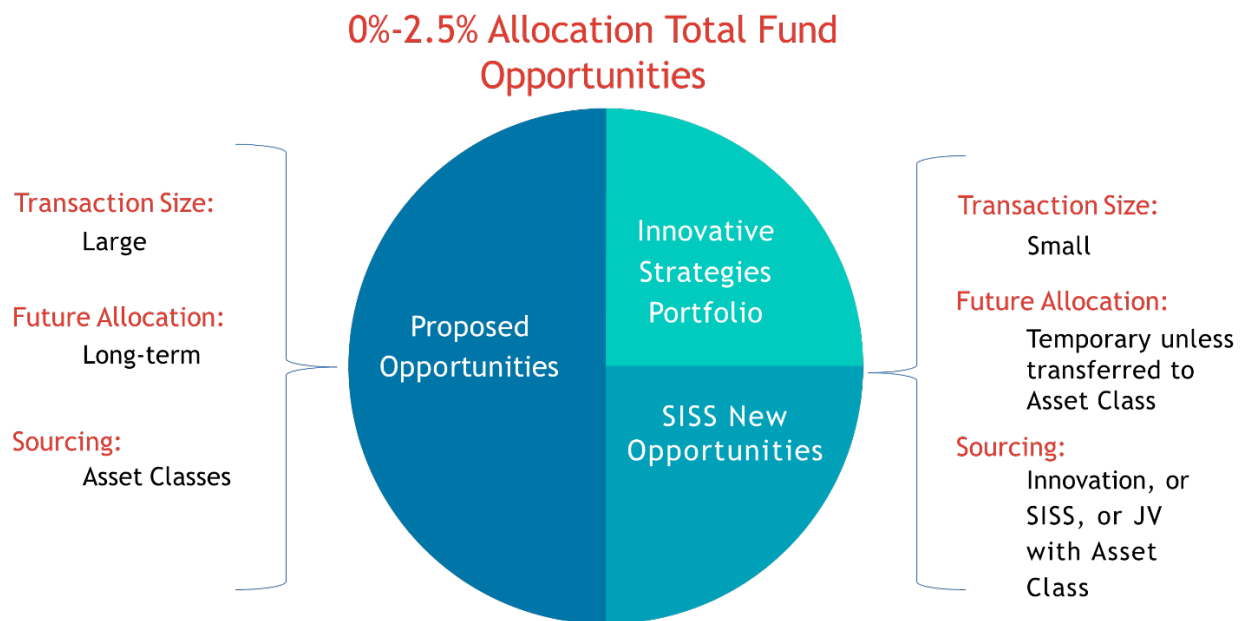
Enhancing our Current Structure to Accommodate an Opportunities Portfolio

CalSTRS’ existing Innovative Strategies Portfolio (which has a 0%-2.5% allocation of the Total Fund) is currently designed to overcome some of the challenges of investing in transactions that lie in the gap between asset classes, across asset classes or traverse private markets to public markets. For example, each unique Innovative Strategies investment has a custom benchmark and for the first four years of private markets investments, relies on an interim T-Bill benchmark to account for the inherent ‘j-curve’ in such opportunities (negative cash flows and performance in the early stages as cash is drawn down to fund the investment).

Furthermore, one ‘sleeve’ of the newly created SISS Private Portfolio (called the SISS New Opportunities sleeve) was deliberately modeled on the Innovative Strategies Portfolio to enable the SISS team to identify sustainability-focused opportunities that do not ‘fit neatly’ into existing asset classes. As such, Staff across asset classes, are already familiar with these concepts and structure.

In the immediate future, Staff proposes consolidating the current Innovative Strategies Portfolio (which includes investments managed by the ISR and SISS teams) and adding the proposed Opportunities Portfolio into one aggregate Total Fund Opportunities allocation as depicted below in **Figure 1**. Another way to think about this is adding an additional element to the existing Innovative Strategies Portfolio and maintaining its allocation at 0%-2.5% of the Total Fund.

Figure 1: Total Fund Opportunities Allocation



Each of the three proposed sleeves of the Opportunities Portfolio are designed to capture ‘One Fund’ deals that fall in between asset classes, across asset classes or traverse private markets to public markets. Each unique sleeve is necessary to broadly capture opportunities for CalSTRS in different areas. However, the proposed Opportunities Portfolio differs from existing Innovative Strategies Portfolios along three dimensions:

- (1) Transaction Size: larger scalable transactions versus smaller starter positions.
- (2) Future Allocation: long-term investments that are permanent in nature versus “seed” and “innovative” initiatives which are later transferred to asset classes permanently or sunset if they don’t succeed.
- (3) Sourcing: leverages the entire platform of CalSTRS sourced by all underlying asset classes versus largely emanating from the ISR and SISS teams.

The Innovative Strategies Portfolio with a 0%-2.5% allocation of the Total Fund was not designed to capture the broader opportunity set of the Opportunities Portfolio. Meketa, has observed U.S. peers to have opportunities portfolios in the range of a maximum 5%-10% allocation. Should your Board wish to continue to move forward, Staff proposes a series of next steps in the following section including working with Meketa to potentially incorporate an increased allocation in the 2023 Strategic Asset Allocation.

4. Next Steps

Staff proposes the Board consider creating an Opportunities Portfolio and consolidate this new sleeve with our existing Innovative Strategies Portfolio to form one Total Fund Opportunities allocation. This goal of this item is to have a robust discussion and receive feedback from the Board to continue to study a proposed Opportunities portfolio. There are many governance and investment questions yet to be resolved. Should the Board wish to continue to move forward, Staff recommends the following topics be brought to the Investment Committee for further consideration:

- (1) Portfolio construction and Management of Risk
- (2) Governance and Monitoring and Reporting
- (3) Policy Changes and Compliance, Monitoring and Reporting
- (4) Asset Allocation Modeling

Staff looks forward to discussing this item with the Board. Please let us know if you have any questions.