



Investment Committee

Item Number 4b – Open Session

Subject: Collaborative Model Savings Report

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Item Type: Information

Date & Time: November 3, 2022 – 15 minutes

Attachment(s): Attachment 1 – Scope and Methodology

Attachment 2 – Savings per Asset Class

PowerPoint(s): Collaborative Model Savings Report

Item Purpose

To enhance the annual cost reporting by providing defined metrics around savings from the CalSTRS “Collaborative Model.”

Executive Summary

The Collaborative Model is an internally led approach to how CalSTRS engages in the investment marketplace. It 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. CalSTRS embraces partnership and collaboration with world-class investment institutions, along with building internal (or ‘direct’) investing capabilities to achieve the benefits of internally managed assets. The Collaborative Model covers a spectrum of different types of investment strategies and investment ownership structures from simple to very complex. This report aims to quantify the savings achieved from the implementation of this strategy.

Background

This report includes 266 collaborative private investment structures, 56 internally managed funds, and 2 rebate agreements that contributed to collaborative savings results as of 2021 and identifies the savings to the Total Fund on a per year basis going back to 2017. Though internal management and investment types like co-investments were around prior to this date, it is used as the starting point for tracking as it correlates to the 2017 workplan project around direct

investing and an allocation shift toward increased private investing, both in committed capital and the number of deals.

Chart 1 – Collaborative Assets Under Management with Savings¹

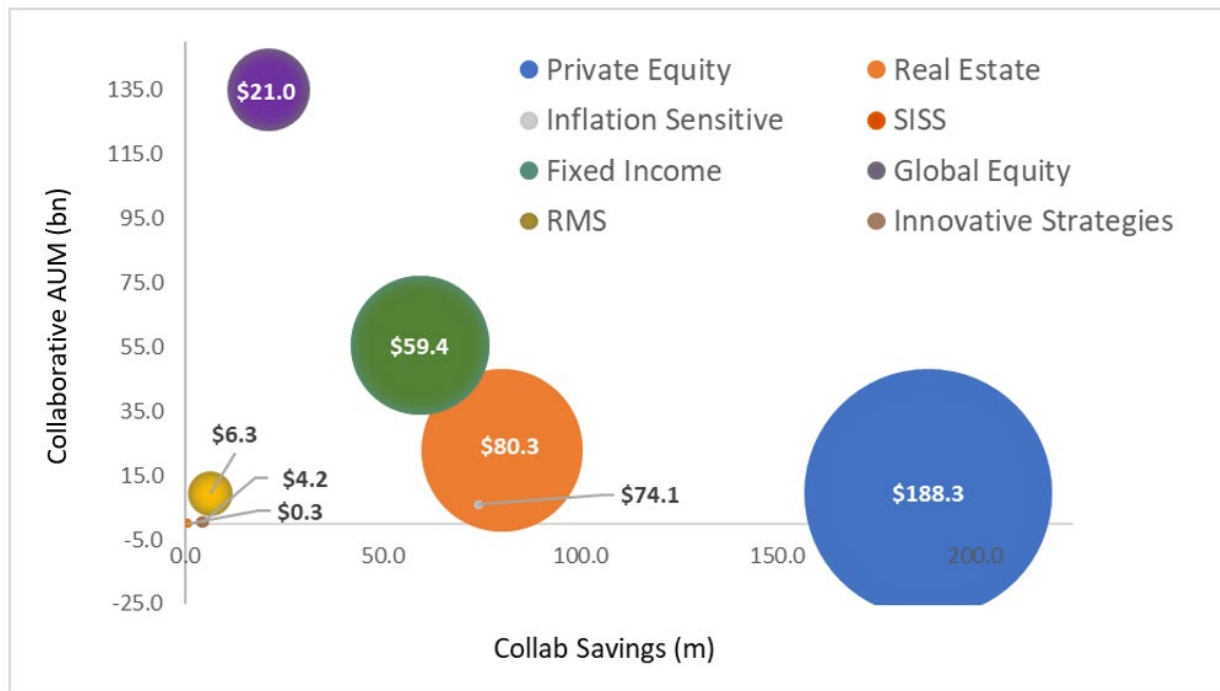


Chart 1 above shows the amount of collaborative assets under management relative to their collaborative savings for each asset class as of the end of the 2021 calendar year. The higher on the chart, the more assets under management. The larger the size of the bubble, or the further to the right of the chart, the more savings.

Of the collaborative components, Private Equity has the highest collaborative savings with one of the lowest collaborative assets under management at roughly \$188 million saved for calendar year 2021. A similar savings to assets under management (AUM) ratio extends to the other private assets like Real Estate and the private portion of Inflation Sensitive. Private assets in general will have the greatest opportunity for savings given their fees are higher, but the potential carried interest savings is where the largest impact of the Collaborative Model will be seen.

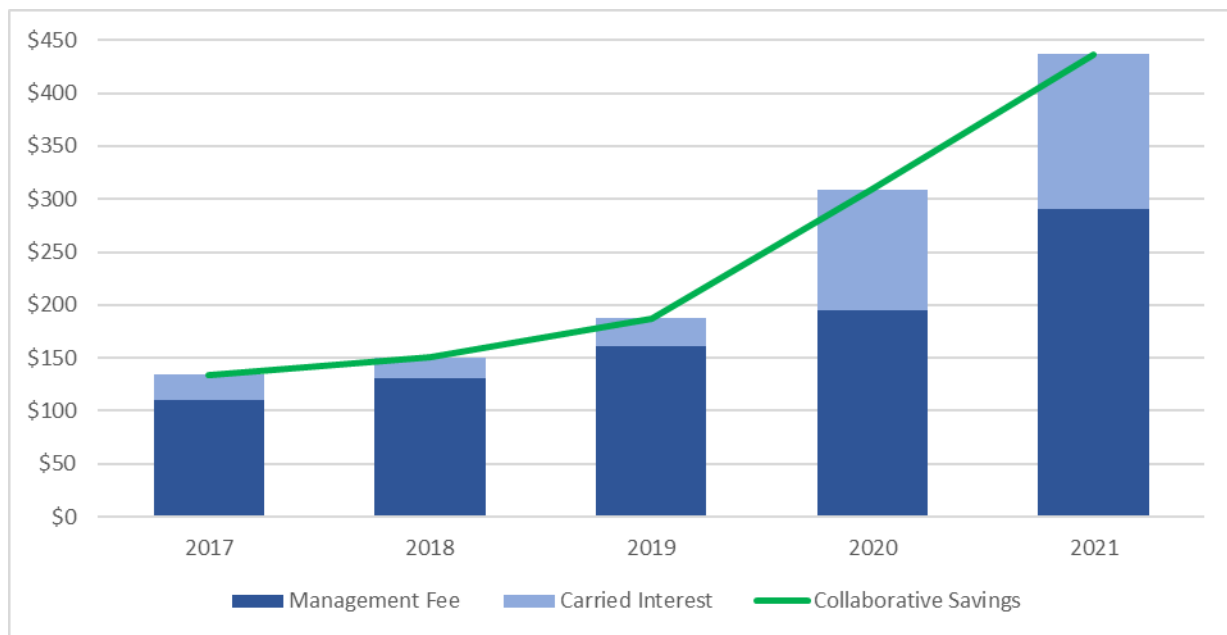
The number of private investment structures increased by 110 from the initial year of the model. The majority of this came from new 2021 vintage year investments or previous vintage year investments that had not been funded – including 53 new co-investments. The remaining includes structures that fit the criteria but were not captured previously due to missing terms or zero impact on savings. The scope and methodology for the collaborative savings calculation is provided in attachment 1.

¹ Fixed Income includes \$25.8 billion in assets managed for the liquidity and securities lending programs

Collaborative Savings Results

As shown in Chart 2 below, CalSTRS has saved over \$1.2 billion since 2017, with an average annual savings of \$243.6 million. The savings in management fees and carried interest has increased each year as the number of collaborative components has increased. This annual savings number will increase or decrease variably over time based on the amount of carried interest paid out in a given year and the number of collaborative components.

Chart 2 – Overall Savings per Year (\$ Millions, since 2017)



| (\$ millions) | 2017 | 2018 | 2019 | 2020 | 2021 | Total 5 Yr Savings |
|------------------------------|--------------|--------------|--------------|--------------|--------------|--------------------|
| Collaborative Savings | 134.4 | 150.6 | 187.2 | 308.9 | 437.0 | \$1,218.0 |
| Management Fee | 110.8 | 130.2 | 161.4 | 195.3 | 290.5 | |
| Carried Interest | 23.6 | 20.3 | 25.8 | 113.5 | 146.4 | |
| Component Count | 106 | 140 | 167 | 200 | 324 | |

The collaborative components (investment types) were outlined in the model’s scope (see attachment 1). Their savings are generated from different combinations of management fees and carried interest. Joint Ventures, Separate Accounts and Managed Accounts often have reduced fee and carried interest expenses. Internally managed public funds generate their savings from the elimination of management fees. Co-investments predominantly have zero management fees and carried interest. Chart 3 below outlines the savings results broken down by investment type.

Chart 3 – Savings per Investment Type (\$ Millions)



As shown in the chart above, internally managed funds and co-investments have provided the greatest amount of savings over this time. Internally managed funds are compared against public managers with low fee structures, so the savings is derived significantly from the AUM. Private investments tend to have higher fee structures, so even with less invested, there can be significant savings in management fees. Co-investments, with their aggressively reduced fee structures (often zero fees and carry), will often reflect the greatest amount of savings in periods after bull markets when profits are realized without having to share profits with a General Partner (carried interest savings). This was evident the past two years, after multiple years of positive market returns, where co-investment savings accounted for over half of the Total Fund’s savings. In 2021, co-investments across the private asset classes saved \$221.7 million, with \$94 million of that coming from carried interest.

Chart 4 – Savings per Asset Class (\$ Millions, since 2017)

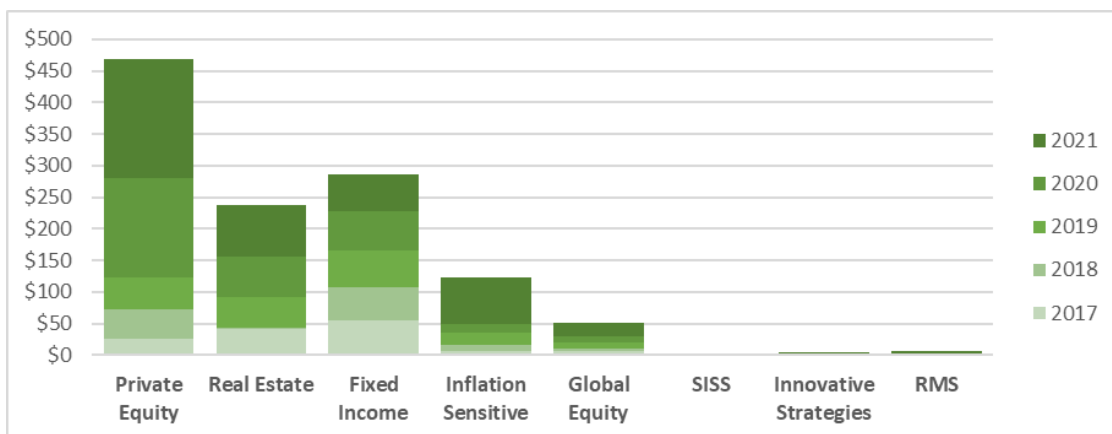


Chart 4 reflects the contributed savings per each asset class over the last five years. A complete breakdown of the dollars saved per asset class and investment type, broken out by management fees, and carried interest, is available in Attachment 2. An excerpt for 2021 is shown here.

Over the 5-year period (Chart 4), Private Equity has contributed the most savings, with Fixed Income internally managed funds having contributed the second most savings over this time. Private assets in general, though, have begun to outpace the public savings over the last two years because of carried interest savings.

Table 1 below estimates the impact the Collaborative Model had on each of the asset classes listed. The savings earned by reducing costs had a direct impact to the dollars earned (dollar return) over 2021. Removing this savings from the dollar return reduced each asset class return as shown in the table below.

| (\$ Millions) Asset Class | 2021 | |
|------------------------------|----------------|------------------|
| | Management Fee | Carried Interest |
| Private Equity | \$97.8 | \$90.5 |
| Co-Investments | \$97.8 | \$90.5 |
| Real Estate | \$62.3 | \$17.9 |
| Co-Investments | \$9.9 | \$3.4 |
| Joint Ventures | \$28.9 | \$11.6 |
| Separate Accounts | \$23.5 | \$2.9 |
| Inflation Sensitive | \$36.6 | \$37.5 |
| Co-Investments | \$15.6 | \$0.0 |
| Internally Managed | \$1.3 | \$0.0 |
| Managed Accounts | \$19.8 | \$37.5 |
| SISS | \$0.3 | \$0.0 |
| Co-Investments | \$0.3 | \$0.0 |
| Fixed Income | \$59.4 | \$0.0 |
| Internally Managed | \$59.4 | \$0.0 |
| Global Equity | \$21.0 | \$0.0 |
| Internally Managed | \$21.0 | \$0.0 |
| Innovative Strategies | \$4.2 | \$0.0 |
| Co-Investments | \$4.2 | \$0.0 |
| RMS | \$6.3 | \$0.0 |
| Internally Managed | \$6.3 | \$0.0 |
| Rebate Agreements | \$2.7 | \$0.5 |
| Total Savings | \$290.5 | \$146.4 |

Table 1 - Collaborative Savings Impact on 2021 Returns (\$ Millions)

| Asset Class | Net Dollars Earned | Collaborative Dollars Saved | 2021 Return | Return with Savings Removed | Excess Return Added | |
|------------------------|-----------------------|-----------------------------|---------------|-----------------------------|---------------------|-------|
| Total Portfolio | \$47,553.1 | \$437.0 | 16.93% | 16.78% | 0.16% | |
| Growth | Global Equity | 23,249.4 | 21.0 | 18.07% | 18.06% | 0.02% |
| | Private Equity | 14,216.2 | 188.3 | 47.78% | 47.14% | 0.63% |
| | SISS | 1,754.9 | 0.3 | 18.39% | 18.39% | 0.00% |
| Real Assets | Real Estate | 5,404.2 | 80.3 | 14.82% | 14.59% | 0.22% |
| | Inflation Sensitive | 2,197.9 | 74.1 | 19.94% | 19.27% | 0.67% |
| Diversifying | Fixed Income | -321.8 | 59.4 | -0.95% | -1.13% | 0.18% |
| | RMS | 1,277.3 | 6.3 | 4.82% | 4.80% | 0.02% |
| | Innovative Strategies | 231.9 | 4.2 | 15.34% | 15.06% | 0.28% |

In 2021, the Collaborative Model saved the Total Fund roughly \$437 million, adding an estimated 0.16% (16 basis points) to the 2021 net return.

Strategic Plan Linkage: [Goal 1 of the strategic plan](#). Trusted stewards – Ensuring a well-governed, financially sound trust fund.

Board Policy Linkage: [CalSTRS Investment Policy and Management Plan](#)

Optional Reference Material: *(e.g., prior board items, supplemental educational materials, etc.)*

Collaborative Model Scope and Methodology

Collaborative Model Scope

The Collaborative Savings Model consists of three components:

- 1) **Private Investments** where CalSTRS has collaborated with external industry partners.
 - *Co-Investments*: Private Equity, Real Estate, Inflation Sensitive and SISS
 - *REOCs¹, Separate Accounts and Joint Ventures*: Real Estate
 - *Managed Accounts*: Inflation Sensitive
 - *Other Collaborative Structures*: to be defined at on-set
- 2) **Internal Management** where CalSTRS has brought specific strategies in-house to leverage internal knowledge and achieve cost savings.
 - *Global Equity (inclusive of SISS) and Fixed Income (inclusive of RMS, Inflation Sensitive, and Currency strategies)*.
- 3) **Relationship Rebate Agreements** where CalSTRS has negotiated rebates based on the size of business across the CalSTRS plan.

Collaborative Savings Methodology

The methodology used in the Collaborative Savings Model is intended to be consistent across components and easily repeatable. It uses standard assumptions across components and investment types with regard to areas like, term of the investment and fee stage, and is therefore an estimate of the savings to the Total Fund. The intent is to provide a conservative savings figure in the first iteration and expand over time.

The methodology focuses on identifying “comparable” investment strategies (comparable) to each of the collaborative investment components (collaborative) and calculating the difference in actual vs. expected fees. The table below provides a hierarchy of the expected fee sourcing and model assumptions. In an effort to provide a reasonable savings figure, the most conservative terms were used. As an example, this means for a public market comparable, the cheapest external manager quote was compared. Many private assets will have a tiered rate structure that lessens in future stages of the investment or a blended rate structure with different rates based on the portion of investments allocated to each strategy. In these cases, the initial fee stage and the highest strategy rate was used in the model. The following describes the variables used to calculate the savings for each of the collaborative components.

Private Investment fee savings are calculated by comparing management fees and carried interest associated with a collaborative investment to a comparable investment’s terms. In many cases, partnership expenses are

¹ Real Estate Operating Companies income to be included in future iterations of the Collaborative Savings Report

reduced in collaborative structures, but for the purposes of this calculation they have not been included. A comparable is identified for each collaborative based on investment type. If a collaborative sells off pieces of the investment and realizes a gain, a net carried interest saved is calculated assuming hurdle rates have been met. The net difference in management fees and carried interest paid is considered the collaborative savings.

Internally Managed Funds fee savings are calculated by generating an average staff rate (cost per dollar) for each asset class, removing that from a comparable management fee, and applying the savings rate to the average monthly Net Asset Value (NAV) used in The Annual Cost Report. The average staff rate includes internal salaries and an estimation of additional expenses incurred by adding internal management staff related to trading & risk systems and licensing fees.

Rebate Agreements fee savings are calculated by obtaining the actual rebate paid to the Total Fund for a given year.

Model Assumptions

- Collaborative investments prior to 2010 were not included unless realized gains were achieved in 2017 – 2020
- Real Estate Joint Ventures and Separate Account fees are often based on Gross Asset Value. For the savings model, State Street reported Market Values were used (which may include Net or Gross Asset Values): Net being a more conservative savings calculation.
- Where Management Fees were not calculated based on GAV or NAV, actual Management Fees incurred were used and removed from the Comparable estimate to calculate savings
- Private Investment fee stage 1 used for rate comparisons

| Investment Type | Comparable Fee Source Hierarchy | | | Impacted Asset Classes |
|--|--|--|--|---|
| | 1 | 2 | 3 | |
| Co-Investments | Sponsor Fund Terms | Avg Parent Fund Terms | RCLCO for Commingled RE Funds <i>only</i> | PE, RE, Inflation Sens, SISS |
| | <i>Mngmt Fee = Sponsor Fee Rate - Co-Inv Fee Rate multiplied by Commitment</i> <i>Carry = Sponsor Carry Rate * any realized cap gain from Co-Invest (adjusted for carry paid by co-invest and only if hurdle rate is achieved), less any carry paid by co-invest</i> | | | |
| Joint Ventures - Core Joint Ventures - Opportunistic Joint Ventures - Value Add Separate Accounts - Value Add Separate Accounts - Core | RCLCO Estimates | Avg Parent Fund Terms | N/A | RE |
| | <i>Mngmt Fee = Sponsor Fee Rate - JV or SA Fee Rate multiplied by Avg NAV</i> <i>Carry = Comparable Carry Rate * any realized cap gain from investment (adjusted for carry paid by investment and only if hurdle rate is achieved), less any carry paid by investment</i> | | | |
| Managed Accounts | Meketa Estimates | N/A | N/A | Inflation Sens |
| | <i>Mngmt Fee = Sponsor Fee Rate - JV or SA Fee Rate multiplied by Avg NAV</i> <i>Carry = Comparable Carry Rate * any realized cap gain from investment (adjusted for carry paid by investment and only if hurdle rate is achieved), less any carry paid by investment</i> | | | |
| Internally Managed Funds | Direct Quote | eVestment | CEM Survey | GE, FI (inclusive of internal funds managed for RMS, Inflation Sens, Strat Overlay) |
| | <i>Quoted fee minus Staff rate</i> | <i>eVestment rate minus staff salary allocation \$</i> | <i>Basis point difference of Internal survey cost vs. External peer survey cost for similar strategies</i> | |
| Rebate Agreements | Annual Rebate Earned | N/A | N/A | CalSTRS |

Collaborative Model Savings per Asset Class and Investment Type (*\$ in millions*)

| (\$ Millions) Asset Class | 2021 | | 2020 | | 2019 | | 2018 | | 2017 | |
|----------------------------------|----------------|------------------|----------------|------------------|----------------|------------------|----------------|------------------|----------------|------------------|
| | Management Fee | Carried Interest | Management Fee | Carried Interest | Management Fee | Carried Interest | Management Fee | Carried Interest | Management Fee | Carried Interest |
| Private Equity | \$97.8 | \$90.5 | \$62.3 | \$95.6 | \$43.6 | \$7.2 | \$28.3 | \$18.9 | \$15.4 | \$10.0 |
| Co-Investments | \$97.8 | \$90.5 | \$62.3 | \$95.6 | \$43.6 | \$7.2 | \$28.3 | \$18.9 | \$15.4 | \$10.0 |
| Real Estate | \$62.3 | \$17.9 | \$46.4 | \$17.7 | \$39.2 | \$10.4 | \$33.3 | \$1.5 | \$27.7 | \$13.6 |
| Co-Investments | \$9.9 | \$3.4 | \$6.2 | \$7.1 | \$5.3 | \$4.3 | \$3.3 | \$0.2 | \$2.0 | \$1.4 |
| Joint Ventures | \$28.9 | \$11.6 | \$21.0 | \$10.6 | \$18.6 | \$6.0 | \$16.3 | \$1.3 | \$14.7 | \$12.2 |
| Separate Accounts | \$23.5 | \$2.9 | \$19.2 | \$0.0 | \$15.4 | \$0.0 | \$13.7 | \$0.0 | \$11.1 | \$0.0 |
| Inflation Sensitive | \$36.6 | \$37.5 | \$13.1 | \$0.0 | \$11.5 | \$8.2 | \$9.9 | \$0.0 | \$6.6 | \$0.0 |
| Co-Investments | \$15.6 | \$0.0 | \$6.3 | \$0.0 | \$4.8 | \$3.5 | \$4.4 | \$0.0 | \$2.6 | \$0.0 |
| Internally Managed | \$1.3 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 |
| Managed Accounts | \$19.8 | \$37.5 | \$6.7 | \$0.0 | \$6.7 | \$4.7 | \$5.5 | \$0.0 | \$4.0 | \$0.0 |
| SISS | \$0.3 | \$0.0 | \$0.3 | \$0.0 | \$0.3 | \$0.0 | \$0.3 | \$0.0 | \$0.3 | \$0.0 |
| Co-Investments | \$0.3 | \$0.0 | \$0.3 | \$0.0 | \$0.3 | \$0.0 | \$0.3 | \$0.0 | \$0.3 | \$0.0 |
| Fixed Income | \$59.4 | \$0.0 | \$62.3 | \$0.0 | \$56.9 | \$0.0 | \$52.8 | \$0.0 | \$55.1 | \$0.0 |
| Internally Managed | \$59.4 | \$0.0 | \$62.3 | \$0.0 | \$56.9 | \$0.0 | \$52.8 | \$0.0 | \$55.1 | \$0.0 |
| Global Equity | \$21.0 | \$0.0 | \$9.2 | \$0.0 | \$9.4 | \$0.0 | \$5.5 | \$0.0 | \$5.7 | \$0.0 |
| Internally Managed | \$21.0 | \$0.0 | \$9.2 | \$0.0 | \$9.4 | \$0.0 | \$5.5 | \$0.0 | \$5.7 | \$0.0 |
| Innovative Strategies | \$4.2 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 |
| Co-Investments | \$4.2 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 |
| RMS | \$6.3 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 |
| Internally Managed | \$6.3 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 |
| Rebate Agreements | \$2.7 | \$0.5 | \$1.8 | \$0.2 | \$0.5 | \$0.0 | \$0.1 | \$0.0 | \$0.0 | \$0.0 |
| Total Savings | \$290.5 | \$146.4 | \$195.3 | \$113.5 | \$161.4 | \$25.8 | \$130.2 | \$20.3 | \$110.8 | \$23.6 |