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MEMORANDUM

TO: Investment Committee, CalSTRS
FROM: John Haggerty, Tad Fergusson, Meketa Investment Group
CC: Scott Chan
DATE: September 25, 2024
RE: Private Equity Policy Revision - First Reading

Summary and Recommendation

CalSTRS Investment Staff ("Staff") has provided Meketa Investment Group ("Meketa") with a First Reading of proposed revisions to the Private Equity Policy ("PE Policy") for review. These revisions primarily reflect both the ongoing update of policy provisions to incorporate language regarding the use of leverage in the private equity asset class and the continued evolution of implementing the Collaborative Model within the CalSTRS private equity portfolio.

As a brief summary, Staff's recommendation includes the following revisions:

→ Incorporate Portfolio Leverage language into the PE Policy to be consistent with changes previously adopted in the Investment Policy Statement ("IPS"); and

→ Eliminate the requirement for an additional independent fiduciary report for co-investments or secondary transactions below $250 million in size.

The private equity co-investment segment, the primary focus of the Collaborative Model within the private equity portfolio, continues to be competitive and access to strong deal flow and being considered a partner of choice remain essential components for success. The proposed policy change removes potential barriers for smaller co-investment transactions that will allow Staff to more fully pursue the Collaborative Model in a more efficient manner. The Private Equity staff continues to grow and deepen its specialized transactional experience and the proposed change is intended to better position CalSTRS as a partner of choice by reducing potential transactional hurdles. Meketa has discussed these recommendations with Staff.

We remind the Investment Committee that the PE Policy, like other CalSTRS investment policies, is designed to provide a measure of risk control, as the Staff builds the investment portfolio under delegation from the Investment Committee. These delegations should be viewed from the perspective of the longer-term business plan, expected market conditions and opportunities, and Staff's experience and capabilities.

After independently evaluating the proposed revisions to the Private Equity Policy, Meketa Investment Group supports the Staff's recommendation to amend the Policy.

September 25, 2024

Discussion

The IPS Revision adopted in January of 2024 enhanced portfolio and liquidity management at the Total Fund level. The proposed revisions to the PE Policy include the use of leverage at the Private Equity Asset Class level, consistent with the tools approved for the Total Fund and in line with policy language currently in place with other asset classes. Previously, the PE Policy was silent on the use of leverage. Any leverage provided to the Private Equity Portfolio will be monitored as part of the Total Fund net portfolio leverage and reported to the Investment Committee. However Meketa notes that the leverage limit will be measured at the Total Fund level and there is not an explicit maximum leverage limit within the private equity asset class, but rather limitations on the amount of leverage at the asset class level will be aligned with the limits within the IPS and guidelines.

We believe this is an appropriate update to the PE Policy and reflects the intent of the January 2024 revision to the IPS, while incorporating language in line with other CalSTRS major asset classes.

As mentioned, co-investments are a competitive segment of the private equity market and successful programs require access to attractive deal flow combined with being perceived as a strong partner of choice with ability to efficiently close on transactions. The use of an independent fiduciary review has been in place to primarily provide an additional, third-party validation of the entry valuation of a proposed transaction, which is already performed by the GP and Staff. Staff believes that this process is an additional burden that can incorporate additional challenges in efficiently closing transactions and diminish their reputation as a partner of choice. CalSTRS Staff continues to grow and develop its transactional expertise, while demonstrating the ability to construct a successful co-investment program that is achieving program goals to date.

The use of an independent fiduciary will still be required for co-investments and secondary transactions where the GP has not been recommended by a PE Program Advisor or the transaction size is greater than $250 million, but will be refocused on reviewing the GP and transaction fit within the manager's investment strategy as well as examining entry valuation. Both the permission to transact with GPs where CalSTRS does not have a current fund commitment and to conduct larger transactions were evolutions to broaden the opportunity set of the Program provided in the updated PE Policy approved in early 2022.

We believe this is an appropriate update to the PE Policy and reflects the continued evolution of the Collaborative Model. The elimination of the fiduciary review for smaller transactions and/or existing GP relationships would be removing a current risk management tool. Meketa, in our role as Board Private Equity Consultant, will continue our regular discussions with Staff on the co-investment program.

If you have any questions, please feel free to contact us at (760) 795-3450.

TF/JH/SPM/jls